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COST AUDIT & OPERATIONAL AUDIT

The Institute of Cost and Works Accountants of India
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STUDY NOTE - 1

Basics of Cost Audit

This Study Note includes:

- Nature and Scope of Cost Audit
- Provisions under Companies Act relating to maintenance of Cost Records and Cost Audit
- Cost Auditor - Appointment, Rights and Responsibilities
- Planning and structuring the Cost Audit

1.1 Nature and Scope of Cost Audit

1.1.1 Origin of Cost Audit

1.1.1.1 Methods and techniques of 'cost accounting' and audit of 'cost accounts' in India can be traced back to the year 1925, when large number of firms were given contracts by the Government of India on "cost plus" basis and the Government started verifying and investigating the cost structure of such firms.

1.1.1.2 Need for large scale industrialization immediately after the independence required lot of concessions and facilities to the entrepreneurs to establish industrial undertakings for production of common man's goods and essential services. Power, electricity and other inputs were provided at concessional rates. Liberal finances were provided by the banks and other financial institutions. Land was made available with all infrastructures. Transport facilities were also provided. However, there were only very few industrial groups and it was a suppliers market in almost all the areas. There were many bureaucratic hurdles in opening of new industries along with need for licenses and permits. Imports were mostly prohibitive due to scarce foreign exchange and very high rate of custom duties on imports. Therefore, consumers had very few choices and there were often complaints of excessive pricing, which encouraged smuggling and other malpractices like under-invoicing of imports to save custom duties or over-invoicing of exports to get higher export benefits. The high prices were often justified on the basis of higher indigenous cost of production. Thus the government felt the need for price controls.

1.1.1.3 The investigations of Dalmia-Jain group of companies further brought out the need for more effective audit. Thus "cost audit" gained recognition, both as an effective tool of cost-control in the hands of management to control costs and produce at competitive rates and also as a monitoring mechanism on behalf of other stakeholders including the consumer and the government. Cost Audit as a tool in the hands of Management enabled them to identify the inefficiencies. It acts as a review of the activities of the various cost centers of the company and points out the avoidable wastages and losses. The expertise and experience of the Cost Auditor helps them in knowing the exact areas having the scope for cost control and cost reduction through inter-firm comparison with standard industrial norms or peers in the industry. Government in turn ensured that the consumers are able to obtain their requirements at a fair price and do not pay for the inefficiency of manufacturers.

1.1.1.4 Consequently, the Companies Act, 1956 was amended in the year 1965 to incorporate the provisions relating to the maintenance of Cost Accounting Records and Cost Audit. These amendments were made on the basis of recommendations from the Vivian Bose Commission, Dutta Commission and the Shastry Committee.

1.1.2 Introduction to Cost Audit

1.1.2.1 Cost audit is the audit of cost records. According to Chartered Institute of Management Accountants, London (CIMA), cost audit is "the verification of the correctness of cost accounts and of the adherence to the cost accounting plan". In other words, cost audit is the verification of the cost of production of any product, service or activity on the basis of accounts maintained by an enterprise in accordance with the accepted principles of cost accounting. This definition of Cost Audit is relevant to the voluntary Cost Audit without any statutory backing.

1.1.2.2 The Institute of Cost and Works Accountants of India on the other hand, defines cost audit as "a system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries." Thus the concept and scope of cost audit as defined in India is more specific and lays emphasis on the evaluation of the efficiency of operations and the propriety of management actions as introduced by the Government of India for specified industries. In this sense, cost audit in India appears to be synonymous with efficiency audit mainly as a guide for management policy and decision making besides being a barometer of actual performance.

1.1.2.3 The justification for mandatory Cost Accounting and Cost Audit provisions has been very well explained in the Parliamentary Debate that led to the adoption of Companies Amendment Bill, 1965 incorporating the provisions related to Sections 209 (1) (d) and 233B. Smt. Tara Ramchandra Sathe (MP for Maharashtra) stated during the relevant Rajya Sabha Debate as under:

What is Cost Audit? The Cost Audit is quite different from the Financial Audit. It is to see whether the labour is efficient or not, whether the industry has provided efficient labour or the labour which is required by that industry is less than what is required, whether every material and every part of the machinery is used to the optimum, whether any material is wasted, etc.

As we all know, we are short of material, there is so much material which is imported, when we are short of foreign exchange. In these circumstances, it is very essential that there should be cost audit. In fact, it should be introduced in almost all the industries, but the Government is trying this in certain cases only. So by this we will know whether there is a proper utilization of the material or not. It is very essential, no doubt, and in factories and industries, everywhere, this cost audit should be emphasized." (Proceedings of Rajya Sabha, 14th September, 1965: Columns 3944 and 3945).

1.1.2.4 Thus Cost Audit in India refers to the statutory Cost Audit of the selected companies covered under the relevant provisions of the Companies Act, 1956. These requirements are mandatory and non-compliance may invite penal provisions also.

1.1.3 Relevance of Cost Audit

1.1.3.1 In the initial years, Cost Audit was taken merely as a tool for 'price control mechanism' for consumer and infrastructure industries in India. The main objective of Cost Audit when statutorily introduced under the provisions of Companies Act, 1956 was to meet the Government requirements for regulating the price mechanism in core industries like Cement, Sugar, Textiles and consumer industries like Vanaspati, Formulations and Automobiles. The objective was to provide an authentic data to the Government to regulate the demand and supply in the country through a price control mechanism.

1.1.3.2 The liberalization of the economy and consequential globalization has further enhanced the need for authentic data. Therefore, the Cost Audit Report Rules have been amended from time to time to ensure that the comprehensive authentic information is available in the format required. The basic structure of the cost audit was laid down by the Cost Audit (Report) Rules, 1968 as prescribed under the relevant provisions of Companies Act, 1956. They were superceded by the Cost Audit (Report) Rules 1996, which were notified vide GSR 511(E) dated 5.1.1996. These Cost Audit (Report) Rules 1996 were also subsequently superceded by the Cost Audit Report Rules 2001, which were notified vide GSR 294(E) dated 27.12.2001.

1.1.3.3 The necessity for and utility of properly documented information is more keenly felt now than ever before. In most parts of the world, free competition co-exists with appropriate rules and regulations to ensure free trade and absence of unfair practices. Therefore, in the present competitive scenario of globalization, the Cost Audit Reports have assumed greater importance and significance being the important source of reliable and authentic feedback to the government and its various departments and agencies. It may be clarified here that the Cost Audit Reports do not only contain merely the cost details, but are full of information related to all aspects of business organization which, if harnessed properly can provide a comprehensive analysis about the company, the industry and the economy as a whole. The Cost Audit Report serves as an effective tool of information in the hands of directors on the Board ensuring good corporate governance.

1.1.3.4 In an environment of increasing foreign trade under WTO regime, dumping of products at very low prices have become a serious issue in the international trade. This dumping of products, often well below the cost price, if not properly countered may harm the indigenous industry. The cost records and the cost audit report play a very critical role in defense of local industry to substantiate their fair approach against any allegation of dumping. Similarly, when dumping allegations are levied against the exports by the Indian companies to any foreign company, the Cost Audit Reports can provide the valuable feedback to protect the interest of Indian companies.

1.1.3.5 The practice of selling below cost to ward off competition attracts the penal provisions of the Competition Law. This necessitates the availability of authentic cost details of the products marketed by industry and business houses to determine normative pricing or fair pricing. In fact, Competition Law to be effective against any anti-competition activity presupposes the availability of reliable and authentic cost data.

1.1.3.6 The transfer pricing issue has gained considerable momentum in international scenario. Cost Audit Report Rules 2001 include the provisions to take care of this aspect in right perspective. The fundamentals of transfer pricing are based on “arm’s length” throughout the world. The cost details form the very basis of determining arm’s length transfer pricing policy of any country. An audited cost records and the resultant Cost Audit Report becomes a majorsource of information, which can be effectively used by both Indirect and Direct Tax Authorities. The Central Excise Authorities also use Cost Audit Reports for verifying claim of the companies relating to ex-factory prices of the excisable goods especially in the case of inter-unit transfers.

1.1.3.7 The Tariff Commission relies on authenticity of the cost audit reports and makes use of these reports extensively in fixation of tariffs for the products covered under Cost Accounting Records Rules. The Cost Audit Reports are also made use of by the respective administrative Ministries of Government of India for fixation of administrative prices and working out subsidy, etc. Fertilizer Industry Coordination Committee (FICC) under the Department of Fertilizers and the Directorate of Sugar under Ministry of Food use Cost Audit Reports extensively in taking decision with respect to the Industries under their purview. The Cost Audit Reports relating to Bulk Drugs and Formulations are used by the National Pharmaceutical Pricing Authority for fixation of prices of various drugs and formulations covered under the Drug Price Control Order, 1995.

1.1.3.8 The Cost Audit Reports have great potential in government procurements especially in case of non-competitive procurements. There are no effective anti-trust laws in India. This always leaves a scope for the traders/suppliers to charge exorbitant prices from the government supplies. For example, 'Clayton Act' in USA clearly provides that any discrimination in price, services or facilities shall be unlawful in USA. It also prohibits the discrimination in rebates, discounts or underselling in particular localities. This 'Act' further provides that any differential in prices etc., shall have to be justified on the grounds of differences in the cost of manufacture, sale or delivery resulting from the differing methods or quantities in which such commodities are sold or delivered and the burden of rebutting the *prima-facie* case shall be upon the person charged with a violation of this act. The 'Clayton Act' also provides that it shall be unlawful for any person to induce or receive a discrimination in price, which is prohibited under the act. In other words, each seller of product or service can charge a uniform price only in the USA. However, this is not the case in India, where each purchaser may be charged a differential price by the supplier or the trader. A significant portion of the government budget is spent every year on procurements, where reasonability of purchase price is always an issue. Therefore, Cost Audit Reports can always fill the vacuum in government procurements ensuring reasonability of prices. Similarly in USA, an "Incurred Cost" statement is made with respect to major projects funded out of Government budgets. This incurred cost is nothing but Cost Audit Report.

1.1.3.9 In addition to above, Government has been giving various incentives for exports by the Indian Industries. These incentives are mainly to refund the taxes paid in the country to provide level playing field to the Indian Industry. Similarly many of the exporters import duty - free material for exports after further processing, where actual productivity is a major issue. Cost Audit Reports provide not only the actual amount of various taxes paid by any unit but also provide the actual productivity and wastage. Thus Cost Audit Reports can benefit the Indian Industry to get at par with global competitors.

1.1.4 Features of Cost Audit

1.1.4.1 The cost audit of the companies under the relevant provisions of the Companies Act, 1956 has the following features:

(i) Assessing compliance of the relevant cost accounting records rules as applicable to the product under review;

(ii) Study of the costing system to assess whether it is adequate for the cost ascertainment of the product under review;

(iii) Evaluation of the operating and other efficiencies of the organization under audit with special reference to the product under review; to ensure the submission of necessary details required under the Cost Audit Report Rules, 2001 as amended from time to time.

(iv) Submission of Cost Audit Report in the format prescribed.

1.1.4.2 Since cost audit is carried out under the various provisions of the Companies Act, 1956, a thorough and comprehensive knowledge of the Indian Companies Act including various rules prescribed thereunder and the circulars issued by the Ministry of Corporate Affairs is essential for conducting an effective Cost Audit.

1.1.5 Objectives of Cost Audit

1.1.5.1 Cost Audit has both general and social objectives. The *general objectives* can be described to include the following :

- Verification of cost accounts with a view to ascertaining that these have been properly maintained and compiled according to the cost accounting system followed by the enterprise.
- Ensuring that the prescribed procedures of cost accounting records rules are duly adhered to.
- Detection of errors and fraud.
- Verification of the cost of each "cost unit" and "cost center" to ensure that these have been properly ascertained.
- Determination of inventory valuation.
- Facilitating the fixation of prices of goods and services.
- Periodical reconciliation between cost accounts and financial accounts.
- Ensuring optimum utilization of human, physical and financial resources of the enterprise.
- Detection and correction of abnormal loss of material and time.
- Inculcation of cost consciousness.
- Advising management, on the basis of inter-firm comparison of cost records, as regards the areas where performance calls for improvement.
- Promoting corporate governance through various operational disclosures to the directors.

1.1.5.2 Among the *social objectives of cost audit*, the following deserve special mention :

- Facilitation in fixation of reasonable prices of goods and services produced by the enterprise.
- Improvement in productivity of human, physical and financial resources of the enterprise.
- Channelising of the enterprise resources to most optimum, productive and profitable areas.
- Availability of audited cost data as regards contracts containing escalation clauses.
- Facilitation in settlement of bills in the case of cost-plus contracts entered into by the Government.
- Pinpointing areas of inefficiency and mismanagement, if any for the benefit of shareholders, consumers, etc., such that necessary corrective action could be taken in time.

1.1.6 Scope of Cost Audit

1.1.6.1 Section 227(2) of the Companies Act, 1956, requires the auditor of a company to state whether the accounts in his opinion give a true and fair view of the state of the company's affairs in the case of the balance sheet and of the profit or loss for its financial year in the case of the profit and loss account. Therefore, statutory financial audit of a company conducted by the Chartered Accountant is an essential annual feature of all the companies registered under the provisions of Companies Act, 1956. The Board of Directors of every company has a statutory obligation to place its audited annual accounts viz. Profit and Loss Account and Balance Sheet before the shareholders in the Annual General Meeting, duly certified by a Chartered Accountant appointed as an 'Auditor' under the provisions of Section 224 of the Act. However, there is no corresponding statutory provision for compulsory annual audit of cost accounts of a company covered under Section 209(1)(d) of the Companies Act or under relevant Cost Accounting Records Rules.

1.1.6.2 One of the pre-requisites of cost audit is the maintenance of cost accounting records by the company. Section 209(1)(d) makes it obligatory for a company pertaining to any class of companies engaged in production, processing, manufacturing or mining to maintain such particulars relating to utilization 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 accounts. The rules provide that only those companies, which are covered under Section 209(1)(d) of the Companies Act and a specific Cost Audit Order has been issued with reference to a specified product by the Cost Audit Branch of Ministry of Corporate Affairs are required to get their cost accounts audited with respect to that specific product. Moreover, Cost Audit Report is not placed before the shareholders during the Annual General Meeting.

1.1.6.3 The Central Government prescribes the separate cost accounting records for each class of companies i.e. companies manufacturing a particular class of product or activity like Cement, Steel, Chemicals and Electricity etc. and these are called the Cost Accounting Records Rules for that specific industry or class of companies. When cost accounting records/formats are prescribed, they apply to those companies engaged in the manufacture of a particular product or activity. In the case of companies engaged in production or processing of other products or activities also in addition to production, processing or manufacture of the specified product, the records will have to be maintained only for the manufacture of particular product for which rules are issued and not necessary for other products. A company manufacturing bulk drugs, formulation and watches need not necessarily maintain cost accounting records in respect of watch making activity if no statutory rules are prescribed for watch making activity. The detailed provisions relating to the manner of prescription of cost accounting records, selection of the product, the contents of the rules and the list of products/ industries covered by the statutory rules under Section 209(1)(d) of the Companies Act have also been explained in Study Notes 2 and 3. Thus Cost Audit u/s 233B does not embrace a particular activity of the company unless a separate cost accounting record rule is already notified for that particular activity under Section 209(1)(d) detailing the nature of cost accounting records to be maintained.

1.1.6.4 The legal provisions relating to statutory cost audit are applicable only to companies registered under the provisions of Companies Act, 1956. Therefore, cost audit is not applicable to other enterprises like partnership, cooperative societies, etc. The Cost Audit is conducted by a Cost Accountant in practice within the meaning of the Cost and Works Accountants Act, 1959. The cost auditor is appointed by the Board of Directors of the company with the previous approval of the Central Government. The report of cost auditor is to rendered to the Central Government with a copy to the Company.

1.1.7 Cost Audit and Efficiency Audit

1.1.7.1 Efficiency Audit is systematic appraisal of management methods and is intended to assess the actual performance levels relative to applicable peer benchmarks or internal standards (e.g., profitability or stated business plan objectives etc.). The process is also designed to identify opportunities to ensure performance benefits. It aims at identifying efficiency and productivity improvement opportunities so that the resources flow into the most remunerative channels to ensure the optimum returns.

1.1.7.2 The parameters of measuring efficiency include overall rate of return, capacity utilization, utilization of national, financial, physical and human resources, cash flow performance and the pay back period of the entire organization. Thus efficiency audit seeks to evaluate the overall organizational efficiency.

1.1.7.3 The cost audit report also mainly the comment on the efficiency of the company namely, utilization aspect of the factors of production. To enable the cost auditor to make efficiency audit, Section 209 (1) (d) of the Companies Act provides for "records of utilization of material, labour and other items of cost." Since a proper appraisal of the extent of efficiency of utilization of factors of production is possible in cost audit, it may appropriately be called efficiency audit.

1.1.7.4 The cost audit as efficiency audit can also be understood from the fact that cost audit reports enable the determination of accurate costs of production of various products, services and activities with a view to compare the same with the comparable figures of the earlier years and those of the peers or benchmarks in the industry. It seeks to identify the areas of inefficiency or poor decision making to ensure diversion of funds to most optimum channels. The information regarding exact unit costs after proper allocation of overheads, capacity utilization, per unit consumption of major raw materials (including power and fuel), man-hour productivity, idle hours or un-productive manpower wastage etc. serve as basis for efficiency audit and helps in fixing appropriate prices of goods and services produced by the company to ensure optimum returns. The detailed financial analysis of the company in cost audit report like determination and comparison of different ratios like 'profit as % of capital employed', 'profit as % of net sales', 'value addition', 'current asset as % of current liabilities', 'profit as % of capital employed' etc. help in assessing the operational efficiency and comparing the financial health of the undertaking with the peers or others in the industry aiming at bringing all round efficiency.

1.1.8 Cost Audit and Propriety Audit

1.1.8.1 *Propriety audit* stands for verification of transactions in the best interest of the public, commonly accepted customs and standards of conduct. The term "propriety" has been defined by Kholer as "that which meets the tests of public interest, commonly accepted customs and standards of conduct and particularly as applied to professional performance, requirements of Government regulations, and professional codes." The tests boil down to consideration of financial prudence and economy, instead of too much dependence on documents, vouchers etc. It shifts the emphasis to find the wisdom and appropriateness of expenditure, rather than verifying whether it has been duly authorized or evidenced by proper vouchers etc.

1.1.8.2 In other words, the propriety audit seeks to ensure that the planned expenditure would yield the optimum returns and there is no other better alternative available. It seeks to ensure that the expenditure is not only appropriate to the circumstances of each case, it has indeed achieved the objectives for which it has been incurred. The audit of public sector undertakings as undertaken by the Comptroller and Auditor-General of India is the best example of propriety audit.

1.1.8.3 The Cost Audit Reports can be termed as propriety audit as these reports seeks to ensure that actual expenditure at each stage is appropriate and optimum returns have been achieved. The cost auditor always aims at ensuring that the actual expenditure should not be *prima facie* more than what the occasion demands. The cost auditor has to report on matters which appear to him to be clearly wrong in principle, cases where the company's funds have been used in a negligent or inefficient manner, arm's length pricing of related party transactions, etc. These are the areas where the propriety aspect is involved and therefore cost audit may be in the nature of "propriety audit".

1.1.9 Cost Audit and Management Audit

1.1.9.1 Cost audit report and the information to be furnished therein is prescribed by the Central Government. However, most of the information contained in the cost audit report is relevant for making managerial decisions. Normally a management audit is an audit for the management and by the management. Such audit looks into the economy and the effectiveness of performance of various activities of an organization. Cost audit also looks into the effectiveness of performance and efficiency in various areas such as capacity, input costs of materials, utilities and other controllable areas so far as the manufacturing aspect is concerned. Detailed information on these areas has to be given in the cost audit report by the cost auditor comparing it with the standards and past actuals wherever necessary. Since Cost Audit is very useful to the management as it points out areas where performance can be improved, it can be called an audit for the management. Though cost audit is not done at the behest of the management, it does not change its character from being a management tool.

1.1.10 Cost Audit and Social Audit

1.1.10.1 *Social audit* is generally defined to be the audit of data or information depicting social performance of a business in contrast to its normal economic performance as measured in financial audit.

1.1.10.2 A lot of research and experimentation are being conducted to device techniques or models, which can measure the contribution of an enterprise to the society. These developments result from an increasing realization of the fact that business undertakings have social responsibilities also and that the performance as a whole should be seen in this context.

1.1.10.3 *Social performance* is discharged by providing some social amenities for the use of community as a whole e.g. provision of a hospital, a recreation club, a temple, etc. As provision of such amenities involves diversion of profits earned by the business for charitable or philanthropic purposes, it is advisable to conduct an audit of such expenses spent on welfare which are in no way related to the main task of business of production or marketing of goods/services and earning profits. Such activities, which apparently are not directly connected with the main business activity, help the business to create a favorable image for the business and those at the helm of affairs.

1.1.10.4 Cost audit provides an adequate information on the cost of production, selling price and margin of profit in respect of each item of product covered by cost audit. This information is very useful to the Government in regulating the prices of essential commodities. Therefore, cost audit can be said to subserve the interest of the community by facilitating the review of prices to be charged to the customer. A review by the government results in fair prices to the consumers which is a major social objective which cost audit is subserving. Thus cost audit is also a social audit.

1.2 Provisions Under Companies Act Relating to Maintenance of Cost Records and Cost Audit

1.2.1 The statutory provisions relating to maintenance of cost accounting records and cost audit were initially introduced by the Companies (Amendment) Act, 1965. Section 209(1)(d) deals with the provisions relating of maintenance of cost accounting records and Section 233B deals with the audit of cost accounts in the certain cases. The amended Section 233B provides that the cost audit can be conducted only by those cost accountants, who are not whole time employees elsewhere. These provisions also provides for a ceiling on the number of cost audits that can be carried out by a cost accountant or a firm of cost accountants. These provisions are explained in detail as under:

1.2.1 Maintenance of Books of Accounts (Section 209(1)(d))

1.2.1.1 Section 209 deals with the books of accounts required to be maintained by the company. Section 209(1) requires that every company is required to maintain at its registered office proper books of accounts with respect to:

(a) *all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place:*

(b) *all sales and purchases of goods by the company;*

(c) *the assets and liabilities of the company; and*

(d) *in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization 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:*

Provided that all or any of the books of account aforesaid may be kept at such other place in India as the Board of Directors may decide and when the Board of Directors so decides, the company shall, within seven days of the decision, file with the Registrar a notice in writing giving the full address of that other place.

1.2.1.2 The Central Government has so far prescribed separate Cost Accounting Records Rules with respect to 44 classes of products or activities, which have been explained in detail in subsequent chapters. These Rules require the books of account to be kept in a manner that the cost of production and cost of sales during the financial year can be properly calculated in the formats prescribed for the respective industries. The books of accounts should also provide all the details required with respect to other elements of cost such as materials, wages, stores and overheads etc. However, most of these rules provide exemptions to small scale units having total annual turnover of less than Rs. 10 crores. In other words, Section 209(1)(d) deals with the maintenance of cost records and provides that in the case of a company (pertaining to any class of companies), which is engaged in either production or processing or manufacturing or mining activities, the company will also be required to maintain such particulars in its books of accounts relating to utilization of material or labour or to other items of cost as may be prescribed by the Central Government.

1.2.1.3 Section 209(2) provides that where a company has a branch office, whether in or outside India, the company shall be deemed to have complied with the provisions, if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarized returns, made up to dates at intervals of not more than three months, are sent by the branch office to the company at its registered office or the other place referred to in sub-Section (1).

1.2.1.4 The reading of Section 209(1), *prima facie* stipulates that the cost accounting records are to be maintained in the registered office of the company. However, a reasonable interpretation of Section 209(2) provides that maintenance of records at the factory, or other locations with periodical returns to registered office may also satisfy the letter and spirit of law. However, it may be clarified here that cost records are generally never exclusively maintained at the factory. Since marketing costs, administrative costs and other items of expenses incurred in corporate, registered and sales offices are also subject matter of cost accounting records and cost audit, these post manufacturing expenses including marketing would be incurred in places other than the factory.

1.2.1.5 Section 209(3) requires the books to give a true and fair view of the state of affairs of the company and to explain its transactions. Books are to be kept on `accrual' basis and according to double entry system of accounting.

1.2.1.6 Section 209(4) provides that the books of account and other books and papers shall be open to inspection by any director during business hours.

1.2.1.7 Section 209(4)(a) provides that the books of accounts of every company relating to a period of not less than eight years immediately preceding the current year together with the vouchers relevant to any entry in such books of account shall be preserved in good order. However, in case of a company incorporated less than eight years before the current year, the books of account for the entire period preceding the current year to be preserved.

1.2.1.8 Section 209(5) provides that if any of the persons referred to in sub-Section (6) of Section 209 fails to take all reasonable steps to secure compliance by the company with the requirements of Section 209 of the Companies Act or has by his own willful act been the cause of any default by the company, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both. This sub-Section further provides that no person shall be sentenced to imprisonment for any such offence, unless it was willfully committed.

1.2.1.9 Section 209(6) clarifies that the persons referred to in sub-Section (5) of Section 209 for punishment are as under:

(a) Where the company has a managing director or manager, such managing director or manager and all officers and other employees of the company; and

(b) Where the company has neither a managing director nor manager, every director of the company.

1.2.1.10 Section 209(7) provides that if any person, not being a person referred to in sub-Section (6), having been charged by the managing director, manager or Board of Directors, as the case may be with the duty of seeing that requirements of this Section are complied with, makes a default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both.

1.2.1.11 These rules require the books of accounts to be kept in a manner that the cost of production and cost of sales of each item (as covered in Section 209(1)(d)) produced or manufactured during the year can be determined in the prescribed format i.e., separate figures for materials, wages, overheads etc.

1.2.1.12 If a company is engaged in manufacture of production of products or activities other than those class of industries as are covered under Section 209(1)(d) also, the cost records may not be maintained for such other products or activities as are not covered under the provisions of cost accounting records rules.

1.2.2 Audit of Cost Accounts in Certain Cases (Section 233 B)

1.2.2.1 The Section 233(B) of the Companies Act, 1956 provides that where in the opinion of the Central Government it is necessary so to do in relation to any company required under clause (d) of the sub-Section (1) of Section 209 to include in its books of account the particulars referred to therein, the Central Government may, by order direct that an audit of cost accounts of the company shall be conducted in such manner as may be specified in the order by an auditor who shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959.

1.2.2.2 Section 233B(2) provides that the auditor under Section 233B shall be appointed by the Board of directors of the company in accordance with the provisions of sub-Section (1B) of Section 224 and with the previous approval of the Central Government. It further provides that before the appointment of any auditor is made by the Board, a written certificate shall be obtained by the Board from the auditor proposed to be so appointed to the effect that the appointment, if made, will be in accordance with the provisions of sub-Section (1B) of Section 224.

1.2.2.3 Section 233B(3) provides that the audit conducted by the auditor under this Section (cost audit by Cost Accountant) shall be in addition to an audit conducted by an auditor appointed under Section 224 (Financial Audit by Chartered Accountant).

1.2.2.4 Section 233B(4) provides that a cost auditor shall have the same powers and duties in relation to an audit conducted by him under this Section as an auditor of a company has under sub-Section (1) of Section 227 (financial audit) and such (cost) auditor shall make his report to the Central Government in such form and within such time as may be prescribed and shall also at the same time forward a copy of the report to the company.

1.2.2.5 Section 233B(5)(a) provides that a person referred to in sub-Section (3) or sub-Section (4) of the Section 226 shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company. Section 226 of the Companies Act provides qualifications and disqualifications of auditors. Sub para (3) of the said Section provides that the following are not qualified for appointment as Auditor of a company:

(a) a body corporate;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who is indebted to the company for an amount exceeding one thousand rupees or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;

(e) a person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000. (Explanation: "security" means an instrument which carries voting rights);

(f) The sub-Section (4) of Section 226 provides that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-Section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company. In other words, if a person is disqualified under any of the aforesaid classes from being appointed as an auditor of any company or body corporate, he cannot be appointed as auditor of its holding company, subsidiary or 'co-subsidiary'; and

(g) A person, who is in full time employment elsewhere.

Sub Para (4) of Section 226 provides that if anybody is disqualified for being appointed as auditor under Section 137, he cannot be appointed as auditor for its holding company, subsidiary or 'co-subsidiary'.

1.2.2.6 Section 233B(5)(b) provides that a person appointed under Section 224 as an auditor of a company shall not be appointed or re-appointed for conducting the audit of the cost accounts of that company.

1.2.2.7 Section 233B(5)(c) provides that if a person, appointed for conducting the audit of cost accounts of a company, becomes after his appointment, to any of the disqualifications specified in clause 5(a) or 5(b) above, he shall on and from the date on which he becomes disqualified, shall cease to conduct the audit of the cost accounts of the company.

1.2.2.8 Section 233B(6) provides that upon receipt of an order under Section 233B(1), it shall be the duty of the company to give all facilities and assistance to the person appointed for conducting the audit of the cost accounts of the company.

1.2.2.9 Section 233B(7) provides that the company shall, within thirty days from the receipt of a copy of the report referred to in Section 233B(4), furnish the Central Government with full information and explanations on every reservation or qualification contained in such report.

1.2.2.10 Section 233B(8) provides that if, after considering the report referred to in Section 233B(4) and the information and explanations furnished by the company under Section 233B(7), the Central Government is of opinion that any further information or explanation is necessary, the Government may call for such further information and explanation and thereupon the company shall furnish the same within such time as may be specified by that Government.

1.2.2.11 Section 233B(10) provides that the Central Government may direct the company whose cost accounts have been audited under this Section to circulate to its members, along with the notice of the annual general meeting to be held for the first time after the submission of such report, the whole or such portion of the said report as it may specify in this behalf.

1.2.2.12 Section 233B(11) provides that if default is made in complying with the provisions of this Section, the company shall be liable to be punished with fine which may extend to fifty thousand rupees and every officer of the company who is in default, shall be liable to be punished with imprisonment for a term which may extend to three years, or with fine which may extend to fifty thousand rupees or with both.

1.2.2.13 Based on the aforesaid provisions, the main features of the Cost Audit Section 233(B) are now summarized as under:

(a) Cost audit is to be conducted only when the Central Government directs such an audit. [Sec. 233B(1)]

(b) The auditor for this purpose is to be appointed by the Board of Directors, with the previous approval of the Central Government. [Sec. 233B(2)]

(c) Cost audit is in addition to financial audit, which is conducted by an auditor (financial auditor) under Sec. 224. [Sec. 233B(3)]

(d) The cost auditor has same powers as financial auditor has, under Sec. 227 (1). The cost auditor is to submit his report to the Central Government, in the form and within the time prescribed, with a copy to the company. [Sec. 233B(4)].

(e) Persons referred to in sub-Section (3) or sub-section (4) of Section 226 shall not be appointed or re-appointed as cost auditor of the company. Similarly a person appointed under Section 224 (Financial Auditor) also cannot be appointed as the cost auditor of the company. [Sec. 233B(5)].

(f) It is the duty of the company to give all facilities and assistance to the cost auditor. [Sec. 233B(6)].

(g) The company shall within thirty days from the date of receipt of a copy of the report, furnish to the Central Government with full information and explanation on every reservation or qualification contained in the report. [Sec. 233B(7)].

(h) The Central Government may call from the company further details which shall be provided within the specified time. [Sec. 233B(8)].

(i) The Central Government may take appropriate action on the report as it may consider necessary. [Sec. 233B(9)].

(j) The Central Government may direct the company to circulate to its members whole or part of the report with the notice of AGM to be held for the first time after the submission of the report. [Sec. 233B(10)].

(k) Penal action is for default in complying with the provisions of this Section. The company liable to fine extending to Rs. 50,000/- and every officer of the company who is in default shall be liable to be punished with imprisonment for a term which may extend to three years, or with fine which may extend to Rs. 50,000/- or with both.

1.3 Cost Auditor – Appointment, Rights and Responsibilities

1.3.1 Issue of Cost Audit Order

1.3.1.1 Issue of Cost Audit Order is the first step in Cost Audit of any company. The Central Government issues a specific order under Section 233(B)(1) of the Companies Act, 1956 on a particular company directing it to get its cost records audited by a practicing Cost Accountant indicating the product for which the order is issued and the period for which it is ordered. Therefore, the starting point for the cost audit exercise is the receipt of cost audit order by the company, specifying the year and the product for which such cost audit is to be conducted. However, the Cost Audit Branch has now been issuing Cost Audit Orders on regular basis to all the companies covered (i.e. every financial year thereafter continuously until further orders.) This amounts to saying that once an order is issued, the cost audit is required to be done every year unless it is specifically withdrawn.

1.3.1.2 It may be clarified here that since the cost audit order issued by the Cost Audit Branch specifies the product, the Company need not have a cost audit for the product not specified in that order. Thus, if the company producing Sugar, Cement and Steel receives an order relating to Sugar for the year ending 31st March, 2009, then it need not get the cost records for products Cement and Steel audited under Sec. 233B for the year ending 31st March, 2009. Similarly for subsequent years also, it needs to get its cost records for Sugar only cost audited unless it gets a specific order on other products also.

1.3.2 Qualification of Cost Auditor

1.3.2.1 Section 233(B) of the Companies Act, 1956 provides that the Central Government may, if it considers necessary, direct that the audit of cost accounts kept by a company for a specified product or activity under Section 209(1)(d) shall be conducted by an auditor who shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959. In other words, the Sec. 233B(1), in so far as it relates to qualifications of cost auditor provides that a person holding certificate of practice from the Institute of Cost and Works Accountants of India only can be appointed as a cost auditor. The cost auditor may be an individual cost accountant or a firm of cost accountants with at least two partners. A firm of cost accountants can be constituted with the previous approval of the Central Government/Institute as required under the regulation 113 of the Cost and Works Accountants Act, 1959 as amended from time to time and in which all the partners are cost accountants holding certificate of practice issued by the Institute of Cost and Works Accountants of India. Section 224 (1-B) of the Companies Act, 1956 further provides that a person can be appointed as a cost auditor only if he is not in full time employment elsewhere.

1.3.2.2 A proviso to Section 233B(1) lays down that if the Central Government is of opinion that sufficient number of cost accountants within the meaning of the Cost and Works Accountants Act, 1959 are not available for conducting the audit of the cost accounts of companies generally, the Government may, by notification in the Official Gazette, direct that, for such period as may be specified in the said notification, such Chartered Accountant within the meaning of the Chartered Accountants Act, 1949, as possesses the prescribed qualifications, may also conduct the audit of the cost accounts of companies. It may be clarified here that the Central Government has not so far issued any notification under the above proviso.

1.3.2.3 There are several members of the Institute of Cost and Works Accountants of India (ICWAI), who have qualified the examination of both the Institutes namely ICWAI and the Institute of Chartered Accountants of India and thus are eligible for membership as well as certificate of practice from both the Institutes. However, none of the members can hold "certificate of practice" in more than one Institute under the provisions of both the Institutes. Therefore, practically there is no possibility of any financial auditor to practice as cost auditor or vice versa.

1.3.2.4 However, it is only in the background of the aforesaid proviso that Section 233B(5)(b) provides that a person appointed under Section 224 as an auditor of the company (financial auditor) shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company (cost auditor of the same company).

1.3.3 Disqualifications of a Cost Auditor

1.3.3.1 The disqualifications of a person for being appointed or re-appointed for conducting the cost audit are detailed in sub-Sections (a), (b) and (c) Section 233 (5) of the Companies Act, 1956 detailed as under:

(a) The sub-Section (5)(a) provides that a person referred to in sub-Section (3) or sub-Section (4) of the Section 226 shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company.

(b) The sub-Section 5(b) provides that a person appointed under Section 224 as an auditor of a company shall not be appointed or re-appointed for conducting the audit of the cost accounts of that company.

(c) The sub-Section (5)(c) provides that if a person, appointed for conducting the audit of cost accounts of a company, becomes after his appointment, to any of the disqualifications specified in clause 5(a) or 5(b) above, he shall on and from the date on which he becomes disqualified, shall cease to conduct the audit of the cost accounts of the company.

1.3.3.2 Section 226 of the Companies Act, 1956 provides for the qualifications and disqualifications of the auditors. Reading of sub-Section (3) of Section 226 implies that the following persons cannot be appointed or reappointed as cost auditor of a company –

(a) a body corporate;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who is indebted to the company for an amount exceeding one thousand rupees or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;

(e) a person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000. (Explanation: "security" means an instrument which carries voting rights);

1.3.3.3 The sub-Section (4) of Section 226 provides that a person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-Section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company. In other words, if a person is disqualified under any of the aforesaid classes from being appointed as an auditor of any company or body corporate, he cannot be appointed as auditor of its holding company, subsidiary or 'co-subsidiary'; and

1.3.3.4 A person, who is in full time employment elsewhere [Section 224 (1B)].

If an auditor becomes disqualified after his appointment, under any of the above provisions he shall be deemed to have vacated his office.

1.3.4 Appointment of firm as Cost Auditor

1.3.4.1 The rules provide that a person appointed as cost auditor should be a member of the Institute of Cost and Works Accountants of India and should also hold a certificate of practice. The term "cost auditor" refers to both, i.e., individual cost accountant as well as the firm of cost accountants also.

1.3.4.2 The Ministry of Corporate Affairs has specifically clarified (Appendix II-A) that the question of appointment of cost auditors in firm's name for conduct of cost audit has been under examination in the department and it has been decided to approve the appointment of cost auditors in firm's name under sub-Section (2) of Section 233-B of the Companies Act, 1956 if such a proposal is received from the Board of Directors of any company subject to the following conditions:

(a) "All the partners of the firm are practicing cost accountants within the meaning of Sections 6 and 7 of the Cost and Works Accountants Act, 1959," and

(b) "The firm itself has been constituted with the previous approval of the Central Government/ Institute as required under Regulation 113 of the Cost and Works Accountants Act, 1959 as amended from time to time."

1.3.4.3 The Government have also clarified (Appendix II-B) that in case a firm of cost accountants is appointed as cost auditors, authentication of the cost audit report is to be done by the signature of any one of the partners of the firm in his own hand for and on behalf of the firm. The report should not be signed by merely affixing firm name.

1.3.4.4 In the case of firms appointed as cost auditors, each partner of the firm who is not in full time employment can hold appointment as cost auditor of the specified number of companies i.e. twenty companies for each such partner who is not in full time employment elsewhere. However, not more than ten such companies should have a paid up share capital of Rs. 25 lakhs or more.

1.3.5 Powers of the Cost Auditor

1.3.5.1 Section 233B(4) of the Companies Act, 1956 gives the cost auditor same powers as the financial auditor has under Section 227(1). In addition, Rule 6 of the Cost Audit Report Rules also requires the company and every officer thereof, including the persons referred to in sub-Section (6) of Section 209 of the Act to make available to the cost auditor, within 135 days from the close of the financial year of the company, such cost accounting records, cost statements, other books and documents, Annexure and Proforma to the Report, duly completed as would be required for conducting the cost audit, and shall render necessary assistance to the Cost Auditor so as to enable him to complete the cost audit and submit his report within the time limit specified in rule 5. Section 233B(6) further provides that it shall be the duty of the company to give all facilities and assistance to the cost auditor so as to enable him to complete the audit and send the report within the prescribed time limit.

1.3.5.2 The powers of the cost auditor under sub-Section (1) of Section 227 are as under:

- Right to access at all times to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere.
- Entitled to require from the officers of the company such information and explanations as he may think necessary for the performance of his duties as an auditor.

1.3.6 Duties of the Cost Auditor

1.3.6.1 The duties of the cost auditor are also similar to those of the (financial) auditor of the company has under sub-Section (1) of Section 227 (Section 223B(4)).The duties of the cost auditor *inter-alia* include:

(a) To ensure that the proper books of accounts as required by Cost Accounting Records Rules have been kept by the company so far as it appears from the examination of those books and proper returns for the purpose of his audit have been received from branches not visited by him;

(b) To ensure that the Cost Audit Report and the detailed cost statements are in the form prescribed by the Cost Audit Report Rules by following sound professional practices i.e. the report should be based on verified data and observations may be framed after the company has been afforded an opportunity to comment on them;

(c) The underline assumptions and basis for allocation and absorption of indirect expenses are reasonable and are as per the established accounting principles;

(d) If the auditor is not satisfied in any of the aforesaid matters, he may give a qualified report along with the reasons for the same;

(e) Sending the Report to the Cost Audit Branch within 180 days from the end of the financial year with one copy to the company;

(f) Sending his replies to any clarification, that may be sought by the Cost Audit Branch on his report. Sending such replies within 30 days from the date of receipt of communication calling for such clarification.

1.3.7 Ceiling on Number of Cost Audits

1.3.7.1 The sub-Section (2) of Section 233B inter-alia provides that before the appointment of any auditor is made by the Board, a written certificate shall be obtained by the Board from the auditor proposed to be so appointed to the effect that the appointment, if made, will be in accordance with the provisions of sub-Section (1B) of Section 224.

1.3.7.2 Section 224(1)(B) provides that no company or its Board of directors shall appoint or re-appoint any person who is in full time employment elsewhere or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies. The proviso to Section 224(1B) further provides that the provisions of this sub-Section shall not apply, on and after the commencement of the Companies (Amendment) Act, 2000, to a private company.

1.3.7.3 Explanation I to the Section 224 provides that for the purposes of sub-Sections (1B) and (1C), "specified numbers" means :

(a) in case of a person or firm holding appointment as auditor of a number of companies each of which has a paid-up share capital of less than rupees twenty-five lakhs, twenty such companies;

(b) in any other case, twenty companies, out of which not more than ten shall be companies each of which has a paid-up share capital of rupees twenty-five lakhs or more.

1.3.7.4 Explanation II to the Section 224 provides that in computing the specified number, the number of companies in respect of which or any part of which any person or firm has been appointed as an auditor, whether singly or in combination with any other person or firm shall be taken into account.

1.3.7.5 In view of aforesaid provisions, the ceilings on the number of cost audits can be clarified as under:

(a) In the case of firm of cost accountants: Twenty companies for each such partner of the firm who is not in full time employment. However, not more than ten such companies should have a paid up share capital of Rs. 25 lakhs or more;

(b) In the case of an individual cost accountant, who is not in full time employment: Twenty companies, out of which not more than ten should have a paid-up share capital of Rs. 25 lakhs or more.

1.3.7.6 It can be seen from above that Section 224(1B) and Explanation I to Section 224 refers to the ceilings for the number of companies and not to the number of cost audit orders or products. Therefore, if more than one products of a particular company are covered under cost audit for the same year, a cost auditor should count their number as one company only, since the audits for all the products relate to the same company despite the fact that separate cost audit orders have been issued with respect to each such product. Similarly, if that company appoints different cost auditors for different products, each auditor shall count the company as one company for counting their individual quota for number of audits.

1.3.7.7 It should be noted that the Companies (Amendment) Act, 2000 has inserted a provision (Explanation II) to Section 224, whereby the provisions of sub-section 1-B shall not apply to a Private Company. It means that for computing the limit on number of companies for audit, Private Companies should not be counted.

1.3.8 Number of Cost Audits at any Point of Time and Tenure of Cost Auditor

1.3.8.1 As already stated above, Section 224(1)(B) provides a ceiling on number of audits that a person can hold on the date of appointment or re-appointment i.e. at any point of time. Section 233B(2) further provides that a written certificate shall be obtained from the cost auditor to the effect that the proposed appointment, if made, will be in accordance with the prescribed ceiling, before the appointment of any cost auditor is made by the Board. Therefore, it becomes important to know when the holding of "appointment as cost auditor" begins and when it ends.

1.3.8.2 The appointment of cost auditor is by the Board, subject to the approval of the Central Government. The question arises whether appointment begins from the date of the resolution of the Board or only after the approval of the Central Government i.e. date of approval. A clarification issued by the Company Law Board (Appendix II-C) states that 'the appointment of an auditor is complete only when the company intimates in writing to the cost auditor that he has been appointed (Refer circular no. 52-354 CAB-87 dated 30/8/88 The Management Accountant, October, 1988 issue Page 719 Appendix II-C). This is further amplified by the subsequent clarification reference No. 3/8/89-CL.V dated 5th March, 1990 (Appendix E) addressed to ICWAI clarifies that the number of companies in respect of which reports have not been submitted should be taken into account for the purposes of ceiling on cost audit. However, the clarification reference No. 35/1/90-CL III dated 2nd March, 1990 (Appendix II-D) to ICAI states that the auditors will take into account not only the actual appointments as auditors but also the proposed appointments in companies for which they have given their consent. But this clarification is applicable to Chartered Accountants only as no approval from Central Government is required in this case. Therefore, it may be advisable that the cost auditor takes into account the number of companies which had submitted applications in Form 23-C forwarding his name for appointment as the cost auditor. Otherwise the cost auditor may find himself having agreed to be cost auditor of more than the permissible limit at any particular time.

1.3.8.3 The second issue relates to the time or date when his appointment comes to an end. In case of financial auditor, the question is specifically answered by Sec. 224(1), which provides that he shall hold office 'until the conclusion of next annual general meeting'. However in case of cost audit, the cost auditor may have to provide clarification to the queries of Cost Audit Branch long after his submission of the report. The Cost Audit Branch on the other hand may have no clarification to seek. Therefore, Cost Audit Branch has clarified (Appendix II-C) that "......it is clarified that for the purpose of furnishing the certificate under sub-Section 2 of Sec. 233B of the Act, a cost auditor shall be deemed to have concluded his appointment as he renders a report to the Central Government in accordance with the Cost Audit (Report) Rules, with a copy to the company". The clarification further adds that 'His obligation to answer queries from the Cost Audit Branch arising out of review of cost audit report should not debar him from accepting another appointment as cost auditor' (Appendix II-C).

1.3.9 Communication to Previous Auditor

1.3.9.1 The first schedule (Part I) of The Cost and Works Accountants Act, 1959, deals with Professional misconduct in relation to cost accountants in practice. This schedule provides that a cost accountant in practice shall be deemed to be guilty of professional misconduct if he accepts a position as a cost accountant previously held by another cost accountant in practice without first communicating him in writing.

1.3.9.2 The Institute of Cost and Works Accountants of India (ICWAI) has also opined in this regard that communication means a letter addressed by the member who is appointed as cost accountant on fee basis to the member previously holding the position of cost accountant in the same company.

However, it may be added here that a categorical reply to said communication may not be essential pre-requisite for the acceptance of the appointment. The ICWAI has also clarified that the words 'previously held' imply any time previous to the offer of appointment to a new cost accountant.

1.3.10 Full Time Employment

1.3.10.1 Section 224(1)(B*) inter-alia* provides that no company or its Board of directors shall appoint or re-appoint any person who is in full time employment elsewhere or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies. Thus no person, who is in full time employment, can take up the practice as Cost Auditor under the provisions of Companies Act. This proviso was added vide Companies (Amendment) Act, 1988. However, the Companies Act has not defined the term 'full time employment'. Therefore, the following guidelines could be helpful:

(a) The Cost auditor should not be a whole time director of any company under the provisions of Section 269 of the Companies Act, 1956 or Secretary under provisions of Section 383A of the Companies Act, 1956. Since both these Sections refer to such director or secretary being in whole time employment, it may be difficult to substantiate to be in part time employment.

(b) Anyone receiving a salary and receiving provident fund contribution from his employer or getting such other benefits or perquisites like Ex-Gratia or Bonus, House Rent Allowance etc. may amount to be in full time employment.

(c) Similarly, there is a separate head of income titled 'Salaries' under the Income Tax Act. A person declaring income under that head may be termed to be in employment.

1.3.11 Penal Provisions for Companies and Cost Auditor

1.3.11.1 Rule 8 of the Cost Audit Report Rules, 2001 provides the following penal provisions –

(i) If the company contravenes the provisions of Rule 6 or Rule 7 (of the Cost Audit Report Rules, 2001) the company and every officer thereof who is in default, including the persons referred to in sub-rule (6) of Section 209 of the Companies Act, 1956, shall, subject to the provisions of Section 233B of the Act, be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for everyday day after the first day during which such contravention continues; and

(ii) Where default is made by the Cost Auditor in complying with the provisions of Rule 4 or Rule 5 (of the Cost Audit Report Rules, 2001), he shall be punishable with fine, which may extend to five thousand rupees.

1.3.12 Procedure for Appointment of Cost Auditor

1.3.12.1 The sub-Section (2) of Section 233B provides that the cost auditor shall be appointed by the Board of directors of the company in accordance with the provisions of sub-Section (1B) of Section 224 and with the previous approval of the Central Government. It further provides that before the appointment of any auditor is made by the Board, a written certificate shall be obtained by the

Board from the auditor proposed to be so appointed to the effect that the appointment, if made, will be in accordance with the provisions of sub-Section (1B) of Section 224.

1.3.12.2 The cost audit order issued by the Cost Audit Branch under Section 233B of the Companies Act, 1956 normally provides that 'the application for the proposal for appointment of Cost Auditor for ONE TERM should be sent to this Department within forty-five days of the date of this order'. It also further provides that 'thereafter the application for the proposal for appointment of Cost Auditor should be sent to this Department within 45 days of the commencement of every financial year'. The fees payable for such application and the manner in which it is to be paid are also specified in that order. These forms are now e-filed. All the relevant information and guidelines in this regard is available on the MCA portal www.mca.gov.in .

1.3.12.3 The cost audit orders issued, normally also state that a firm of cost accountants, whether proprietary or partnership, may be proposed, if such firm is constituted under regulations 108 and 113 of the Cost and Works Accountants Regulations, prescribed under the Cost and Works Accountants Act, 1959. Therefore on receipt of cost audit order by the company, the Board of Directors should select a cost accountant or a firm of cost accountants qualified to conduct the cost audit. The concurrence of the cost auditor is also obtained (Section 224(1B)) prior to passing the resolution. The Board of Directors then passes a resolution either at a meeting or through circulation appointing a cost auditor, subject to the approval of the Central Government.

1.3.12.4 The Board resolution normally authorizes the Secretary of the Company or a Director to make necessary application to the Central Government. This application is to be e-filed in Form 23C (Appendix I-D) within the time limit specified in the cost audit order. The application should be accompanied by the requisite fees.

1.3.12.5 The Department of Company Affairs considers the application and accords approval of the appointment of the cost auditor. Normally, the Central Government approves the appointment of cost auditor unless he suffers from any disqualification under Section 224(1-B) or Section 233-B(5) of the Companies Act. The approval is communicated to the company and the copy of the approval is sent to cost auditor by the Central Government. However, the appointment of cost auditor is confirmed only when the Board of Directors informs the cost auditor that he has been appointed as the cost auditor with the approval of the Central Government.

1.3.12.6 Detailed forms/procedures relating to the appointment of the cost auditor, starting from issue of cost audit order to the time of approval of appointment of cost auditor is accorded by the Central Government, are given at the end of this Study Note detailed as under:

Appendix 1-A	Specimen of Cost Audit Order
Appendix 1-B	Format for Written Certificate u/s 233B(2)/224(1-B) in case of an Individual/ Firm
Appendix 1-C	Specimen Board Meeting Resolution regarding Cost Auditor
Appendix 1-D	Form 23-C – Application for Appointment of Cost Auditor
Appendix 1-E	Approval for Appointment of Cost Auditor
Appendix 1-F	Intimation to the previous Cost Auditor

1.3.13 Written Certificate by the Cost Auditor

1.3.13.1 Section 224(1)(B) provides that no company or its Board of directors shall appoint or re-appoint any person who is in full time employment elsewhere or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies. The explanation to the said Section provides that maximum number of companies for which a person can be the auditor at a point of time cannot be more than twenty.

1.3.13.2 Proviso to sub-Section (2) of Section 233B further provides that before the appointment of any auditor is made by the Board, a written certificate shall be obtained by the Board from the auditor proposed to be so appointed to the effect that the appointment, if made, will be in accordance with the provisions of sub-Section (1B) of Section 224.

1.3.13.3 Therefore, Company should obtain a written certificate from the proposed cost auditor to the effect that the appointment, if made, will be in accordance with the provisions laid down by Section 224 of the Companies Act, 1956. A specimen copy of certificate by the Cost Auditor is given at Appendix I-B.

1.3.14 Board Resolution

1.3.14.1 The sub-Section (2) of Section 233B *inter-alia* provides that the auditor under this Section shall be appointed by the Board of directors of the company in accordance with the provisions of sub-Section (1B) of Section 224 and with the previous approval of the Central Government.

1.3.14.2 The company has to make an application to the Central Government for obtaining an approval for an appointment of Cost Auditor in Form No. 23-C. As per clause 12, a certified copy of the resolution passed by the Board of Directors of the company sanctioning the proposal for which the Government's approval has been sought is to be attached along with Form 23-C.

1.3.14.3 Hence, it is imperative that a resolution has to be passed by the Board of Directors for the appointment of the Cost Auditor. Since, the appointment of the Cost Auditor is subject to the previous approval of the Central Government, the Board Resolution (Appendix I-C) should specifically mention that, `subject to the approval of the Central Government and pursuant to the provisions of Section 233B of the Companies Act, 1956, Mr. / M/s .... be and is hereby appointed as Cost Auditor(s)...'.

1.3.14.4 On receipt of approval of the Central Government (Appendix I-E), the company should send letter of appointment to Cost Auditor(s).

1.3.15 Form 23 Application to The Cost Audit Branch Requesting Approval of Cost Auditor

1.3.15.1 The cost audit orders issued by the Cost Audit Branch normally mention that – `the application in the prescribed form no. 23-C proposing for appointment of cost auditor for one term should be electronically filled at the website of department i.e., www.mca.gov.in within 45 days of the date of the order and thereafter within 45 days of the commencement of every financial year'. The application fee is payable along with form 23-C which is presently as under:

Nominal Share Capital Rs.	Fees Payable
less than Rs. 25 lacs	Rs. 500
Rs. 25 lacs or more but less than Rs. 5 crores	Rs. 1,000
Rs. 5 crores or more	Rs. 2,000

1.3.15.2 The payments can now be made through appropriate mechanisms – electronic (credit card, internet banking) or traditional means (at the Bank counter). Electronic payments can also be made at Virtual Front Office (VFO). If the user selects the traditional payment option, the system generates a pre-filled challan in the prescribed format. Traditional payments through cash, cheque can be done at the designated bank branches using the system generated challan.

1.3.16 Approval of Cost Auditor by Central Government

1.3.16.1 The powers of the Central Government are exercised by the Cost Audit Branch of the Ministry of Corporate Affairs, New Delhi for approving the appointment of Cost Auditor. After receiving Form 23-C with all particulars contained therein as per the check list, the approval letter is generally issued within a period of about two to three weeks.

1.3.17 Exemption from Cost Audit Orders

1.3.17.1 Even though there is no provision in the Companies Act, 1956 for grant of year-to-year exemption from Cost Audit, the exemption from Cost Audit on year-to-year basis is granted by Cost Audit Branch in situations arising out of temporary closure of the company and/or its manufacturing facilities, negligible production/activity, etc. These exemptions are based on logic that exemptions can be accorded by the executive since the cost audit orders are also issued by the executive.

1.3.17.2 Applications for seeking exemption are required to be made to the Central Government, along with fee, as prescribed above for appointment of Cost Auditor. Following documents are required to be furnished along with application for exemption:

- Printed or attested true copy of complete Annual Report containing balance sheet and profit and loss account for the year for which exemption is being sought along with copies of the same pertaining to preceding two years. In case, exemption is being sought in the beginning of the financial year, the printed or attested true copy of Complete Annual Report for last three years may be provided.
- An affidavit containing full facts of capacity utilization, turnover and financial status of the company such as sick or not or such other grounds on the basis of which exemption is being sought, duly signed by two Directors of the company and authenticated by a Notary Public.
- A brief note/status report on steps taken by the management for revival of the company and/ or the said unit.

1.3.18 Withdrawal of Cost Audit Orders

1.3.18.1 Even though there is no provision in the Companies Act, 1956 for withdrawal of cost audit order, the withdrawal of Cost Audit is considered in case of permanent closure or sale or merger/ amalgamation of production activities for the product under reference. These exemptions are based on logic that approval for withdrawal can be accorded by the executive since the cost audit orders are also issued by the executive.

1.3.18.2 Following documents are required to be furnished along with application for withdrawal:

- Printed or attested true copy of complete Annual Report containing balance sheet and profit and loss account for the year for which exemption is being sought along with copies of the same pertaining to preceding two years (or immediate last three years).
- An affidavit containing full facts of capacity utilization, turnover and financial status of the company such as sick or not, duly signed by two Directors of the company and authenticated by a Notary Public.
- Documentary evidences substantiating closure/winding-up, sale, merger, amalgamation, etc. e.g. Court's order, surrender of licenses, sale of plant and machinery, power disconnection, manpower reduction, etc.

1.3.19 Constitution / Reconstitution of Partnership Firm of Cost Accountants

1.3.19.1 Only the members of the Institute i.e. AICWA or FICWA who have obtained Certificate of Practice and are engaged in full time practice are entitled to constitute/reconstitute a partnership firm of Cost Accountants. For this purpose, the following procedure have to be followed and the related conditions have to be complied with :-

1. Application has to be made to the Council in Form L, which should be duly filled in and signed by all the partners, indicating the name and membership no. against each signature.
2. The application should be accompanied by a copy of Deed of Partnership duly executed on a non-judicial stamp paper by all the partners and attested by at least two witnesses indicating their full names and addresses. The date of execution of the Deed and submission of Form L should pertain to a date on or after the date of purchase of the non-judicial stamp paper.
3. A declaration in the Deed of Partnership is required from all the partners that they are fully engaged in the practice of profession of Cost Accountancy and engaged in no other occupation.
4. The name of the partnership firm to be indicated in sl. no. 1 of Form L and Deed of Partnership should be in accordance with the provisions of Regulation 108 of the Cost and Works Accountants Regulations, 1959. Such a firm's name should have the suffix "& Associates" or "& Co."
5. Prior to the approval of the Council, the use of any stamp/visiting card/letterhead or the like in any firm name is strictly prohibited.
6. When a partnership firm is reconstituted on account of admission, retirement, death of partners or change of terms and conditions, etc., a fresh Deed of Partnership has to be duly executed by the existing partners, and copy of such Deed along with Form L has to be submitted to the Council for Reconstitution of the partnership firm.
7. When a partnership firm is dissolved, a copy of Deed of Dissolution of Partnership duly executed by all the partners has to be submitted to the Council for its record.

8. Whenever there is a change in the address of the Head Office or Branch Office of the partnership firm, it is to be immediately intimated to the Council in Form L.

9. The Head Office or any Branch Office, if any, of the firm should be headed by a person who is member of the Institute i.e. AICWA or FICWA.

10. No Constitution or Reconstitution of partnership firm is valid unless it is approved by the Council of the ICWAI.

11. If the partner of a firm gets engaged in any salaried employment, he should immediately retire from the partnership firm and intimate to the Institute immediately. Under such circumstances, the remaining partners may reconstitute the firm by executing a fresh Deed of Partnership and Form L.

1.4 Planning and Structuring the Cost Audit

1.4.1 Need for Planning an Audit

1.4.1.1 (a) The Cost Auditor should always plan to conduct an effective cost audit in an efficient and timely manner. This is very necessary to attain objectives of the cost audit. Audit plan for new client will be generally more detailed than in case of a repeat audit. In case of new audit, the cost auditor has to collect all information about the company like nature of business, organization structure, key personnel, accounting system etc. Similarly, he has to also collect information about other peers in the industry, nature of problems etc. The details required shall be much less in case of a repeat audit. The proper planning helps in:

(a) appropriate attention to all the areas for comprehensive audit;

(b) identification of key areas needing more attention;

(c) timely completion of work;

(d) optimum utilization of assistants;

(e) no overlapping and proper co-ordination between the work done by different assistants, other auditors and experts.

1.4.2 Elements of Planning

1.4.2.1 Planning of cost audit involves:

(a) Familiarization about the company and applicable cost accounting record rules;

(b) Collection of all relevant information;

(c) Evaluation of internal control procedures and the system;

(d) Preparation of appropriate cost audit programme; and

(e) Audit of working papers and cost sheets.

1.4.2.2 Familiarization about the Company and Applicable Record Rules

1.4.2.2(a) It is very necessary for the cost auditor to familiarize himself with the requirements of

Cost Accounting Records Rules for the class of the companies to which the company under audit belongs. Similarly, the disclosure requirements as contemplated under the Cost Audit Report Rules 2001 should also be seen before actually designing the cost audit programme. This is necessary to ensure that the audit programme includes the examination of all the relevant records required to be maintained.

1.4.2.2(b) In addition to these, the cost auditor should also familiarize himself with the company especially with respect to its organization, organization structure, product range, market share, major inputs, profitability, financial status, marketing set-up, method of inventory valuation and detailed cost accounting system etc.

1.4.2.3 Collection of All Relevant Information

1.4.2.3 (a) The following records, explanations and information may also need to be collected before finalization of audit programme and actual commencement of audit:

(a) A brief history of the company and its business activities;

(b) Memorandum of Association and Articles of Association;

(c) Annual reports and accounts for the last three to five years;

(d) A list including addresses of all factories, branch offices and depots with the names of managers-in-charge;

(e) Organization chart with details of key personnel;

(f) Collaboration agreements, if any, including agreements for payment of royalty;

(g) Details of manufacturing capacity – installed, licensed and utilization installed capacity for the last three years;

(h) A detailed note indicating the system and procedure followed in –

- (i) Cost department
- (ii) Financial accounting department
- (iii) Purchase, raw materials/packing materials stores, etc.
- (iv) Time office
- (v) Production department
- (vi) Sales department
- (vii) Management Information System
- (viii) Personnel Department
- (ix) Internal audit department

(i) Copies of budget manual;

(j) Flow charts and description of manufacturing process;

(k) Major raw materials with quantitative details for each unit of finished output;

(l) Labor incentive schemes, if any;

(m) Details of important contracts/agreements regarding purchases, sales and services;

(n) Details of budgetary control and standard costing procedures with treatment for variances;

(o) Copies of industrial licenses if any, issued from time to time;

(p) Periodical reports submitted to Excise and other Govt. authorities;

(q) Details of price control orders/distribution control orders, if any by the Regulatory body;

(r) A broad idea of the cost structure of the industry or other benchmarks in the industry;

(s) Special features of the industry including economic environment in respect of the industry such as capacity, production, demand, prices, markets, international scenario;

(t) Systems and procedures of the organization and accepted cost accounting principles;

(u) The different types of government levies such as excise duty, sales tax, cess, royalty and freight equalization etc; and

(v) Follow-up based on earlier cost audit reports, if any.

1.4.2.3(b) In case of repeat audit engagements, most of the aforesaid information would be available with the cost auditor, which would then be appropriately updated.

1.4.2.4 Evaluation of Internal Control Procedures and System

1.4.2.4(a) The evaluation of internal control procedures and systems provides a reasonable assurance to the cost auditor. This evaluation helps in identifying the strong points as well as the weak points of the internal control system. This will facilitate setting up of materiality levels and designing of audit programme accordingly. The cost auditor may confine his checks and audit procedures to a representative sample, if these internal control procedures are effective. This will help in reducing the avoidable verification of each and every transaction, which will be not only very time consuming but costly as well.

1.4.3 Structuring the Cost Audit

1.4.3.1 The basic concept of audit may be looked at from the angle of planning the audit work. This may be elaborated under the following heads :

1. Cost audit programmes;
2. Cost audit working papers; and
3. Checking including test checking

1.4.4 Preparation of Cost Audit Programme

1.4.4.1 A cost audit programme is the cost auditor's plan of action indicating the tests and procedures to be followed to implement the cost audit plan. The programme should be comprehensive and detailed to serve as a manual to the assistants and as a means to efficiently and effectively execute the audit of each of the element of cost of sales prescribed in the cost accounting records rules.

1.4.4.2 The cost audit programme should then be discussed with the management to ensure that the programme does not clash with other audits as far as possible. This will also reveal the preparedness of the company for cost audit and any arrears in the compilation of cost accounting records could be taken care of well in advance before the actual commencement of cost audit.

1.4.4.3 The planning the cost audit would *inter-alia* include :

(a) Deciding on the audit team of persons having adequate training, experience and competence in cost auditing

(b) Briefing the personnel on the requirements, coverage and documentation of audit evidence

(c) Deciding on areas of cost audit, quantum to be covered, types of checks and techniques to be used, methodology of collection of facts and on recording the progress of cost audit

(d) Laying down time targets for completion of different segments of cost audit.

1.4.4.4 A cost audit programme is usually subdivided in the following stages :

(a) Review of cost accounting records

(b) Verification of cost statements, proformae and annexures

(c) Preparation of cost audit report.

1.4.4.5 The cost auditor prepares the cost audit report under the Cost Audit Report Rules, 2001 after reviewing the cost accounting records and detailed verification of the cost proformae, annexures, cost statements and other financial data submitted by the company to the cost auditor.

1.4.5 Working Papers

1.4.5.1 The Audit working papers contain the basic records including audit programme, nature of queries raised in course of audit, important information about the business of the company and audit findings. Such audit working papers help to locate audit findings. The working papers are the important aid in planning and performance of the cost audit. It facilitates the supervision and review of the audit work. It also provides supporting evidence of the audit work performed. Audit of working papers usually consist of:

(a) evidence obtained during the audit exercise;

(b) details of methods and procedures followed during such exercise; and

(c) conclusions derived by the cost auditor as regards objectives of the cost audit.

1.4.5.2 The working papers should record the cost audit plan, the timing, nature and extent of the audit procedures performed and the conclusions derived from the evidence obtained. The working papers serve as an important proof regarding the way evidence was found, analyzed and verifiable conclusion drawn.

1.4.5.3 Whenever any question is raised or a clarification is desired by the Central Government regarding any point, the cost auditor can reply properly if the audit working papers are properly kept. Such working papers will help the cost auditor in cost audit of that company during subsequent years also. The working papers should be cross-indexed in such a manner that required information could be obtained with minimum delay. The working papers may be arranged properly according to Para numbers of the Annexure to the Cost Audit Report Rules.

1.4.5.4 The audit working paper may be kept in two files – a “permanent” file for all the years and a “variable” file for each year of audit. Thus copies of Memorandum of Association, Articles of Association, collaboration agreement, process flow chart, cost manual etc. may belong to the permanent file.

1.4.5.5 It is advisable that detailed comments on verification of supporting statement are kept attached to that statement. This would enable the cost auditor to know at any time how a figure was arrived at, what examination he made to satisfy himself, what queries he raised, what replies were received and what comments he finally decided to put in his report.

1.4.6 Verification of Records and Reports

1.4.6.1 Details of Cost Accounting Records

1.4.6.1(a) The records contemplated under Section 209(1)(d) of the Companies Act, 1956 would include all cost accounting records maintained by the company and made available for audit. The following records are considered as part of the cost accounting records-

(1) *Production*

- (a) Consumption register of raw material, packing materials, etc.
- (b) Production reports.
- (c) Scrap, wastage, spoilage and defective reports.
- (d) Machine utilization report and idle time report.
- (e) Details of production hours, labour and machine hours.

(2) *Raw materials stores etc. :*

- (a) Goods received register.
- (b) Bin cards and stores ledger.
- (c) Material consumption and stock reports.

(3) *Utilities (Steam, power & water) :*

- (a) Records of inputs and outputs.
- (b) Records of cost centre-wise allocation of products.
- (c) Records for own generated power and purchased power.

(4) *Wages and Salaries :*

- (a) Attendance registers.
- (b) Payroll.
- (c) Leave wages and gratuity payments.
- (d) Overtime and idle time records.

(5) *Overheads :*

(a) Overheads analysis/distribution registers.

(b) Overhead absorption details.

(6) *Repairs and maintenance :*

(a) Work order register

(7) *Work-in-progress and finished goods :*

(a) Cost centre-wise/product-wise stock register.

(b) Product-wise finished goods register.

(8) *Cost accounts, records and statements :*

(a) Cost centre-wise assets register.

(b) Product ledger.

(c) Annexures and proformae as per Cost Accounting Records Rules.

(d) Reconciliation of profit/loss as per costing and financial records.

(9) *Sales :*

(a) Sales register including export sales register.

(b) Sales analysis by products (quality, size, variety-wise).

1.4.6.1 (b) The above mentioned cost records shall be maintained on a regular and continuous basis and not at the end of the year only.

1.4.6.2 Review of Cost Accounting Records by Cost Auditor

1.4.6.2(a) The cost auditor during the course of audit will thoroughly review the cost accounting records. Such review and verification may include :

1. Methods of costing in use – batch, job, process etc.
2. System of fixation of cost centres.
3. Procedures for accounting of raw materials, packing materials, and spares, etc.
4. Methods of accounting of wastes, rejections and defectives.
5. System of recording of wages, salaries and overtime and their allocation.
6. Incentive schemes in vogue.
7. Basis of allocation/apportionment of utilities.
8. Method of accounting for depreciation and charging depreciation to cost centres.
9. Method of apportionment/allocation of service department expenses.
10. Basis of reapportionment of service department expenses to production departments.
11. Basis of absorption of overheads to products.

12. Basis of absorption of interest, bonus, gratuity and selling and distribution cost to products.
13. Treatment of research and development expenses.
14. Budgetary control system.
15. Internal audit system.
16. Method of accounting of production and sales.
17. Method of evaluation of work-in-progress.
18. System of stock-taking.
19. Method of valuation of inventories.

1.4.6.2(b) If the company has manual for cost accounting, the cost auditor should study the manual thoroughly.

1.4.6.3 Verification of Cost Proformae and Annexures

1.4.6.3(a) The cost auditor has to examine all the cost accounting records, cost statements, other books and documents, annexures and proforma to the report and other relevant data in course of his audit work. Such examination of the cost and financial statements by the cost auditor may include the following –

1. Financial position including financial ratios as required to be stated in Para 24 of the Annexures to the Cost Audit Report Rules.
2. Licensed capacity, installed capacity, production and capacity utilized (Para 4).
3. Consumption of raw materials, power and fuel, salary and wages, stores and spare parts, provision for depreciation, expenditure on overheads, royalty and technical know-how charges, quality control expenses, pollution control expenses, abnormal non-recurring costs and other items.
4. Sales realization – local and export unit and total for each variety of product.
5. Cost proformae maintained by the company as per cost accounting records rules.
6. Reconciliation with financial books.

1.4.6.3(b) As mentioned earlier, the examination of cost proformae as per provisions contained in relevant cost accounting records rules and other items mentioned above may commence only after the end of the accounting year when all the closing entries are passed through the books of account.

1.4.7 Preparation of Cost Audit Report

1.4.7.1 When review and verification of the cost accounting records and proformae and Annexures/ financial statements are completely in line with the Cost Audit Report Rules, the cost auditor will be in a position to prepare his report. It may be pointed out that the report should reflect the professional care exercised by the cost auditor. Certification of figures is only a part of the report. Other aspects are the analysis, critical review of the systems in vogue in the company, identification of areas where improvements can be made and suggestions on those areas.

1.4.7.2 The cost auditor has to give his observation in the main certificate with qualifications, if any. He has to complete all paras contained in the Annexure to the Cost Audit Report Rules, 2001 and finalise the checking of Proforma to the Cost Audit Report.

1.4.8 Authentication of Annexure to the Cost Audit Report

The annexure and proforma prescribed under the cost audit report shall be approved by the board of directors of the company before submitting the same to the Central Government by the cost auditor.

1.4.9 Number of Copies of Cost Audit Report

1.4.9.1 The Cost Audit Report is electronically filed with the Central Government and is physically submitted as was done previously. However, Cost Auditor may sign at least five physical reports also as per following usage :-

e-filing for Cost Audit Branch

One copy to the cost auditor himself

One copy for the company

One copy for the Central Excise

One copy for Income Tax authority

(One copy extra for future cost audit)

1.4.9.2 In view of e-filing, no hard copy is required to be submitted to the Cost Audit Branch.

1.4.10 Supplementary Report / Follow-up Action by the Company

Where the cost audit report is finalized with provisional figures, a supplementary cost audit report should be submitted by the cost auditor to the Government as soon as the audited accounts are made available. As per Section 233B(7), the company has to furnish explanation and full information on every qualification or reservation in the cost audit report to the Government within 30 days from the date of receipt of the copy of the said report. According to sub-rule (2) of Rule 4 of Cost Audit Report Rules, 2001, the Cost Auditor shall also give clarifications required by the Central Government on the Cost Audit Report submitted by him, within 30 days of the receipt of communication addressed to him calling for such clarifications.

1.4.11 Use of Statistical Sampling Methods

This is the most vital part of auditing. In fact this is the main part of auditing, as the audit programme is no more than a plan of checking and audit working papers are the records of such checking. Traditionally, the operations of auditing are classified as casting, posting and vouching. Casting refers to arithmetical operations whereas posting refers to copying figure from one place to another. Vouching on the other hand is often described as “the backbone of auditing” and is most important operation. Vouching is the examination of entries in the books of accounts with reference to vouchers and supporting documentary evidence. The cost auditor, because of time constraints cannot examine each entry with the voucher and as such has to resort to test check which helps to form an opinion about the nature and quality of work and enables him to obtain definite basis for audit observations. The cost auditor also uses the following techniques in cost audit :

1. Flow charts
2. Statistical sampling
3. Ratio analysis

1.4.12 Flow Charts

1.4.12.1 Flow chart is chart or diagrammatic representation of flow of information etc. In auditing it is used to diagrammatically represent the flow of information with the help of documents. It is useful to record the "decision" at different levels, the posting of data, and the recording of transactions on the document. It is customary to indicate the analysis of systems and documents in the flow chart detailed as under –

a) The number of copies of each document.

b) Its movements to different departments and sequence of such movements and where every copy is finally kept.

c) The operations like initialing, approving, etc. done on the documents in each department with brief description of the operations.

d) The collection from these documents into another register/documents as well as posting any information in the former from the latter by dotted line.

1.4.12.2 This helps in identifying –

a) The division of responsibilities of the different departments.

b) The source of document whose error would be of far reaching consequences.

c) Possible clerical errors that can occur at each stage.

d) It gives a bird's eye view of the system and an efficient documentation for the auditors testing it.

e) It is the most efficient tool for doing actual analysis.

However, flow charts might not give the desired results as details are sometime omitted and the individual charts are not properly cross referenced and indexed. Failure to standardize the symbols and incomplete nature of the chart fails to give desired results.

1.4.13 Statistical Sampling

It is the principle, established by statistics, that every sample has the attributes of the population to which it belongs. It follows that from examination of such attributes of the sample, conclusions can be drawn from examination of every member of the population. Statistics recognizes that every member has certain $66^2/_3$% to 97% confidence level. It has further refined tools like stratified sample to ensure that a small sample reasonably enlarges confidence level. Statistical sampling is adopted by auditors and is an effective tool their attempt to express an opinion based on test checking on the sample. Sometimes statistical sample may be dangerous to the auditor not because the tool is defective but because the auditor's knowledge of statistical sample is inadequate. However, if properly applied statistical sampling could enhance the objectivity of checking and as such auditor's observation would be more correct.

1.4.14 Ratio Analysis

Ratios show the trends and may help in focusing attention to the more important areas where detailed checking may be necessary. Such ratio analysis may identify anything abnormal or anything which deviates from the expected and the known. Ratios highlight only symptoms; it is for the auditor to study those symptoms properly, correlate them and reach definite conclusions or identify the areas for further enquiries. A cost auditor has to work out the financial ratios contained in Para No. 24 of the Annexure to the Cost Auditor Reports Rules and also to comment on them.

1.5.1

Appendix I - A

Specimen of Cost Audit Order

REGISTERED A/D

52/645/CAB\-2009

Ministry of Corporate Affairs

Cost Audit Branch

Dated ....

ORDER

Whereas in the opinion of the Central Government, it is necessary to conduct an audit of the cost accounts M/s...........................LTD. (hereinafter referred to as the Company) required under clause (d) of sub-Section (1) of Section 209 of the Companies Act, 1956 (1 of 1956) so as to include in its books of accounts the particulars referred to therein, now in exercise of the powers conferred by sub-Section (1) of Section 233 B of the Companies Act,1956 (1 of 1956), the (Central Government hereby directs that an audit of the cost accounts maintained by the Company in respect of ....(Name of the Product) for the year ending .... and also for every financial year thereafter continuously be conducted by an auditor with the qualifications prescribed in Section 233B(1) aforesaid, until further orders.

2. The application in the prescribed Form No. 23-C proposing for appointment of Cost Auditor for ONE TERM should be e-filed to this Department Within forty five days of the date of this order and thereafter within forty five days of the commencement of every financial year. It may be noted that the Cost Auditor proposed shall be an individual or a partnership firm of Cost Accountants, provided the firm is constituted with the previous approval of the Council of the Institute of Cost and Works Accountants of India under Regulation 113 of the Cost and Works Accountants Regulations, 1959. The application fee of Rs. 500, Rs. 1000 or Rs. 2000 if the nominal share capital of your company is less than Rs. 25 Lakh, Rs. 25 Lakh or more but less than Rs. 5 crores and Rs. 5 crores or more respectively should be remitted in the manner mentioned hereunder

   (a) Remittances may be made by means of challan which must be on authorised branches of PUNJAB NATIONAL BANK only and not on any other bank. The head of account to be indicated is 104 -other General Economic Service, Regulation of Joint Stock Companies -Fees realised by the Central Government on application made to it under the Companies Act, 1956 adjustable by the Pay & Accounts Officer, Department of Company Affairs, New Delhi. The original copy of challan shall be sent along with the application

   (b) Remittance can also be made by means of demand draft drawn in favour of the Pay & Accounts Officer. Department of Company Affairs, New Delhi on any nationalised bank in Delhi (preferably on the Punjab National Bank, Barakhamba Road, New Delhi) and demand draft should be sent to this Department along with the prescribed documents.

3. The audit shall be conducted in such a manner as will enable the Auditor to prepare the report in accordance with the Cost Audit (Report) Rules, 2001 as amended from time to time. The report of the Cost Auditor shall be forwarded to the Central Government in the prescribed format within the time stipulated under the said Rules.

4. The receipt of this order may please be acknowledged.

( )

Director (Cost)

(Phone No. 011-)

1.5.2

Appendix I - B

FORMAT FOR WRITTEN CERTIFICATE UNDER SEC. 233B(2)/224(1B)
IN CASE OF AN INDIVIDUAL/ PROPRIETARY FIRM.

Date --------------------

The Board of Directors
ABC Ltd.
1, X Street, Calcutta 700 001.

Dear Sirs,

I hereby certify that my appointment as Cost Auditor for the audit of Cost Accounts maintained by your Company relating to ....(PRODUCT UNDER REFERENCE) for the year ...., will be in accordance within the limits specified in sub-Section (1-B) of Section 224 read with sub-Section (2) of Section 233B of the Companies Act, 1956.

I hereby declare that, I am not in full time employment as a cost accountant within the meaning of Cost and Works Accountants Act, 1959 (23 of 1959) and I am holding a valid certificate of practice.

Thanking You,

Yours faithfully

( )

COST ACCOUNTANT

M.No. ....

IN CASE OF A FIRM

Date -------------------

The Board of Directors
ABC Ltd.
1, X Street, Calcutta 700 001.

Dear Sirs,

We hereby certify that our appointment as Cost Auditors for the audit of Cost Accounts maintained by your Company relating to ....(PRODUCT UNDER REFERENCE) for the year ...., will be in accordance within the limits specified in sub-Section (1-B) of Section 224 read with sub-Section (2) of Section 233B of the Companies Act, 1956.

We hereby declare that, none of the partners of our firm are in full time employment as a cost accountant within the meaning of Cost and Works Accountants Act, 1959 (23 of 1959) and are holding a valid certificates of practice.

We further certify that our firm is constituted with the previous approval of the Central Government under regulation 113 of The Cost and Works Accountants Act, 1959.

Thanking You,

Yours faithfully

For M/s ....

( )

Partner

Cost Accountant

M.No. ....

1.5.3

Appendix I - C

SPECIMEN BOARD MEETING RESOLUTION

Extract from minutes of the Board Meeting of M/s .... Ltd. held at the Registered office of the Company on ....

Tabled the letter No. 52/ /CAB-01 (CLB) dated .... , ordering cost audit of ...., for the year ....

The Chairman informed the Board that ....have given their consent to act as cost auditors and laid on the table the certificate received from ---------------------

It was accordingly

Resolved that, pursuant to Section 233B of the Companies Act, 1956 and subject to the approval of the Central Government .... be and are hereby appointed as the cost auditors of the company to conduct audit of .... (PRODUCT UNDER REFERENCE) manufactured by the company for the year ending on .... at a remuneration of Rs. .... plus out-of-pocket expenses.

Further resolved that the secretary of the company be and is hereby directed to submit the necessary application in Form 23-C to the Central Government and to do all such other acts as may be necessary.

1.5.4

Appendix I - D

Form No. 23-C

Form of Application to the Central Government for Appointment of Cost Auditor (s)

FORM 23C

[Pursuant to section 233B(2) of Companies Act, 1956]

Form of application to the Central Government for appointment of cost auditor

Note - All fields marked in * are to be mandatorily filled.

1(a). *Corporate identity number (CIN) or foreign company registration number of the company [Pre-Fill]

(b). Global location number (GLN) of company

2(a). Name of the company

(b). Address of the registered office or of the principal place of business in India of the company

3. *Paid-up capital (in Rs.)

4. *Proposal for which government's approval is sought indicating the product for which cost audit is ordered

5(a). *Number of the Central Government's order directing cost audit

(b). *Date of the Central Government's order directing cost audit (DD/MM/YYYY)

6(a). *Income-tax permanent account number (PAN) of cost auditor

6(b). *Name of cost auditor or firm who is proposed to be appointed

(c). i. *Address Line I

Line II

ii. *City

iii. *State

iv. Country

v. *Pin code

(d) i. *Whether the proposed cost auditor is a cost accountant within the meaning of the cost and works accountants Act,1959 (23 of 1959)

○ Yes ○ No

ii. *Whether he has a certificate of practice

○ Yes ○ No

(e) The associateship or fellowship number of the cost accountant

7. *Whether the cost auditor is subject to any disqualification under section 233B(5) of the Companies Act, 1956

○ Yes ○ No

8(a). *Proposed remuneration of the cost auditor (in Rs.)

(b). Any other remuneration detail

9. The financial year to be covered by the cost auditor

(a). *From (DD/MM/YYYY)

(b). *To (DD/MM/YYYY)

10. *Date of the meeting of the Board of Directors proposing the name of the cost auditor (DD/MM/YYYY)

11. Name and address of previous auditor

12. If there is any change in the auditor, the reasons therefor may be stated

Attachments

1. Copy of the order passed by the central government directing the company for the cost audit [Attach]
2. *Copy of the board resolution of the company sanctioning the proposal for which the Government approval has been sought. [Attach]
3. *Copy of the certificate obtained from cost auditor regarding compliance of the section 224(1B) of the Companies Act, 1956. [Attach]
4. Optional attachment(s) - if any [Attach]

List of attachments

[Remove attachment]

Declaration

To the best of my knowledge and belief, the information given in this application and its attachments is correct and complete.

I have been authorised by the board of directors' resolution dated* (DD/MM/YYYY) to sign and submit this application

To be digitally signed by

Managing director or director or manager or secretary of the company (in case of Indian company) or an authorised representative (In case of a foreign company)

[Modify] [Check Form] [Prescrutiny] [Submit]

For office use only:

Digital signature of the authorising officer

This e-Form is hereby approved

This e-Form is hereby rejected

[Submit to BO]

Page 2 of 2

[Pursuant to Section 233B(2)]

The Companies (Fees on Application) Rules, 1999 prescribe the fees which are presently as under:

Nominal Share Capital Rs.	**Fees Payable**
less than Rs. 25 lacs	Rs. 500
Rs. 25 lacs or more but less than Rs. 5 crores	Rs. 1,000
Rs. 5 crores or more	Rs. 2,000

1.5.5 Appendix I - E

SPECIMEN OF "APPROVAL FOR APPOINTMENT OF COST AUDITOR"

No. 52/ /CAB-89 (CLB)

GOVERNMENT OF INDIA

MINISTRY OF CORPORATE AFFAIRS

BIKANER HOUSE,
Hutments No. IV,
Shahjahan Road,
NEW DELHI - 110 011.
Dated ....

To,

M/s ....

....

Subject: APPOINTMENT OF COST AUDITOR

Dear Sirs,

I am directed to refer to your Form 23-C on the above subject and to convey the approval of the Central Government for appointment of Shri ………………. as Cost Auditor of your Company relating to the manufacture of .... (Product under reference) for the year ending .... and .... subject to the provisions of Section 22 (1B) and Section 233B (5) of the Companies Act, 1956 as amended.

2. In this connection your attention is invited to Rule 7(2) of the Cost Audit (Report) Rules 2001 and also to Section 233-B(7) of the Companies Act, 1956, as amended from time to time.

Yours faithfully,
(..................)
DIRECTOR (COST)
Phone:
Dated ………….

No. 52/ /CAB-89 (CLB)

Copy forwarded for information to :

Shri ……………………………… (Cost Auditor)

His attention is invited to Rule 7(1) of the Cost Audit (Report) Rules 2001 as amended from time to time.

(...............................)
Director (Cost)
Phone:

1.5.6

Appendix I - F

DRAFT OF COMMUNICATION WITH PREVIOUS COST AUDITOR

(By Regd. A/D.)

Date: ....

To,

Dear Sir,

I/We have been approached by M/s. ------------------------------------ to conduct the cost audit relating to the ------------------------(product/service under reference) of the company /unit(s) located at ----------------------for the year ending on -----------.

I/We understand that you were the cost auditor of the Company immediately prior to this offer. Accordingly, I hereby communicate to you before I/we accept the said appointment. May I request you to for your feedback on this matter.

This communication is being addressed to you in view of the provisions of clause (8) of Part I of the First Schedule to The Cost and Works Accountants Act, 1959.

I also hereby confirm that the audit fees that will be received by me/us for this assignment will not be lower than the fees received by you for similar work.

Thanking you,

Yours faithfully,

For M/s ....

(   )

COST ACCOUNTANT

M. No. ....

Note: 1. It is suggested to write the letter on an Inland Letter Card.

2. The communication must be addressed by Register A/D.

1.5.7 Appendix - II (A)

APPOINTMENT OF COST AUDITOR IN FIRM'S NAME

No. 54/ /80-CAB

GOVERNMENT OF INDIA

Ministry of Law, Justice and Company Affairs,

Department of Company Affairs, Shastri Bhavan, V Floor, A Wing

Dr. Rajendra Prasad Road, New Delhi - 100 001.

November 19, 1983

To

The President,

Institute of Cost & Works, Accountants of India,

12, Sudder Street, Calcutta - 700 016.

Sir,

I am directed to state that the question of appointment of Cost Auditors in firm's name for conducting cost audit has been under examination in the department and it has been decided to approve the appointment of Cost Auditors in firm's name under sub-Section (2) of Section 233B of the Companies Act, 1956, if such a proposal is received from the Board of Directors of any company subject to the following conditions :-

(i) All the partners of the firm are practising cost accountants within the meaning of Sections 6 and 7 of the Cost and Works Accountants 1959, and

(ii) The firm itself has been constituted with the previous approval of the Central Government as required under Regulation 113 of the Cost and Works Accountants Act, 1959.

2. It is requested that the above decision may be brought to the notice of practising cost accountants through the journal of the Institute of Cost and Works Accountants of India.

Yours faithfully,

(V. GOPALAKRISHNAN)

Senior Cost Accounts Officer

1.5.8

Appendix - II (B)

No. 52/409/80-CAB

GOVERNMENT OF INDIA

Ministry of Law, Justice and Company Affairs,

Cost Audit Branch 801, Kanchenjunga Bldg.,

Barakhamaba Road, New Delhi.

Dated the 24th Aug. 1984

To

The President,

Institute of Cost & Works Accountants of India,

12, Sudder Street, Calcutta - 700 016.

Sub :- Authentication of Cost Audit Report in cases where a firm of Cost Auditors is approved u/s 233B (2) of the Companies Act. 1956. for conducting cost audit.

Sir,

I am directed to refer to this Department's letter of even number dated 19.11.83 intimating the decision of the Department regarding the approval for appointment of cost auditors in firm's name under sub-Section (2) of Section 233B of the Companies Act, 1956.

2. In case where a firm of Cost Auditors is approved for appointment under sub-Section (2) of Section 233B ibid, the Cost Audit report shall be signed by any one of the partners of the firm responsible for the conduct of Cost Audit in his own hand, for and on behalf of the firm, which has been approved for appointment as cost auditors of the company. In any case the report should not be signed by merely affixing the "firm's name."

3. The above position may be brought to the notice of all practising Cost Accountants, through the Journal of the Institute.

4. The receipt of this letter may please be acknowledged and a copy of the Journal wherein it is published may be sent to this Department for information.

Yours Faithfully,

(V. GOPALAKRISHNAN)

Joint Director (Cost)

1.5.9 Appendix - II (C)

Section 224 (1-B) & 233-B OF THE

COMPANIES ACT, 1956 : A CLARIFICATION

No. 52/354/CAB-87

Date: 30.8.1988

Sub: Clarifications relating to sub-Section (1 B) of Section 224 and sub-Section (2) of Section 233 B of the Companies Act, 1956 regarding the appointment of Cost Auditor.

In the application of the amended provisions of the Companies Act, 1956 relating to the amendment to Section 233 B (2) of the Act, the following points are hereby clarified :-

(i) U/s 233B of the Act, the Cost Auditor is appointed by the Board of Directors of the Company with the previous approval of the Central Government. According to sub-Section (2) of S. 233B ibid, the Board ~ can make an appointment of the Cost Auditor only after obtaining a written certificate from him that his appointment if made will be in accordance with the provisions of sub-Section (1 B) of Section 224 of the Act.The Cost Auditor can give such a certificate only if he does not exceed the specified number of audits , prescribed u/s 224 of the Act. As the appointment of Cost Auditor has to be made by the Board of Directors of the company after obtaining the previous approval of the Central Government, the appointment of an auditor is complete only when the company intimates in writing to the Cost Auditor that he has been appointed. Therefore, the Cost Auditor at the time of furnishing a certificate u/s 233 B(2) of the Act will have to take into consideration only the number of companies for which he holds firm letters of appointment from various companies, as Cost Auditor.

(ii) Under the provision of Section 233B of the Act and the Cost Audit Report Rules made thereunder, the Cost Auditor after the submission of the Cost Audit Report has to furnish replies to all the supplementaries, queries from the Department of Company affairs arising through a review of the Cost Audit Report. A question has arisen as to when the term of a Cost Auditor in respect of company shall be deemed to have concluded. It is clarified that for the purpose of furnishing the certificate under sub-Section (2) of Section 233B of the Act, a Cost Auditor shall be deemed to have concluded his appointment as soon as he renders a report to the Central Government in accordance with the Cost Audit Report Rules, with a copy to the company. His obligation to answer queries from the Company Law Board arising out of review of cost audit reports should not debar him from accepting another appointment as Cost Auditor of a company provided the specified number of companies contemplated in Section 224 (1) (B) is not exceeded.

The above clarification may be published in the Journal of the Institute of Cost and Works Accountants of India at an early date.

(V. Gopalakrishnan)

Joint Director (Cost).

1.5.10 Appendix - II (D)

CLARIFICATION UNDER Section 224 (1B) OFTHE COMPANIES ACT, 1956

No. 35/1/90-CL.III

Government of India, Ministry of Industry

Department of Company Affairs

Shastri Bhavan, 5th Floor, 'A' Wing

New Delhi.

Dated 2nd March 1990.

To,

The President,
The Institute of Chartered Accountants of India,
Post Box No. 7100,
Indraprastha Marg,
New Delhi-110 002.

Subject: Clarification under Section 224 (1) of the Companies Act, 1956.

Sir,

I am directed to refer to your letter No. CLC/79/89 dated 8th January, 1990 on the subject mentioned above and to say that while giving a certificate in terms of provision to sub-Section (1) of Section 224 of the Companies Act, 1956, the auditor or auditors will not only take into account the actual appointments as auditors in the companies but also their proposed appointments in companies for which they have given their consent.

Yours faithfully,

K.M. Gupta

Under Secretary to the Govt. of India

1.5.11 Appendix - II (E)

CLARIFICATION UNDER Section 224(1B) OF THE COMPANIES ACT, 1956

No. 3/8/89-CL. V.
Government of India
Ministry of Industry
Department of Company Affairs
Shastri Bhavan, 5th Floor, 'A' Wing
Dr. R.P. Road, New Delhl - 1.

the 5th March, 1990

To,
The Institute of Cost & Works Accountants of India
ICWAI Bhavan, 3, Institutional Area,
Lodi Road, New Delhi.

Subject: Clarification under Section 224(1B) of the Companies Act, 1956 read with Section 233 of the Act.

Sir,

I am directed to refer to your letter No. PD/69/90 dated 19-2-1990 on the subject mentioned above and to say that the cost auditor shall be deemed to have concluded his appointment as soon as he renders a report to the Central Government in accordance with the cost Audit Report Rules. The specified number of companies for the purpose of Section 233B(2) of the Act is to be computed with reference to the number of Companies wherein he is appointed as cost auditor and in respect of which reports is yet to be submitted. The number of companies in respect of which reports have not been submitted should be taken into account for the purposes of ceiling on cost audit.

Yours faithfully,

(U.P. Mathur),
Director

1.6 Specimen Questions With Answers

Question No. 1.1 :

Your company has received an order from the Government of India directing your company to have the cost records maintained by the company under Sec. 209(1)(d) for the year ending 31st March, 2009 and for every subsequent year thereafter audited. List the actions to be taken by the company step by step from cost auditor appointment till the submission of the Cost Audit Report, specifying time schedules. What are the penalties for non compliance?

Answer :

(1) The Central Government issues a specific order under Section 233-B (1) of the Companies Act, 1956 to get its cost records audited by a practising Cost Accountant, indicating the product for which the order is issued and the period for which it is ordered (in this case 31st March, 2009). The order is also applicable for every subsequent year thereafter.

(2) On receipt of the order, the Board of Directors shall select a Cost Accountant in practice or a firm of Cost Accountants and pass a resolution at the Board meeting appointing the cost auditor subject to approval by the Central Government. The Board may propose a single auditor for all the units of the company manufacturing the product under audit, or assign the work to more than one cost auditor. The cost accountant so appointed should fulfill the following conditions:

(a) The cost Accountant or all the partners of the firm as the case may be, should be qualified cost accountants within the meaning of the Cost and Works Accountants Act, 1959 and holding certificate of practice.

(b) In the case of a firm, it should have been constituted with the previous approval of the ICWAI as required under Regulation 113 of the Institute of Cost and Works Accountants Act, 1959.

(c) The Cost Accountant should not be in whole time employment elsewhere as provided in Section 224 (1-B) of the Companies Act, 1956.

(d) He/they should not suffer from any of the disqualification mentioned in S. 233-B (5) of the Companies Act.

(e) He/they should not also exceed the ceiling on the number of audits prescribed u/s 224 (1-B).

(3) The Secretary of the company or a Director should make the application to the Central Government in Form 23-C, accompanied by the requisite fees, for approval of the appointment of Cost Auditor. The application should be e-filed within 45 days from the commencement of the accounting year for which audit is ordered (in this case 15th May, 2008).

(4) On receipt of approval from Government the company should issue a letter to the cost accountant confirming his appointment.

(5) Within 135 days from the end of the accounting year, i.e. before 14th August, 2009, the company should make available all the cost accounting records maintained in accordance with Section 209 (1) (d) of the Companies Act to the cost auditor and render all assistance to him to carry out the audit.

(6) The cost auditor should complete the audit and submit his report to the Central Government within 180 days i.e. before 30th September, 1998.

The company and the executives responsible should ensure that the audit is completed and report is submitted within the stipulated time.

If the company contravenes the provisions of the Cost Audit Report Rules, the company and every officer of the company who is in default shall be punishable with a fine upto Rs. 5000 and where the contravention is a continuing one, with a further fine of up to Rs. 500 for every day after the first day during which period such contravention continues.

Question No. 1.2 :

(a) Under what conditions, will the appointment of cost auditor for conducting cost audit be appointed in firm's name? Who will authenticate such reports and how? Can the appointment of proprietary firms also be appointed?

(b) Can a cost auditor of a company also be its internal auditor? Justify your answer.

(c) Can a cost accountant who is appointed as the concurrent auditor of a company accept appointment as cost auditor of the same company?

Answer:

(a) Appointment of cost auditor under a firm's name will be subject to the following conditions :

(i) All the partners of the firm are full time cost accounting practitioners within the meaning of Sections 6 and 7 of the Cost and Works Accountants Act, 1959.

(ii) The firm must have been constituted with the previous approval of Central Government or of the Central Council of ICWAI as per amended regulation 113 of the Cost and Works Accountants Act, 1959.

The Cost Audit Report shall be signed by any one of the partners of the firm responsible for the conduct of the cost audit in his own hand for and on behalf of the firm. In any case the report should not be signed by merely offering the firm's name.

With the amendment to Regulation 108 of the ICWAI Regulations on 25.9.93, a proprietary firm can be approved by the Council of the Institute and therefore can be appointed as Cost Auditor.

(b) Since the Cost Auditor is required to comment on the scope and performance of internal audit it would tend to militate against proper and dispassionate discharge of the duties of the cost auditor if he is also the Internal Auditor of the audited company. Hence the cost auditor of a company cannot be its internal auditor also.

(c) A concurrent auditor may be viewed as a person holding an office of profit of the company and so cannot be appointed as the cost auditor of the same company.

1.7 Self-examination Questions

1 What is the origin of Cost Audit in India?

2 What are the salient features of Cost Audit? How is it a variance with the financial audit as contemplated in S. 224 of the Companies Act, 1956?

3 Can you consider "Cost Audit" – (a) as Management Audit, (b) as Social Audit, (c) as Propriety Audit? If so, to what extent?

4 What are the various stages and the procedure in the appointment of a Cost Auditor? List the forms that are normally to be used.

5 Can the Central Government insist on the appointment of a particular person as Cost Auditor, while approval of appointment? When does the term of appointment of Cost Auditor end?

6 What are the limits on the number of audits that a Cost Auditor can take at a time? How is the limit operated in the case of multi-product companies, all subject to Cost Audit?

7 What are the rights and responsibilities of a Cost Auditor?

8 What are the disqualifications of a Cost Auditor?

9 Can a firm of Cost Accountants be appointed as Cost Auditor? If so, under what conditions?

10 You have been appointed as the Cost Auditor of an industrial undertaking covered under Cost Accounting Records Rules. The industry is new to you. What preparations and knowledge would you consider necessary while planning its cost audit?

11 In planning to take up a cost audit of a unit what documents and information should a cost auditor take note of?

12 What do you understand by structuring the audit? Discuss the importance of audit programme, audit working papers and checking including test check.

13 Write explanatory notes on the following techniques used in auditing – (a) Flow charts, (b) Statistical sampling, (c) Ratio analysis.

14 Write briefly about review of cost accounting records by cost auditor during the course of audit.

15 "A cost auditor has to examine all the cost records, cost statements and financial statements and other relevant data in the course of his audit work". Discuss.

16 Mention the guidelines relating to rendition of cost audit report. Discuss the provision relating to supplementary report.

☆☆☆

STUDY NOTE - 2

Cost Audit Report Rules, 2001

This Study Note includes:

- Provisions of Cost Audit Report Rules 2001.
- Cost Audit Report Rules 2001
- Form II - The Cost Audit Report
- Annexure to the Cost Audit Report
- Review of Cost Audit Report
- Disposal of Cost Audit Report by the Central Government
- Other End Users of Cost Audit Report
- Disclosure of Information and Confidentiality

2.1 Provisions of Cost Audit Report Rules 2001

Cost Audit was initially introduced in the country about 43 years back in the year 1965, when the Companies Act, 1956 was amended through Companies (Amendment) Act, 1965 to incorporate the provisions relating to the maintenance of Cost Accounting Records and Cost Audit. These amendments were made on the basis of recommendations received from Vivin Bose Commission, Dutta Commission and Shastry Committee. The basic structure of Cost Audit was implemented through Cost Audit (Report) Rules, 1968. These report rules were superceded subsequently by the Cost Audit (Report) Rules, 1996 notified vide GSR 511(E) dated 5.11.96. These Report Rules were again been superceded vide Cost Audit Report Rules, 2001 notified vide GSR 924(E) dated 27.12.2001. The section 233(B) of the Companies Act 1956 requires the cost auditor to submit his cost audit report to the Central Government in the prescribed form and simultaneously send a copy of report to the company. The Cost Audit Report Rules 2001 prescribe the form, procedures and rules regarding the cost audit report. The following are the salient features:

(a) The report is to be sent to the Central Government and to the company within 180 days from the end of the company's financial year to which the cost audit report relates (Rule 5);

(b) The Cost Audit Report includes auditor's observation and suggestions, Annexure and Performa to the Cost Audit Report. Therefore, these must also be submitted along with the Cost Audit Report (Rule 2(c));

(c) The cost statements as prescribed under Cost Accounting Records Rules are not required to be attached with the cost audit report to be submitted to the central government. These cost statements and other working papers duly audited and signed by the cost auditor remain with the company (Rule 4);

(d) The Annexure and Proforma prescribed with the Cost Audit Report shall be approved by the Board of Directors before submitting the same to the Central Government by the Cost Auditor;

(e) The Annexure and Proforma, duly audited by the Cost Auditor, shall also be signed by the Company Secretary and at least one Director on behalf of the company. In the absence of Company Secretary in the Company, the same shall be signed by at least two Directors (Rule 7);

(f) The Cost Audit Report (Amendment) Rules 2006 provide that these reports shall be filed through electronic media or through any other computer readable media as referred u/s 610A of the Companies Act, 1956. These shall be authenticated by the authorized signatories using digital signatures.

(g) A copy of the Report is also to be submitted to the Company by the Cost Auditor and a dated acknowledgement should be obtained from the company;

(h) Clarifications sought by the Central Government from the Cost Auditor should be furnished by the Cost Auditor within thirty days of the receipt of such communication. It is a statutory duty of the Cost Auditor;

(i) If the Cost Auditor gives a qualified report, he should indicate the extent to which he has qualified the cost audit report and the reasons therefore;

2.2 Cost Audit Report Rules, 2001 (With Author's Comments)

The Cost Audit Report Rules, 2001 as notified vide G.S.R. 924(E) dated 27th December 2001 along with author's comments (in italics) are explained as under:

MINISTRY OF LAW, JUSTICE AND COMPANY AFFAIRS

(DEPARTMENT OF COMPANY AFFAIRS)

NOTIFICATION

New Delhi, the 27th December, 2001

G.S.R. 924(E).- In exercise of the powers conferred by sub-section (4) of section 233B, read with sub-section (1) of section 227 and clause (b) of sub-section (1) of section 642, of the Companies Act, 1956 (1 of 1956), and in supersession of the Cost Audit (Report) Rules, 1996, except as respect things done or omitted to be done, before such supersession, the Central Government hereby makes the following rules, namely:-

1. **Short title and commencement . –**

   (1) These rules may be called the Cost Audit Report Rules, 2001.

   (2) They shall come into force on the date of their publication in the Official Gazette.

   (Comments: Rule 1: The Cost Audit Report Rules, 2001 were published in the Official Gazette vide GSR 924(E) dated 27 December 2001. These rules have superceeded the Cost Audit (Report) Rules, 1996 and came into force on the date of publication in the Official Gazette i.e., 27th December 2001. The application clause (rule 3) clarifies that all the cost audit reports submitted on or after 1st October 2002, shall be in the form prescribed irrespective of the financial year to which it relates.)

2. **Definitions** – In these rules, unless the context otherwise requires,-

   (a) "Act" means the Companies Act, 1956 (1 of 1956);

   (b) "Cost Auditor" means an auditor directed to conduct an audit under sub-section (1) of section 233B of the Act;

   (c) "Form" means the Form of the Cost Audit Report and includes auditor's observations and suggestions, Annexure and Proforma to the Cost Audit Report;

   (Comments: Rule 2(c) - This rule clearly states that the auditor's observation and suggestions, Annexure and Proforma to the Cost Audit Report are included in the prescribed form of Cost Audit Report to be submitted to the Central Government under rules.

   (d) "Report" means Cost Audit Report duly audited and signed by the Cost Auditor in the prescribed form of Cost Audit Report;

   (e) "Product under reference" means the product or activity to which the Report relates;

   ((Comments: Rule 2(e) -The term "product under reference" was defined to include "product" as well as "activities" (in service sector). This explanation was followed by notification of Cost Accounting Records (Electricity) Rules, 2001 and Cost Accounting Records (Telecommunication) Rules 2001.This clarification brought paradigm change in the applicability of Cost Audit as the various "services" are also produced, processed and sold like "products" now a days and in any case the term "processing" always meant to include "services" as well. In any case, the fast pace of technology development and opening up of economy for international

competition has brought services at par with other products as today services are also being brought and sold just like any other product or commodity.

(f) All other words and expressions used in these rules but not defined, and defined in the Act and rules made under clause (d) of sub-section (1) of section 209 of the Act shall have the same meanings as assigned to them in the Act or rules, as the case may be.

3. Application

These rules shall apply to every company in respect of which an audit of the cost accounting records has been ordered by the Central Government under sub-section (1) of section 233B of the Act. The Cost Audit Report submitted on or after 1st October, 2002, irrespective of the financial year of the company to which it relates, shall be in the form prescribed under these rules.

(Comments: Rule 3 : The rules clearly provide that all the cost audit reports submitted on or after 1st October, 2002 shall be submitted in the form prescribed under the Cost Audit Report Rules, 2001 irrespective of the financial year, it belongs to.

4. Form of The Cost Audit Report

(1) Every Cost Auditor, who conducts an audit of the cost accounting records of the company shall submit the report (a hard copy and a soft copy) along with auditor's observations and suggestions, Annexure and Proforma to the Central Government in the prescribed form and at the same time forward a copy of the report to the company.

(2) Every Cost Auditor, who submits a report under sub-rule (1), shall also give clarifications, if any, required by the Central Government on the Cost Audit Report submitted by him, within thirty days of the receipt of the communication addressed to him calling for such clarifications.

(3) The Forms prescribed in these rules may be filed through electronic media or through any other computer readable media as referred under section 610A of the Companies Act, 1956 (1 of 1956).**

(4) The electronic-form shall be authenticated by the authorized signatories using digital signatures, as defined under the Information Technology Act, 2000 (21 of 2000).**

(5) The Forms prescribed in these rules, when filed in physical form, may be authenticated by authorized signatory by affixing his signature manually.

(Comments: Rule 4 : The Cost Auditor shall submit Cost Audit Report containing:

(a) Auditors' observations and suggestions (as included in the Form of the Cost Audit Report); and

(b) Annexure to the Cost Audit Report (Para 1 to Para 28); and

(c) Proforma (product-wise cost, sales and margin)

The Cost Auditor has to submit the said Cost Audit Report to the Central Government and at the same time send a copy of the Cost Audit Report to the company. However, the Cost Audit Report (Amendment) Rules, 2006 provide for e-filing of Cost Audit Reports and have also prescribed Form – I for filing cost audit report and other documents with the Central Government.

*** The Cost Audit Report (Amendment) Rules, 2006 issued vide notification no GSR 148(E) have inserted the aforesaid sub-rule (3), (4) and (5). These amendments allow the cost auditor to submit cost audit reports through* *electronic media or through any other computer readable media as referred under section 610A of the Companies Act, 1956. The electronic form of the cost audit report shall be authenticated by the authorized signatories using digital signatures.*

Even though, the rules (5) regarding provision for submission of Cost Audit Report in Physical Form still theoretically remain in the rules, no cost audit report is being submitted in the physical form.

5. Time Limit For Submission Of Report

The Cost Auditor shall forward his report referred to in sub-rule (1) of rule 4 to the Central Government and to the concerned company within one hundred and eighty days from the close of the company's financial year to which the report relates.

(Comments: Rule 5 : Even though, there is no provision for extension of time for the submission of the Cost Audit Report, extension of time can be granted by the Ministry for any valid reason like loss or damage of records under fire or floods etc.)

6. Cost Auditor to Be Furnished with the Cost Accounting Records etc.

Without prejudice to the powers and duties the Cost Auditor shall have under sub-section (4) of section 233B of the Act, the company and every officer thereof, including the persons referred to in sub-section (6) of section 209 of the Act, shall make available to the Cost Auditor within one hundred and thirty five days from the close of the financial year of the company, such cost accounting records, cost statements, other books and documents, Annexure and Proforma to the Report, duly completed, as would be required for conducting the cost audit, and shall render necessary assistance to the Cost Auditor so as to enable him to complete the cost audit and submit his report within the time limit specified in rule 5.

(Comments: Rule 6 - Rule 6(2) of the earlier Cost Audit (Report) Rules, 1996 provided that " if the cost accounting records, cost statements, other books and papers are not made available by the company within the time limit specified, [i.e. within 90 days from the end of the financial year of the company], the cost auditor shall intimate the facts of not having made available to him such records, statements, books and papers to the Central Government within 10 days after expiry of said time limit of 90 days. However, the corresponding rule is not appearing in Cost Audit Report Rules 2001. Moreover, the number of days allowed to the company for making available cost records etc. have been increased from 90 days earlier to 135 days under the new rules. It is probably due to the following reasons:

(a) The existing rule clearly place the specific responsibility for duly complete cost accounting records, cost statements, Annexure and Proforma to the Report on the company, which was not there in the earlier rules.

(b) Companies were earlier finding it difficult to complete the accounting records within 90 days as financial figures would often change due to financial audit. Therefore, Cost Auditors would initially submit the provisional report followed by the supplementary report. Therefore, it was requested that if 135 days are allowed to companies, there may be no need to submit supplementary report as first report itself would be based on the audited figures.

(c) Rule 7 of the Cost Audit Report Rules 2001 further provides that the Annexure and Proforma prescribed with the Cost Audit Report shall be approved by the Board of Directors before submitting the same to the Central Government by the Cost Auditor. Since, the Board would approve the audited Annexure and Proforma only, the additional 45 days were allowed to the company enable them to complete their documents

in all respects. This would also ensure that there is no difference in figures adopted in financial accounts and those in cost accounts as any changes in financial figures due to audit of financial accounts shall also reflected in cost accounts; and

(d) Rule 7 of the Cost Audit Report Rules 2001 provides that the Annexure and Proforma, duly audited by the Cost Auditor, shall also be signed by the Company Secretary and at least one Director on behalf of the company. In absence of Company Secretary in the Company, the same shall be signed by at least two Directors. With independent Directors, Audit Committes and strict penalties for not complying with corporate governance requirements, it was felt that this type of issues regarding not providing of cost records etc. may not arise

(e) A clarification was also issued that the Cost Auditor shall attend the Audit Committee meetings held by the company. The issues of delays and non availability of cost statements etc. can always be discussed in such Audit Committee meetings. A better understanding and coordination was thus contemplated between the company management and the cost auditor.

(f) The provisions regarding approval by Board of Directors or signing of Annexure and Proforma by Company Secretary and one director etc. were not there earlier in the Cost Audit (Report) Rules, 1996 and therefore, these documents were often signed by the very low officials, who were often responsible for complying with the lawful requirements. Hence the need for intervention by the Central Government at higher levels under those earlier rules.

(g) The responsibility for the compliance of these provisions has been placed on the company and every officer thereof including the persons referred to in sub section 209 (6), i.e. Managing Director, Manager, all officers and employees of the company, and if there is neither a Managing Director nor Manager, every Director of the Company. The company has also to render necessary assistance to the Cost Auditor in and through out the assignment. Therefore, it can be concluded that chances of non-compliance of the rules shall be almost nil.

(h) However in case of delay in furnishing the Cost Accounting Records, etc by the Company, the Cost Auditor may still be advised to write a letter within 10 days from the expiry of 135 days from the close of the financial year to the company for non-receipt of Cost Accounting Records / Statements, Annexure / Proforma to the Cost Audit Report, as the case may be, and get it acknowledged by the Company.

7. Authentication of Annexure to the Cost Audit Report

The Annexure and Proforma prescribed with the Cost Audit Report shall be approved by the Board of Directors before submitting the same to the Central Government by the Cost Auditor. The Annexure and Proforma, duly audited by the Cost Auditor, shall also be signed by the Company Secretary and at least one Director on behalf of the company. In the absence of Company Secretary in the company, the same shall be signed by at least two Directors.

(Comments: Rule 7 : The following procedure may be suggested:

(a) The company has to compile the cost statements, Annexure to the Cost Audit Report and Proforma;

(b) The cost auditor has to complete the audit of the cost statements, annexure to the cost audit report and Proforma etc simultaneously and in any case to complete his audit before they are presented to the Board of Directors for their approval.

(c) The Annexure to the Cost Audit Report and Proforma etc. should be initialed both by the Director and / or

Secretary along with the Cost Auditor before presenting them to the Board of Directors for their approval. It is statutorily not required but it is advisable that the Cost Auditor puts some identification mark (say stamp) on the final Annexure to the Cost Audit Report & Proforma before they are placed for approval of the Board of Directors. This procedure offers a comfort level to both the Auditors and the Board of Directors that the 'final' statements etc. are only placed before the Board for approval. Especially under electronic data processing environment, this procedural matter assumes lot of significance.

(d) Draft Cost Audit Report to be prepared by the Cost Auditor and presented to the Board to give them an opportunity to comment on the report, suggestions, observations and conclusions arrived at by the Cost Auditor. This will also meet the requirements of Note (4) given below the Form of the Cost Audit Report Rules, 2001.

(e) As per Sec 233B (7) the company has to furnish to the Central Government full information and explanations on every reservation or qualification contained in the Cost Audit Report within a period of 30 days of the receipt of Report. The above procedure will facilitate the company in complying with the requirements of this section.

(f) It is not necessary that the Annexure, Proforma to the Cost Audit Report etc. should be approved by the Board of Directors at the time of handing over the same to the Cost Auditor within 135 days. The approval by the Board of Directors may be done subsequently but in any case before the Cost Audit Report is submitted to the Central Government

(g) Sec 227 of the Companies Act, 1956 deals with powers and duties of Auditors. It gives the auditors access at all times to the Books of Accounts of the company. Thus once the procedure for the appointment of Cost Auditor is completed, he can immediately commence the Cost Audit work. It may be advisable that the work of auditing be done concurrently with that of completing the Cost Accounting Records, Statements, and the Annexure and Proforma to the Cost Audit Report. Thus there may be a situation when the Cost Auditor signs the cost statements etc. on the same date on which it is approved by the board of Directors. Similar view in case of financial audit has been upheld by the Departmental Circular No 7 of 1974, dated 26th April 1974.

(h) There is no violation of Sec. 215 where the audit of accounts is completed before approval of the balance sheet by the Board of directors (letter no 8/13 /215/65-CL-V,dated 19/9/1965). The same analogy can be drawn in the sense that audit of Cost Accounts may be completed even before the approval of the same by the Board of Directors.

8. Penalties

(1) If default is made by the Cost Auditor in complying with the provisions of rule 4 or rule 5, he shall be punishable with fine, which may extend to five thousand rupees.

(2) If the company contravenes the provisions of rule 6 or rule 7, the company and every officer thereof who is in default, including the persons referred to in sub-rule (6) of section 209 of the Act, shall, subject to the provisions of section 233 B of the Act, be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first day during which such contravention continues.

(Comments: Rule 8,- The penalties prescribed under Rule 8 of the Cost Audit Report Rules, 2001 are tabulated as under :

<table>
<tr><th>Sl. No</th><th>Provision</th><th>Reason for penalty</th><th>Person Liable</th><th>Penalty</th></tr>
<tr><td>1</td><td>Rule 4 (1)</td><td>Prescribed form of Cost Audit Report not followed</td><td>Cost Auditor</td><td>fine upto Rs. 5000/-</td></tr>
<tr><td>2</td><td>Rule 4 (2)</td><td>Clarifications not submitted to the Central Government within 30 days</td><td>Cost Auditor</td><td>fine upto Rs. 5000/-</td></tr>
<tr><td>3</td><td>Rule 5</td><td>Cost Audit Report not forwarded to the Central Government within 180 days</td><td>Cost Auditor</td><td>fine upto Rs. 5000/-</td></tr>
<tr><td>4</td><td>Rule 6</td><td>Duly completed cost statements, Annexures and Proforma to the Cost Audit Report not made available to the Cost Auditor within 135 days, and; not rendering necessary assistance to the Cost Auditor</td><td rowspan="2">The Company and every officer in default including persons referred to in section 209 (6) of the Companies Act, 1956 i.e.
1) Manager,
Director, Manager
All officers and other employees of the company
2) Where there is no MD or manager, every Director of the company</td><td rowspan="2">Fine upto Rs. 5000/-. and
For continued contravention further fine upto Rs. 500/- per day</td></tr>
<tr><td>5</td><td>Rule 7</td><td>Approval of the Board of Directors to the Annexure and Proforma not obtained before submission of the same to the Central Government, and;
Annexure and Proforma not duly signed</td></tr>
</table>

9. Saving of Action Taken or that may be Taken for Contravention of Cost Audit (Report) Rules, 1996

It is hereby clarified that the supersession of the Cost Audit (Report) Rules, 1996, shall not in any way affect –

(i) any right, obligation or liability acquired, accrued or incurred thereunder ;

(ii) any penalty, forfeiture or punishment incurred in respect of any contravention committed thereunder ;

(iii) any investigation, legal proceeding or remedy in respect of any such right, privilege, obligation, liability, penalty, forfeiture or punishment as aforesaid, and; any such investigation, legal proceeding or remedy may be instituted, continued or enforced and any such penalty, forfeiture or punishment may be imposed as if those rules had not been superseded.

(Comments: Rule 9: By virtue of this provision, the Central Government gets the power to continue with the proceedings, investigations etc. initiated under Cost Audit (Report) Rules, 1968 or Cost Audit (Report) Rules, 1996 even if these rules have been superseded by Cost Audit Report Rules, 2001.

2.3 Form II - The Cost Audit Report

2.3.1 The Rule 2(c) of the Cost Audit Report Rules, 2001 provides that the term "Form" means the Form of the Cost Audit Report and includes auditor's observations and suggestions, Annexure and Proforma to the Cost Audit Report. The Cost Audit Report (Amendment) Rules, 2006 have renamed the Form of the Cost Audit Report as "FORM II – THE COST AUDIT REPORT" and have introduced one more Form i.e., FORM I, which is the form for online filing of the cost audit report and other documents with the Central Government.

2.3.2 The Cost Audit Report Rules 2001, which are framed in exercise of the powers conferred under various provisions of the Companies Act, require the Cost Auditor to enlarge his function beyond verification / audit and to give his observations and suggestions on various aspects of Cost Audit and Efficiency Audit/Propriety Audit mentioned therein.

Cost audit is not confined to narrow concepts of audit. It has a much wider role and ambit. Cost Audit involves complete process of audit and on completion of that elaborate process only, the Cost Auditor is drawing various conclusions and is offering his observations. The said FORM – II – THE COST AUDIT REPORT gives an opportunity to the cost auditor to share his expertise and competence with the company management. The detailed para-wise comments are explained as under:

FORM II - THE COST AUDIT REPORT

[See rule 2(c) and rule 4]

I/We, ... having been appointed as Cost Auditor(s) under Section 233B of the Companies Act, 1956 (1 of 1956) of .... (mention name of the company) having its registered office at ....(mention registered office address of the company) (hereinafter referred to as the company), have examined the books of account prescribed under clause (d) of sub-section (1) of section 209 of the said Act, and other relevant records in respect of the unit .... (mention name and location of the unit) for the period/year .... (mention the financial year) relating to .... (mention name of the product or activity) maintained by the company and report, in addition to my/our comments in para 3 relating to auditor's observations and suggestions, that -

Comments: The words "in respect of the unit .... (mention name and location of the unit)" were not there in the earlier form of cost audit report prescribed under the Cost Audit (Report) Rules, 1996. This was added by the Cost Audit Report Rules, 2001 and it clearly indicates that the Cost Audit Report is required to be submitted separately for each Unit.

In case of companies engaged in production, processing, manufacturing and/or mining activities, unit is to be interpreted as "factory" producing the product under reference. However, in case of "activities" i.e. services e.g., electricity or telecommunication etc., the Unit will have to be defined considering the operational conveniences, business processes or accounting divisions etc.

1. (i) I/We have/have not obtained all the information and explanations, which to the best of my/ our knowledge and belief were necessary for the purpose of this audit;

   (ii) proper cost accounting records, as prescribed under clause (d) of sub-section (1) of section 209 of the Companies Act, 1956, have/have not been kept by the company;

(iii) proper returns adequate for the purpose of my/our Cost Audit have/have not been received from the branches not visited by me/us;

(iv) the said books and records give/do not give the information required by the Companies Act, 1956 in the manner so required;

(v) the cost statements in respect of product or activity under reference as specified in the Annexures/ Proformae of Schedules I, Schedule II or Schedule III of the concerned Cost Accounting Records (**...........................) Rules duly audited by me/us are kept in the company.

2. In my/our opinion, the company's cost accounting records have/have not been properly kept so as to give a true and fair view of the cost of production, cost of sales and margin of the product under reference as prescribed under the rules.

Comments :

It can be seen that Para 1(i), (iii) and (v) of "Form II - The Cost Audit Report" are in the nature of statements of facts. On the other hand, Para 1(ii), (iv) and 2 of Form of the Cost Audit Report are in the nature of opinions. It is important for a cost auditor to appreciate as to which of the various items require a qualification and whether they are in the nature of "statements of facts" or in the nature of "opinion". It may be clarified that failure to report or disclose material facts, material departures from the generally accepted principles or procedure of costing or misstatements may amount to professional misconduct under The Cost & Works Accountants Act, 1959.It is therefore, necessary that a cost auditor should know when to qualify the report and how to qualify the report as detailed hereunder:

When to Qualify the Report :

Where the Cost Auditor finds that items in the cost statements are misstated to such an extent that the said statements do not give true and fair view, he should give an adverse opinion, i.e. he should clearly state that "In my/our opinion, the company's cost accounting records have not been properly kept so as to give a true and fair view of the cost of production, cost of sales and margin of the product under reference as prescribed under the rules."

Where the auditor is unable to form an opinion due to non availability of appropriate records/data for whatever reasons, he should make a disclaimer i.e. he should mention clearly that he is unable to state whether the cost statements etc. give a true and fair view. Sometimes, the issues involved may not substantially affect the results presented in the cost statements for that year, still it may be advisable to qualify the report to avoid future problems.

Where to make qualifications

The Note (3) clearly indicates that the short comings, lapses etc. (material deficiencies or qualifications) that may be observed by the Cost Auditor during the course of his audit must be stated in para 1 (i) to 1(iv), Para (2).

How to qualify a report

*Merely making a factual statement without taking exception thereto does not tantamount to qualification.Whenever the auditor wants to qualify, he should use the words **'subject to'** in the beginning of the remark which imply that it is a qualification.*

Reference may be made to Sec 227(3)(E) which states that 'the auditors shall also state – in thick type or in italics the observations or comments of the auditors, which have any adverse effect on the functioning of the company.' The Cost Auditors should follow the same procedure.

Quantifying the effect of qualification

The cost auditors should specify the matters in respect of which they have reservations or qualifications and the amount / quantum involved should be brought out in clear and unambiguous manner where ever possible. If the Auditor is unable to quantify the effect of the qualifications he may rely on the basis of estimates made by the management and should clearly disclose the fact that the figures are based on the management estimates.

3. Based on my/our examination of the records of the company subject to aforesaid qualifications, if any, I/We give my/our **observations and suggestions** on the following -

Comments :

This para requires the cost auditor to give his 'observations' and 'suggestions', which can at best be termed as expression of his opinion mainly on issues, which affect the cost and cost control. This opinion expressed by a cost auditor may be un-qualified, qualified or adverse. An auditor may also disclaim the opinion. An unqualified opinion is when a cost auditor gives an opinion without any reservation. If the auditor makes a statutory affirmation without reservation, he is said to have given an unqualified opinion. Qualified opinion is when an auditor gives an opinion subject to reservation. where an Auditor does not agree with the affirmations to be made, he gives an adverse opinion. An adverse opinion is appropriate where the reservations or the objections of the auditor are so material that he feels that the overall view of the cost accounts is materially distorted. In such case he must disclose the reason thereof. For example "the related party transactions have been priced at direct cost only, which have resulted in under pricing of related party transactions to the extent of indirect expenses and other common overheads besides reasonable amount of profits, which could have been earned otherwise. The total estimated impact on account of indirect expenses and apportionment of common overheads is Rs……… Crores". In case of disclaimer of opinion, the auditor states that he is unable to express an opinion because he has not been able to obtain sufficient data and information to form his opinion. e.g. "we have been unable to verify the arm's length pricing of related party transactions. Since, related party transactions constitute about 25% of total sales volume, we are unable to state reasonability of such prices or their impact on the margin of the product under reference."

(a) the adequacy or otherwise of the cost accounting system including inventory valuation in vogue in the company and suggestions for the improvement thereof. The Cost auditor shall also indicate the persistent deficiencies in the system, pointed out in earlier reports but not rectified;

Comments :

This para requires the cost auditor to give his opinion on the adequacy or otherwise of the cost accounting system including inventory valuation in vogue etc. Para 2 of the Annexure to the Cost Audit Report regarding Cost Accounting System should be referred in this regard. Para 19 of said Annexure regarding Inventory Valuation read with para 18A (non-moving stock) and para 18B (written off stock) may also be referred in this regard. This para also requires the cost auditor to indicate the persistent deficiencies in the system, which were pointed out earlier but have not been rectified. It may be clarified here that it may not be proper to merely give the reference of an earlier Report mentioning the deficiencies stated therein. All material deficiencies even though pointed out in the earlier Cost Audit Reports must be repeated wherever they are in continuance.

(b) the adequacy or otherwise of the budgetary control system, if any, in vogue in the company;

Comments :

This para requires the cost auditor to give his opinion on the adequacy or otherwise of the budgetary control system, if any, in vogue in the company. The cost auditor should go through the system of setting up of the budgets, comparison *of actual and budgets, analysis of variances, corrective actions etc. Budgetary control and MIS go hand in hand and hence the review of MIS will enable the Cost Auditor to express his opinion.*

(c) matters which appear to him to be clearly wrong in principle or apparently unjustifiable;

Comment :

This para is very open para without any limits and leaves the field open for the cost auditor to give his opinion on any matter, which appear to him to be clearly wrong in principle or apparently unjustified. This para shall include the adverse or negative opinions of the cost auditor on all issues other than issues, for which separate paragraph has been provided.

Matters clearly wrong in principle are the treatment of various items of cost and revenues, inconsistent with generally accepted cost accounting principles e.g. recognition of certain expenses likely to affect the long term cost competitiveness of public owned company etc. The term apparently unjustifiable means unwarranted, inexcusable, uncalled for, indefensible etc. This is to be regarded as an opinion of the cost auditor. There may be a divergent view expressed by the company. However it is the responsibility of the cost auditor to express his view point. e.g. considerable amount of money given by way of charities or donations when company is having a poor financial health.

If the point raised by the auditor is debatable on which there is a difference of opinion between cost auditor and the management, it may be appropriate that the auditor should express his own opinion and should also point out that a divergent opinion is held by the company.

(d) cases, where price charged for related party transactions as defined in the respective Cost Accounting Records Rules is different from normal price, impact of such lower/higher price on margin of the product under reference shall be specified;

Comments :

This para requires the cost auditor to state facts i.e., cases where price charged for related party transactions is different from "normal price". The term 'Normal Price' has been defined as price charged for comparable and similar product in the ordinary course of trade and commerce, where the price charged is the sole consideration of sale and such sale is not made to a related party. The term 'normal price' is the 'arm's length price'. Now 'arm's length price' is in itself a very subjective issue as two products may not be totally similar and the price of any product may vary if other terms and conditions of the contract are also different. Therefore it may be prudent to give an opportunity to the company to explain the pricing charged from different customers.

Therefore, cost auditor should then see the reasonability of actual price by taking into consideration all the differentials. So, it may involve lot of opinion also from the cost auditor. Para 26 of the annexure to the cost audit report may be referred. Impact of such lower/higher price on margin of the product under reference shall also be required to be specified. At times it may not be possible/ practical to work out such impact product wise. Under such situation the overall impact may be quantified.

(e) areas where the company is incurring losses or where there is considerable decline in profitability, the cost auditor should comment on the reasons thereof including indicative break-even point. The cost auditor shall also comment on the default, if any on the payments due to the Government, financial institutions and banks, penal interest levied thereon and its impact on the cost of sales and profitability.

Comments :

This para is like a watch dog or whistler blower and can provide very useful information to the management and independent directors especially in case of sick or loss making units. However, the computation of indicative break-even point is very subjective and involves a lot of assumptions. It may, therefore, be preferred to indicate the break-even point in terms of capacity utilisation. Similarly, before making any comment on the default on paying dues to the Government, financial institutions etc. and the amount of penal interest levied thereon, it is suggested that the cost auditor should obtain a certificate from the Management. The calculation of impact of the same on the profitability will be subjective and in totality (not product wise). Only undisputed and confirmed dues need only be covered under this clause. Items in the nature of contingent dues may not be covered. The company should compile and provide this information to the Cost Auditor. Majority of this information is 'factual data', which is quantifiable. The Cost Auditor has to particularly see the loan agreements, compliances of various statutes and the penal provisions thereof.

As regards areas incurring losses or declining profitability, the Cost Auditor has to pin point the reasons and their extent for such occurrences. Generalised statements of facts may not be called for. e.g. "Reduction in Sale Turnover is the main cause for losses etc. Cost Auditor has to use his analytical abilities to reach to the real causes or problem areas. e.g. Decline in sales turnover or market share may be a factual position but it must be quantified in figures along with estimated .impact on profitability on account of that reduction in turnover. The analyses may reveal that the real cause being company's negligence, laxity or disregard in up gradation of it's facilities and technology.

(f) steps required to strengthen the company under the competitive environment especially with regard to need for protection from cheaper imports, if any;

Comments :

This para requires the cost auditor to comment on the steps required to strengthen the company under the competitive environment. This competition can be from indigenous competitors as well as foreign multi-nationals. This amounts to marketing audit and developing a product/market strategy. This para gives an opportunity to the cost auditor to offer his expert comments on marketing strategy and need for the company especially in those sectors, where there is lot of competition from the foreign competitors. It will also allow the company to make a strong case for protection, if required. The cost auditor may also develop a product/market strategy for the company.

The Company should provide the necessary information to the Cost Auditor regarding the competitive imports and their apprehensions regarding the subsidies being offered by the exporting countries, dumping that may be taking place in India and so on. Based on the discussions with the top management the Cost Auditor will be in a position to offer his comments for the protection of the Indian Industry. It may be added here that different services may give the different figures for total market share, total import etc. Therefore the cost auditor should indicate the source of information also w.r.t. figures, which are estimated only and not based on facts.

(g) export commitments of the company vis-à-vis actual exports for the year under review. Also comment on comparative profitability and pricing policy of the company for domestic and export sales. Give impact of exports benefits/ incentives offered by the Government on export profitability;

Comments :

This para gives one more opportunity to the cost auditor to expand his role much beyond audit / verification only and advise the company on the matters pertaining to profitability and pricing policy. The information of export commitments vis-à-vis actual exports will indicate the outstanding export commitments yet to be executed by the company.

A comment on the pricing policy of the company may be subjective since the fixation of domestic and export prices are based on different parameters. The impact of export benefit is already available from the productive margin statement and hence there will be no difficulty in furnishing the same. However, this para provides a company with authentic database to authoritatively defend any dumping case, if any brought against the company.

The export/import policy and handbook of procedure must be referred to understand the existing provisions. The cost auditor should give his comment on overall impact of such benefits on the profitability of export sales. This para can enable the Industry Association/Ministry to revise the amount of export incentives, if required to make the indigenous industry competitive and efficient.

(h) the scope and performance of internal audit of cost records, if any, and comment on its adequacy or otherwise.

Comments:

This para is restricted to comments on internal audit of Cost Records. A question is sometimes raised as to whether the Cost Auditor can do the internal audit of cost records also. It may be clarified that most of the companies appoint internal Auditors for the entire organization, which includes cost records as well. Moreover, there is no statutory binding for any company to have separate Internal Auditor for cost records only and the Cost Auditor can himself do the extensive checking audit, if required. However, no cost auditor can be appointed as internal auditor for cost records as there may be conflict of interests.

4. The Cost Auditor shall suggest measures for making further improvements in the performance in respect of cost control and cost reduction.

Comments:

This para gives an opportunity to the cost auditor to use his analytical skills and suggest measures for making further improvements in the performance through cost control and cost reduction. The Cost Auditor may comment upon the following areas which may be considered as an illustrative list only.

» *Plant Capacity – Utilisation and balancing of production facilities.*
» *Sub-contracting/outsourcing – cost and effects.*
» *Inventory holdings, Inventory carrying on procurement costs.*
» *Quality Control and performance evaluation.*
» *Increased productivity of various resources employed.*
» *Standardization and simplification in varieties, product design, etc.*
» *Packing and transportation costs.*
» *Change in product mix*

5. The Cost Auditor may also give his other observations and suggestions, if any, relevant to the cost audit.

Comments:

This Para is again open ended. It expects concrete, real tangible observations and valued added suggestions from the Cost Auditor, e.g., the Cost Auditor may recommend increase in crushing capacity in case of a sugar mill, or installation of oxygen bottling plant in case of Vanaspati industry and so on.

However, Note (4) clearly provides that the report, suggestions, etc., shall be based on verified data and it should *be included only after the company has been given an opportunity to explain/comment on them. Hence the Note contemplates the following course of action –*

a) It is necessary that the cost auditor shall state the reasons for such observations, remarks and particularly for the qualifications.

b) Such observations, remarks, qualifications shall be discussed with the company management and their views be ascertained. This will enable comprehensive reporting in the Cost Audit Report.

c) The views/comments of the management on auditor observations, remarks and qualifications should also be incorporated by the auditor in his report.

Dated : this-------------date of-------------------200---------at-----------------------

(mention name of place of signing this report).

SIGNATURE & SEAL OF THE COST AUDITOR(S)

MEMBERSHIP NUMBER

Notes:

(1) Delete words not applicable.

(2) **Specify the title of the concerned Cost Accounting Records Rules made under clause (d) of sub-section (1) of section 209 of the Companies Act, 1956 which are applicable to the product or activity of the company.

(3) If as a result of the examination of the books of account, the Cost Auditor desires to point out any material deficiency or give a qualified report, he shall indicate the same against the relevant para (i) to (vi) only in the prescribed form of the Cost Audit Report giving details of discrepancies he has come across.

(4) The report, suggestions, observations and conclusions given by the Cost Auditor under this paragraph shall be based on verified data, reference to which shall be made here and shall, wherever practicable, be included after the company has been afforded an opportunity to comment on them.

Note :

The Cost Audit Report shall consist of the following :

(a) Main certificate of the Cost Audit Report;

(b) Annexure to the Cost Audit Report Rules (Para 1 to 28);

(c) Proforma (showing product-wise cost, sales and margin cost statements).

(d) A copy of the Annual Report containing audited Profit and Loss Account, Balance Sheet and Auditor's Report in respect of the financial year of the company (Para 1(16) of the Annexure to the Cost Audit Report); and

(e) A copy of the Profit and Loss Account and Balance Sheet of the division/unit of the product under reference, if applicable.

2.4 Annexure to the Cost Audit Report

[See rule 2(c) and rule 4]

2.4.1 General

(1) (a) Name and address of the registered office of the company whose accounts are audited.

(b) Name and address of the place where the cost accounting records are maintained viz. registered office, head office or factory.

(2) Name of the product and location of the unit to which the Annexure pertains.

(3) The Company's financial year to which the Cost Audit Report relates.

(4) Date of first commencement of commercial production of the product under reference.

(5) Location of other sites manufacturing or producing or processing or mining the product or carrying out the activity under reference.

(6) Name and address of the Cost Auditor.

(7) Membership number of the Cost Accountant. In case of firm of Cost Accountants, name and membership number of all the partners.

(8) Reference number and date of Government Order under which the Audit is conducted.

(9) Reference number and date of the Government letter approving the appointment of the Cost Auditor.

(10) Date of Board of Directors' meeting wherein the Annexure and Proforma to the cost audit report were approved.

(11) The number of Audit Committee meetings held by the company, and attended by the Cost Auditor during the year under reference.

(12) Name, qualification and designation of the officer heading the cost accounting section or department of the company.

(13) In case of loan license/ job work arrangement by the company, mention the name of the third party and location of the factory, where the product has been produced/manufactured.

(14) If there is any foreign technical collaboration for the product under reference, the following details shall be given:

(a) name and address of the foreign collaborators;

(b) main terms of agreement ;

(c) amount of royalty, lump sum payment, technical aid fee payable and the basis of calculating the same;

(d) whether the technical collaborator has contributed to the share capital. If so, the paid up share capital so held.

(15) If the company is engaged in other activities besides the manufacture of the product under reference,

the following details in respect of each such product or activity shall be given:

(a) list of the products or activities;

(b) list of the products or activities for which Cost Accounting Record Rules have been prescribed under section 209(1)(d) of the Act.;

(c) whether Cost Audit Order has been issued by the government in respect of any of the products or activities. If so, number and date of the order.

(16) A printed copy of the Annual Report, containing audited Profit and Loss Account, Balance Sheet and Auditor's Report in respect of the company's financial year for which the report is rendered, shall be enclosed with the Cost Audit Report.

[Comment :

Para 1 of the Annexure of Cost Audit Report [4.1 above] *is mainly an introduction about the company and its technical capabilities and competence. The Annexure to the Cost Audit Report is to be compiled separately for each unit / factory. Therefore, the information should be given with reference to the each unit / factory. Product under reference means the product to which the cost audit report relates. Since the Cost Accounting Record Rules are prescribed for `products' within an industry, product-wise date of commencement of commercial production should be given. e.g. in case of chemical industry, date of commencement of commercial production for various products viz. ethylene, ethylene oxide, ethylene glycol etc. should be given separately. However, if the exact date is not available from the records, year of commencement may also be given.*

[4.1(6) above]: *The information w.r.t cost auditor should be given that of the proprietor in case of a proprietary firm or of the partnership firm, incase where a firm of cost auditors is appointed and approved u/s 233 B (2) of the Companies Act, 1956 for conducting cost audit.*

[4.1(11) above] : *As per Section 292-A of the Companies Act, 1956, the term "Auditor" includes Cost Auditor and hence "scope of audit including observations of the auditors" appearing in Sec. 292-A includes scope of cost audit including observations of the cost auditor also.*

In circular No. 6/2000 dated 20.8.2001, the Department of Company Affairs had initially clarified that the cost auditor would also attend and participate at the meetings of the audit committee but without voting rights. The department has further clarified vide DCA circular No. 2/2000 dated 9.1.2003 that cost auditor would attend audit committee meeting as an internal auditor of the company and not as member of the Committee as audit committees are constituted only from directors.

2.4.2 Cost Accounting System

(1) Briefly describe the cost accounting system existing in the company, keeping in view the requirements of the Cost Accounting Records Rules applicable to the class of companies manufacturing the product under reference and also its adequacy or otherwise to determine correctly the cost of production, cost of sales, sales realisation and margin of the product under reference.

(2) Briefly specify the changes, if any, made in the costing system; basis of inventory valuation; method of overhead allocation; apportionment to cost centers/departments and final absorption to the product under reference etc., during the current financial year as compared to the previous financial year.

[comments:

***Para 2 of the Annexure to Cost Audit Report [4.2(1) above] :** This para requires description of the Cost Accounting System in the Company with reference to the requirements of Cost Accounting Records Rules applicable to the product under reference. The auditor has to categorically state here as to whether the cost accounting system is adequate or otherwise to determine correctly the cost of production, cost of sales, sales realization and margin of the product under reference.*

***[4.2(2) above] :** The cost auditor has to briefly mention the changes, if any, made in the costing system, basis of inventory valuation, method of overhead allocation, apportionment and final absorption to the product under reference, etc. during the current financial year as compared to the previous financial year. It may be clarified that all changes may not be negative. Fine tuning is a continuing process and many changes are often necessitated due to accounting standards, or other improvements in methods & procedures etc.*

To have better judgment to form opinion, the Cost Auditor is advised to review the Cost Accounting System with reference to the requirements of relevant Cost Accounting Record Rules. The Schedule annexed to Cost Accounting Record Rules enlists details of records to be maintained.]

2.4.3 Process of Manufacture

A brief note regarding the process of manufacture along with flow chart covering production, utility and service department of the product.

[Comments :

Para 3 of the Annexure to Cost Audit Report [4.3 above] : There are two requirements of this para i.e., (a) A brief note on process of manufacture covering production, utility and service department of the product and (b) A flow chart showing process of manufacture, utility and service departments.

The flow chart should be self-explanatory showing sequence of operations preferably corresponding to that of the cost centers formed. The use and consumption points of utilities and services at the various production centers should be clearly shown in the flow chart. The Cost Auditor may also visit the work spot to obtain first hand knowledge of the process and to understand the flow chart and the write up.

2.4.4 Quantitative Details

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Installed capacity *			
2. Capacity enhanced during the year by leasing arrangment etc.			
3. Total available capacity			
4. Production during the year:			
(a) self manufactured			
(b) third party on job work etc.			
(c) loan license basis			
5. Total production quantity			
6. Production as per Excise Records			
7. Capacity utilisation percentage			
8. Opening stock (finished quantity)			
9. Total available quantity			

Particulars	Current Year	1st Previous Year	2nd Previous Year
10. Quantity captively consumed			
11. Quantity sold			
(a) domestic at controlled price			
(b) domestic at market price			
(c) export under advance license			
(d) export under other obligation			
(e) export at market price			
(f) total			
12. Closing stock (finished quantity)			

Notes :

1. It should be clarified whether the installed capacity is on single shift or multiple shift basis.
2. In order to have a meaningful comparisons of production and installed capacity, wherever necessary these details should also be expressed in appropriate units, e.g. standard hours or equipment/ plant/ vessel occupancy hours, crushing hours, spindle/ loom shifts, equivalent production, production in terms of standard hours etc.

[Comments :

Para 4 of the Annexure to the Cost Audit Report [4.4 above] : The above information needs to be given for each type of product under reference separately. The capacity utilisation, if indicated merely based on the actual physically installed capacity of the manufacturing unit, may not be correct indicator in this era of outsourcing, licensing and leasing. Therefore, this para seeks to determine the effective production capacity effective and capacity utilisation of the unit. This is an important parameter especially in case of allocation of fixed overheads, which are sometimes apportioned on the basis of physically installed capacity. In fact, the installed capacity as basis for allocation of fixed overheads led to an era of 'gold plating' in fertilizer units (constant capacity utilization more than 100%) and caused outflow of excess subsidies from the Government exchequer in form of fixed overhead amount per unit of capacity utilisation, whereas the actual amount incurred was much less. Therefore, this para becomes very critical in determining the subsidies or incentives, wherever payable by the Government.

This para requires that if some machineries have been taken on lease, their capacities be shown separately. Similarly, where some of the machines have been given on lease, their capacities should be shown with negative sign with reduction in available capacity i.e., actually effective capacity shall be less production - third party on job work means the company has manufactured goods for others. Production loan license basis means the company gets manufactured goods from outside parties/third parties.

Where machines operate at varying speeds (time factor) producing different thickness/gauges of products, installed capacity in terms of MT etc. cannot be compared with actual production in MT for arriving at capacity utilization. In such situations it is proper to calculate capacity utilization in terms of machine hours as per Note 2 of Para 4. In such cases it is proper to express the installed capacity and actual production in terms of machine hours, etc.

The captive consumption as required to be disclosed at Sl. No. 10 refers to quantity transferred for subsequent product/ process may be of two types i.e., (a) Intra Unit / factory consumption; and (b) Inter Unit / factory transfers. In both the cases, the product is consumed internally and not available for sale. Hence, their pricing also becomes critical.

2.4.5(a) Major Input Materials / Components Consumed:

Particulars	Current YearTwo			Previous Years Separately		
	Qty.	Rate	Amount	Qty.	Rate	Amount
1. Indigenous:						
(a) (specify)						
(b)						
(c)						
2. Self manufactured:						
(a) (specify)						
(b)						
(c)						
3. Imported:						
(a) (specify)						
(b)						
(c)						
4. Total						

Note : Details should be furnished in respect of major input materials each constituting at least 2% of the total raw material cost.

[Comments :

Para 5(a) of the Annexure to the Cost Audit Report [4.5(a) above] :

This para requires that details be furnished in respect of major input materials each constituting at least 2% of the total raw material cost. Major raw materials have been defined in terms of money i.e., 2% of total raw material cost. Therefore, a cheap input, even if consumed in huge quantities may not appear here unless its value exceeds 2% of total raw material cost. The requirement is to specify the consumption details of direct materials under the three broad categories i.e., separately under each category namely indigenous, self manufactured and imported. The total consumption shown under item 4 should match with the material consumption for the product under reference (prior to effect of work in progress)

The material ingredients having consumption value less than 2% in total consumption value should be aggregated and shown as "others" under each category. In case of self manufactured items, only the material content need be given since the total material consumption is to be furnished under this Para.

2.4.5(b) Standard/ Actual Consumption of Input Materials Per Unit

Particulars	Unit	Standard	Actuals		
			Current Year	1st Previous Year	2nd Previous Year
1. (specify)					
2.					
3.					

Note : Details should be furnished in respect of major input materials each constituting at least 2% of the total raw material cost for each major type/ variety/ size etc. of product under reference.

[Comments :

Para 5(b) of the Annexure to the Cost Audit Report [4.5(b) above]: This para requires comparison of per unit actual consumption of the major inputs indicated in para 4.5(a) above. This comparison is in terms of quantitative consumption per unit. This is a very important control ratio and will enable the cost auditor to analyze the production efficiency or otherwise during the period under audit as compared to previous two years or as compared to standard requirements to form his opinion/suggestions to be indicated in the cost audit report.

2.4.6 Break-Up of Cost of Input Materials Imported During the Year

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. FOB Price in foreign currency rupees			
2. Insurance & freight			
3. Customs duty			
4. Clearing charges			
5. Inland freight			
6. Other expenses			
7. Total			

Note : Details should be furnished in respect of major input materials each constituting at least 2% of the total material cost.

[Comments :

Para 6 of the Annexure to the Cost Audit Report [4.6 above]: *This para seeks to analyze the cost of major imported materials, which can be easily compared with cost of comparable indigenous material, if any available. This type of authentic data shall enable the Government to look into the reasons for higher prices by indigenous manufacturers and may help in rationalizing the duty structure, if required to make indigenous industry more competitive. Therefore, the information contained in this para can be used very usefully to the respective administrative ministry of the Government of India.*

This para requires break-up of the cost of major imported input materials each constituting at least 2% of the total material cost. The total material cost should be interpreted as aggregate cost of both imported and indigenous materials purchased / received during the period. If such figure is not readily available, consumption value may be considered.

The purchase details should preferably be given separately in case the same item of material input is imported with payment of duty and also without payment of duty under Government schemes {such as DEPB, Advance License Scheme, etc.).]

2.4.7(a) Power, Fuel And Utilities

Particulars	Current YearTwo			Previous Years Separately		
	Qty.	Rate	Amount	Qty.	Rate	Amount
1. Indigenous:						
(a) (specify)						
(b)						
(c)						
2. Self manufactured:						
(a) (specify)						
(b)						
(c)						
3. Imported:						
(a) (specify)						
(b)						
(c)						
4. Total						

Note :

Details should be furnished in respect of major items each constituting at least 2% of the total material cost.

[Comments :

Para 7(a) of the Annexure to the Cost Audit Report [4.7(a) above] : *This para requires details of major items of power, fuel and utilities, each constituting at least 2% of the total material cost. The total material cost should be interpreted as aggregate cost of both imported and indigenous materials purchased / received during the period. If such figure is not readily available, consumption value may be considered. This information is to be provided for every type of energy input for e.g., coal, electricity, furnace oil, wood, bagasse etc. and utilities such as steam, treated water, compressed air, etc. provided their individual value exceeds 2% of the total material cost.*

The above data relates to purchases/ receipts/ generation and not to consumption. Inter unit/ factory transfers, if any, should be shown separately. Cost data in respect of purchased power and self-generated power have to be given separately. In case of fuel, data may be obtained from the utility cost sheet maintained under the relevant Cost Accounting Record Rules.

Energy costs are becoming critical on account of rising prices of crude oil and other fuels. Supply is also shrinking in these cases, while demand is rising very fast. Amendment to section 217 of the Companies Act, 1956 calls for specific information in the Director's Report on this aspect in case of certain selected industries. It may be relevant to add here that all the specified industries are covered under Cost Accounting Records Rules. There are some products, for example, caustic soda, aluminum, where cost of energy inputs are even higher than that the cost of raw materials. Additionally in almost in every product there would be certain processes where energy inputs constitute a major element of cost. Rubber mixing in manufacture of tyres and tubes could be cited as an illustration. Therefore, comparison with earlier two years shall enable the auditor to comment on the impact on the competitiveness of the company, if any.

Calorific value of fuel (furnace oils, coal or gas etc.) needs to be reviewed. The purchase rates of these items vary on the basis of the quality. In case of power, the overall power factor needs to be reviewed by the Auditor and theoretically it should be near to unity.]

2.4.7(b) Standard/ Actual Consumption of Power, Fuel and Utilities in Terms of Quantity Per Unit of Production

Particulars	Unit	Standard	Actuals		
			Current Year	1st Previous Year	2nd Previous Year
1. (specify)					
2.					
3.					

Note : Details should be furnished in respect of each major type/ variety/ size etc. of product under reference.

[Comment :

Para 7(b) of the Annexure to the Cost Audit Report [4.7(b) above]: This para requires comparison of per unit actual consumption of major power, fuel and utilities in terms of per unit of production. This comparison is in terms of quantitative consumption per unit. If there are many types of products/output, such comparison has to be made for each type of product/output. If that is not possible, may be due to the type of output being innumerable, a common unit has to be identified and usages expressed to the base of that unit.

This per unit consumption assumes significance in view of rising prices of crude oil and other energy inputs. It will enable the cost auditor to not only analyze the efficiency or otherwise during the period under audit as compared to previous two years or as compared to standard requirements but also to form his opinion/suggestions about the competitiveness of the company to be indicated in the cost audit report.]

2.4.8 Salaries and Wages

Particulars	Current Year	1st Previous Year	2nd Previous Year
A. Quantitative Details :			
1. Direct Workers:			
a. Average number during the year			
b. Man days available			
c. Mandays actually worked for:			
(i) own production			
(ii) job work			
d. Reason-wise analysis of idle man-days (a-b) i) absenteeism ii) shortage of raw materials iii) power shortage/ failures iv) Others (specify)			

Particulars	Current Year	1st Previous Year	2nd Previous Year
2. Indirect Workers :			
a. Average number during the year			
b. Man days available			
c. Mandays actually worked for:			
(i) own production			
(ii) job work			
d. Reason-wise analysis of idle man-days (a-b) i) absenteeism ii) shortage of raw materials iii) power shortage/ failures iv) Others (specify)			
B. Cost Detail :			
1. Direct labour cost on production			
2. Indirect employee costs on production			
3. Employee costs on administration			
4. Employee costs on selling and distribution			
5. Other employees costs, if any (specify)			
6. Total employee costs			
7.a. Payments under any VRS scheme			
7.b. Amount provided during the year			

[Comments :

Para 8 of the Annexure to the Cost Audit Report [4.8 above] : *The above information should preferably be given only for the product under reference. If it is not possible to provide this information for the product under reference separately, it should be given for the Unit/ Factory as a whole. Under such circumstances, it should be clearly mentioned that the information provided refers to the entire unit/ factory.*

Direct workers include workers connected with the production cost centers (whose wages are normally charged as direct wages). Indirect workers include all workers employed by the company, who are not direct workers.

Para 4.8(A)(1)(a) : *The average number of workers employed daily should be calculated by dividing the aggregate number of attendances on working days (that is, man-days worked) by the number of working days in the year. In reckoning attendance, attendance by temporary as well as permanent employees should be counted and all employees should be included, whether they are employed directly or by or through any agency including contractors. Attendance on separate shifts (e.g. night and day shifts) should be counted separately). Days on which the factory was closed for whatever cause and days on which manufacturing process were not carried on should not be treated as working days. For seasonal factories, the average number of workers employed during the working season and off-season should be given separately.*

Para 4.8(b) : *Man days available may be calculated (illustrative) as follows:-*

Days available in the year	*365*
Less : Weekly Offs	*52*
Less : Paid Holidays	*8*
Less : Lay-off days	*Nil*
Man days available for one worker	*305*

(The above data is illustrative only. The number of paid holidays may vary from unit to unit). Similarly days available in the leap year shall be 366.

The difference between man-days attended and man-days actually worked will represent idle man-days. An illustration giving reasons for idle man-days is given as under:.

No of workers employed throughout the year		–	*100.*
No. of workers employed for 150 days		–	*50*
a.	*Man days available*	=	*100*305 + 50*150 = 38000*
b.	*Man-days attended*	=	*(from attendance records) 36500*
c.	*Absenteeism*	=	*38000-36500 = 1500*
d.	*Average number during the year*	=	*38000/305 = 124.59 say 125.*
e.	*Man-Days Actually Worked* *Reason-wise analysis of Idle Man-days*		*35700*
i)	*Absenteeism*		*1500*
ii)	*Shortage of raw materials*		*350*
iii)	*Power shortage/ failures*		*300*
iv)	*Others (specify)*		*150*
	Total		*2300*

Thus total idle man-days equal to available days less man-days actually worked.
(38000-35700 = 2300).

It may be noted that man-days available are the factory working days (other than continuous process industries where there are no planned production stoppages on account of weekly offs, etc.)]

2.4.9 Repairs And Maintenance

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Land and Building			
2. Plant and machinery			
3. Staff quarters and colony			
4. Others (to be specified asset category wise)			
5. Total amount			
6. Amount capitalized / deferred during the year			
7. Net amount (5 - 6)			
8. Deferred amount of earlier years,if any			
9. Total amount provided in the cost records (7 + 8)			

[Comments :

Para 9 of the Annexure to the Cost Audit Report [4.9 above] : *Repairs and Maintenance expenses incurred during the year should be specified. For this purpose Assets should be classified under different heads. Schedule VI Part I of Companies Act, 1956 (refer section 211 of the Companies Act) prescribes classification of fixed assets under different heads and the same classification should be followed. The classification of assets may also follow the heads as per the Fixed Assets and Depreciation Schedule forming part of Balance Sheet for the year under audit of the company.*

The heads of assets/ asset categories, specified under points 1,2,3 are to be considered only as illustrative.

As per Schedule VI Part II of Companies Act, 1956 (refer section 211) `Requirements as to Profit & Loss Account '– Expenditure incurred on Repairs to building and Repairs to machinery has to be shown separately. Normally the companies group the expenditure on all other heads of assets under the group `Repairs – Others'. Hence it may be necessary to segregate asset head wise, the expenditure grouped under `Repairs – Others', for proper presentation.

It is necessary that gross expenses on repairs and maintenance should first be stated in items 1 to 4 above. Out of the gross expenses on repair and maintenance, the expenses which are capitalized / deferred during the year should be shown under item No. 6.

Item No. 8 deals with amortization of deferred amount of earlier years, if any. It is advisable during the current year also to show the capitalization or deferral under different asset heads. This will simplify the workings during next year's cost audit.

As per point no. 9, net repair and maintenance charges for the year and amortization of deferred repairs & maintenance charges of the earlier year(s) should constitute the total cost of repairs and maintenance charges to be provided in cost accounts.

2.4.10 Fixed Assets Register and Depreciation

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Whether fixed assets register maintained cost centre-wise			
2. Method of providing depreciation			
3. Amount of depreciation under section 205(2) of the Companies Act, 1956 or any other relevant Act, as the case may be			
4. Amount of depreciation provided in the financial records			
5. Amount of depreciation absorbed in the cost records			
6. Shortfall / Excess, if any (3 and 5)			

Note : The impact of re-valuation of assets, if any, shall not be included.

[Comments :

Para 10 of the Annexure to the Cost Audit Report [4.10 above]: *This para require the proper and adequate records for assets, allocation of gross fixed assets, depreciation etc. employed for production activities of the product under reference etc., the basis on which depreciation is calculated and allocated or apportioned to various cost centers or activities and absorbed on such activities etc. Thus, it is imperative that for proper allocation of depreciation to activities / cost centers etc., the Fixed Assets Register must also be maintained in the similar manner.*

This para seeks confirmation from the cost auditor that the company maintains the cost center-wise fixed assets register and the method of providing depreciation.The Companies Act, 1956, Schedule XIV, prescribes two alternative methods for providing depreciation:

1. *The written down value method (WDV).*
2. *The straight line method (SLM).*

It is open to a company to adopt any of the said two methods of depreciation and apply appropriate rate of depreciation. Ministry of Corporate Affairs has also clarified that the rates contained in Schedule XIV should be viewed as the minimum rates, and, therefore, a company shall not be permitted the charge depreciation at the rates lower than those specified in the Schedule. However, if on the basis of a bonafied technological evaluation higher rates of depreciation are justified they may be provided with proper disclosure.

The depreciation rates are also prescribed under the provision of other Acts for example, the Electricity (Supply) Act, 1948 prescribes rates of depreciation for the units covered under the provisions of the said Act. Under this situation, the depreciation will be provided under the provisions of that particular statute. Hence, in point 3 the depreciation as computed under the provisions of Companies Act, 1956 or any other relevant Act is required to be given.

This para aims at disclosing the amount of under-absorption or over-absorption of depreciation in cost accounts. Therefore, point 4 above seeks to disclose the amount of depreciation provided in the financial records, whereas point 5 seeks to disclose the amount of depreciation absorbed in the cost records. The Note to the para clearly provides that the impact of re-valuation of assets, if any shall not be included.

On revaluation (value increase), of fixed assets, the asset values are enhanced and revaluation reserve is created. The depreciation is charged on the revalued value of the asset and this depreciation gets reflected in the asset schedule under the column "depreciation charges during the period". This gross charge of depreciation is debited to Profit & Loss Account. The excess depreciation on account of revaluation is reduced from this gross charge and the corresponding effect is given in revaluation reserve account. Thus the depreciation for the period which gets charged to Profit & Loss Account is only the "net" depreciation as if there was no revaluation of assets. The depreciation that is to be absorbed in cost accounts is the depreciation without consideration of revaluation of fixed assets and hence the same depreciation should be given under this Para.]

2.4.11 Gross Block, Depreciation and Lease Rent

Particulars	Gross Block	Depre-ciation	Lease Rent paid, if any	Total (b+c)	1st Previous Year	2nd Previous Year
	a	b	c	d		
Name of major cost centers/ products:						
(a) (specify)						
(b)						
Total						

Note : Excluding gross block of assets given on lease, if any.

[Comments :

Para 11 of the Annexure to the Cost Audit Report [4.11 above] :

The information required to be given for major cost centers or products. Depending upon the nature of industry, product lines, process of manufacture etc. the company should form the cost centers. The cost centers may be unique for a particular product or there may be cost centers rendering service to more than one particular product or there may be cost centers rendering service to more than one type of product. Depending upon the design of the cost system in a particular Unit/Factory, information should be given either cost centre-wise (when there are cost centers rendering service to more than one product line} or product-wise/cost centre-wise (when products are basis for division of factory and within the products cost-centers are formed}.

As per the note, it is required that the assets given on lease are to be excluded from the gross block. It naturally follows the figure of depreciation under col. (b) should also exclude the depreciation on assets given on lease. Similarly in case of assets taken on lease, the value of these assets should not be included in the gross block as these are not owned by the company and their lease rent shall be included under the column (c).]

2.4.12 Overheads

Particulars	Current Year		Two Previous Years Separately	
	for the product under reference	for factory as a whole	for the product under reference	for factory as a whole
1. Factory Overheads a) (specify) b)				
2. Administration OHs a) (specify) b)				
3. Selling Overheads a) (specify) b)				
4. Distribution OHs a) (specify) b)				

Note :The break-up under each head should be furnished in respect of major items constituting at-least 80% of the overhead cost under each head.

[Comments :

Para 12 of the Annexure to the Cost Audit Report [4.12 above] : *(i) This para seeks to furnish the break-up of total amount of functional overheads under various heads (items) complying with the condition of "at least 80%" of the total overheads cost under each head. Other heads/ items may be grouped under one group may be termed as "others". However it may be advisable to furnish as many heads as "practical" so that comparison over a period of time is more meaningful. The information also becomes more explanatory and useful.*

(ii) Overheads constitute a significant portion of total cost in any industry and is therefore an important element of cost. Controls over such costs particularly in the process of monitoring and responsibility accounting is an critical area in any organisation. It is, therefore expected from the cost auditor that he will comment on the amount of overheads like the basis of allocation/apportionment of cost collected to other cost centers or products in the light of accepted principles of cost accounting. The cost auditor has to ensure that overhead allocations to the product under reference are reasonable considering the total amount for a factory as a whole.

2.4.13 Research and Development Expenses

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Process development and improvement			
2. Existing product development			
3. New product development			
4. Others, if any			
5. Total amount			
6. Amount capitalized / deferred during the year			
7. Net amount (5-6)			
8. Deferred amount provided in the years, if any			
9. Total amount provided in he cost records (7 + 8)			
10. Amount paid to related parties			

[Comment :

Para 13 of the Annexure to the Cost Audit Report [4.13 above] : *This para seeks to furnish the break-up of total amount of research and development expenses under various heads to know the type of R&D activities carried out by the company i.e., how much on existing product development and how much on new product development etc. In case, the expenditure incurred on the development of new product is successful or the development of existing product or process etc. is technically and commercially feasible and the company has adequate resources to market the product, the company may opt to capitalize the same or defer the cost related to R&D activities to future periods (point 6).*

In view of above, It is necessary that gross expenses on research and development expenses should first be stated in items 1 to 4 above. Out of the gross expenses on research and development, the expenses which are capitalized / deferred during the year should be shown under item No. 6. Item No. 8 deals with amortization of deferred amount of earlier years, if any. It is also advisable during the current year to show the capitalization or deferral under respective heads. This will simplify the workings during the next year.

Net amount of research and development expenses at sl. No. 7 for the year and amortization of deferred research and development expenses of the earlier year(s) should constitute the total cost of research and development expenses to be provided in cost accounts. Point 10 above seeks to furnish the amount paid to related parties out of the total amount spent on research and development during the year. The cost auditor shall have to ensure that these transactions are also disclosed in para 26 related to "Related Party Transactions' and these transactions normal price or are at arm's length price. These expenses constitute a significant portion of total cost in some of the industries like Bulk Drugs/Formulations etc.

2.4.14 Royalty and Technical Know How Charges

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Royalty on production/ Sales			
2. Lump sum payment of royalty, if any			
3. Technical know how charges			
4. Others, if any			
5. Total amount			
6. Amount capitalized/ deferred during the year			
7. Net amount (5-6)			
8. Deferred amount of earlier years, if any			
9. Amount provided in the financial accounts (7+8)			
10 Amount absorbed in the cost records			
11 Shortfall/ Excess, if any			
12 Amount paid to related parties			

Note : The details should be furnished in respect of each agreement separately.

[Comment :

Para 14 of the Annexure to the Cost Audit Report [4.14 above] : *This para seeks to furnish the break-up of total amount of royalty and technical know-how charges to understand the mode of royalty charges paid by the company, if any i.e., how much on production/sales and how much as lump sum payment of royalty etc. The technical know how charges are required to be indicated separately. These details are to be furnished in respect of each agreement separately. In case, the expenditure incurred on the technical know how charges for the development of new product or the development of existing product or process etc. is successful and technically and commercially feasible, the company may opt to capitalize the same or defer these costs to future periods (para 6).*

In view of above, It is necessary that gross expenses on royalty and technical know-how charges should first be stated in items 1 to 4 above. Lump sum payments of Royalty (Point-2), Technical know how charges (point 3) are generally considered as a "consideration for the transfer of technology know-how" or other abstract benefits flowing from the transferor to the transferee company. However these payments are sometimes split in different instalments or stage payments to facilitate the progressive payments linked to the physical progress of the project. Out of the gross expenses on royalty and technical know-how charges, the expenses which are capitalized / deferred during the year should be shown under item No. 6. Item No. 8 deals with amortization of deferred amount of earlier years, if any.

Net amount of on royalty and technical know-how charges at sl. No. 7 for the year and amortization of deferred royalty and technical know-how charges of the earlier year(s) at Sl. No 8 should constitute the total cost of royalty and technical know-how charges to be provided in books of accounts. Point 10 above seeks to furnish the amount absorbed in the cost accounts and point 12 seeks to disclose the amount paid to related parties out of the total amount *spent on royalty and technical know-how charges during the year. The cost auditor shall have to ensure that these transactions are also disclosed in para 26 related to "Related Party Transactions' and these transactions are at normal price or arm's length price.*

The Note below this Para directs to furnish the information separately for each agreement. If the same agreement covers both products covered under Cost Audit and products not covered under Cost Audit, information in relation to both should be given separately.

2.4.15 Quality Control Expenses

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. ISO number, if any			
2. Name of certifying agency			
3. Salaries & Wages			
4. Other direct expenses			
5. Others, if any (specify)			
6. Total amount			

[Comment :

Para 15 of the Annexure to the Cost Audit Report [4.15 above]: *Quality has a meaning at all the stages of production and means any characteristic of the materials, parts, assemblies, process and processing conditions, and products including packing, thus embracing all sphere of production. This para seeks to indicate the expenses on quality control and yearly trend i.e., whether the company is giving increasing importance to quality control or otherwise.*

ISO is an international standard having a serial number. It is issued by International Standards Organisation. It is a quality system (quality management) oriented and not merely only product quality based. It is universal and unique for any product and service. The ISO quality assurance standards, were produced first time in 1987 and the updations are carried out continuously. Certification of conformity to ISO is another universal phenomenon. National schemes for accreditation of certification bodies are in operation. In India also there are lot of certifying agencies in operation. After carrying out audit, the certifying authorities will give an ISO certificate. Sl. No. 1 and 2 of the para require information on ISO certification, which emphasizes the role of ISO for Indian industries and its recognition in the statutory Cost Audit Report.

Quality Control may actually relate to various functions and activities such as inspection of incoming material, inspection during the progressive stages of manufacture of the product, inspection on completion of the finished product etc. The company may establish cost centers suitable to its design of the costing system. If quality control activity is distinctly segregated by forming different cost centers, it may get reflected under the corresponding functional overheads such as materials related overheads. In fact, the cost inspection of incoming material, can be added to the relevant material cost also, if separately available. The quality control expenses relating to production may be presented as a separate cost head in the costing proforma, however, if it is not so, the entire expenditure on quality control may be presented as a separate cost head in the costing proforma. The PROFORMA representing the 'Statement showing the cost of production, cost of sales, sales realization and margin in respect of product under reference produced during the year / period', requires the "Quality Control" expenses to be shown separately at Sl. No.14 of said proforma. Thus Quality Control expenses are required to be shown separately.

2.4.16 Pollution Control Expenses

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Effluent treatment			
2. Control of air pollution			
3. Control of ash pound/ ash mound			
4. Penalty, if any			
5. Others, if any			
6. Total amount			

[Comment :

Para 16 of the Annexure to the Cost Audit Report [4.16 above]: *This para provides the break-up of total amount under the head Pollution Control Expenses with different sub-heads like Effluent Treatment, Control of Air Pollution and Control of Ash Pound etc. This list may be taken as illustrative only. This para seeks to indicate the expenses on pollution control and yearly trend i.e., whether the company is giving increasing significance to pollution control or otherwise. However, it may added here that any reduction in the yearly trend could be due to installation of any pollution control equipment machinery also. Therefore Cost Auditor may ask for complete details before firming up his views.*

Sl. No. 1 to 3 of this para require the expenses incurred for controlling various types of pollutions to be shown and the list is only illustrative. The Sl. No. 4 requires the amount of penalty, however small it may be, has to be disclosed separately. Thus any irregularities, non-compliance or contraventions of any of the Acts dealing with pollution for which the company had to pay penal charges/penalties require a separate disclosure. This shows the importance attached to pollution control as no company would like to show having violated any pollution control related rule. This is world wide phenomenon, where violators of environment are looked down by the society.

2.4.17 Abnormal Non-Recurring Costs

Particulars	Current Year	1st Previous Year	2nd Previous Year
1.(specify)			
2.			
3.			
Total			

[Comment :

Para 17 of the Annexure to the Cost Audit Report [4.17 above]: *Generally, all expenditures of recurring nature are considered as "normal", even though they may not be linked to the production. For example 'off season' salary and wage paid to the employees in Sugar Industry. Abnormal non-recurring costs are charged on the company's profit but do not form part of the product cost. This is based on the principal that product cost should not be vitiated by abnormal costs and hence abnormal costs have to be shown separately in the cost audit report. This para seeks to disclose such abnormal costs. It is imperative from this para that the company has to make a self declaration of abnormal non-recurring costs. The following characteristics are required before including any figure under this para:*

(a) *The cost should be "abnormal" and*

(b) *The abnormal cost should be nonrecurring.*

In other words even if any particular cost is of abnormal nature, but if it is of recurring nature, it need not be shown under this para. This may be due to the fact that the continuous occurrence of an event makes the abnormal cost look like a normal cost not attracting mentioning thereof under this para e.g. 'off season' salary and wages paid to employees in Sugar Industry..

It may be clarified here that defining a certain expense as 'abnormal' expense is not only a question of fact, but also a matter of judgment. Moreover, an expense to be termed as 'abnormal', has to pass the test for both 'principle' and 'materiality' i.e., an expense having a very minor or insignificant amount is generally not termed as 'abnormal', even though, it may have some merit principally.

Illustrations :

The following are the illustrations of the situations when abnormal costs may arise–

(a) *Strikes, lockouts*

(b) *Scarcity of raw materials*

(c) *Major breakdowns in the plant*

(d) *Substantial power cuts*

(e) *Serious accidents*

(f) *Gross underutilization of capacity may give rise to abnormal costs which may also be reported under this para.*

Situations under normal conditions giving rise to abnormal non-recurring costs. The situations may arise due to –

(a) *Absorption of new technology*

(b) *Introduction of new products*

(c) *Commissioning of new machines or plants*

In the above cases, the production may not yet be stabilized and considerable wastages of material inputs may be incurred as the organization may still be in the beginning of learning curve. Similarly the company may be incurring heavier warranty expenses in respect of its new products.

2.4.18(a) Non-Moving Stock (at the end of the year) :

Particulars	*Current Year*	*1st Previous Year*	*2nd Previous*
a1 Total direct material consumption			
a2. Closing stock of direct material			
a3. Value of non-moving stock			
a4. Percentage of a3 to a2			
b1. Total indirect material consumption			
b2. Closing stock of indirect material			
b3. Value of non-moving stock			
b4. Percentage of b3 to b2			
c1. Work-in-progress			

Particulars	*Current Year*	*1st Previous Year*	*2nd Previous*
c2. Closing stock			
c3. Value of non-moving stock			
c4. Percentage of c3 to c2			
d1. Finished Goods			
d2. Closing stock			
d3. Value of non-moving stock			
d4 ercentage of d3 to d2			
e1 Total :			
e2 Closing stock			
e3 Value of non-moving stock			
e4 Percentage of e3 to e2			

[Comments :

Para 18(a) of the Annexure to the Cost Audit Report [4.18(a) above] : This para provides the analyses of non-moving stock at the end of the year and is aimed at disclosing the composition of obsolete or other non-moving materials in overall inventory. These stocks usually have low value and may result in reduction in Net Worth/Profits, if written off. This information is very useful information for the stakeholders including banks and Financial Institutions. The information should be compiled at item level for each items of stock. The value should be as disclosed in the cost accounts of the company. The information may be further grouped in various categories suitable for analysis. The basis adopted for Cost Auditor must review the causes explained by the company for non-movement of the items. He should also review the policy of the company regarding determination of non-moving items and analysis of non-moving items with written off stocks for defining categories should be disclosed.

2.4.18(b) Written Off Stock (during the year)

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Direct Materials (Raw Material & Components etc)			
2. Indirect Materials			
3. WIP			
4. Finished Goods			
Total			

[Comment :

Para 18(b) of the Annexure to the Cost Audit Report [4.18(b) above] : *This para provides the break-up of written off stock during the year The information should be compiled at item level for each of the item for which the writing-off action had been taken during the period under consideration. The information may be further grouped in various categories suitable for analysis. The basis adopted for defining categories should be disclosed.*

Auditor should review –

- *The causes explained by the company for write-off of the items.*
- *The action taken by the company for recovery of realization value/residual value.*
- *The accounting policy of the company for writing off of various categories of inventory and the consistency in the policies.*

2.4.19(a) Inventory Valuation (at the end of the year) :

Particulars	Basis of valuation	Current Year			Previous Year		
		Quantity (unit)	Rate (Rs.	Amount (Rs.)	Quantity (unit)	Rate (Rs.)	Amount Rs.
Input material:							
(i) Purchased							
- Indigenous							
(ii) Self manufactured							
2. Chemicals, additives and consumables							
3. Stores and spares							
4. Packing materials							
5. Tools and implements and Jigs, Dies and Fixtures.							
6. Work-in progress: (i) material cost (ii) conversion cost (details to be given)							
7. Finished goods: (i) unpacked (ii) packed							
8. Scrap/ wastage							
9. Others, if any							
10. Total value of inventory as per cost accounts							
11. Total value as per financial accounts							
12. Reasons for major difference, if any							

Notes :

(1) In respect of item at Sr. No. 1 and 6 details be furnished in respect of each major input material constituting at least 2% of the total material cost.

(2) In respect of items at Sr. No. 2 to 5, total amount be given without any quantitative details.

(3) Give in brief the method of inventory valuation system indicating the elements of cost included therein and the extent thereof.

(4) Capital work-in-progress to be shown separately.

[Comments :

Para 19(a) of the Annexure to the Cost Audit Report [4.19(a) above] : *This para provides the break-up of inventory as per cost records at the end of the year along with basis of valuation of each element of closing inventory. This total value of inventory is then compared with financial accounts along with major reasons for differences, if any. It may be clarified that valuation of inventory is guided by Accounting Standard-2. However, sometimes there may be situations when valuation of inventories as per cost accounts differs from the valuation of inventories as per financial accounts as companies may opt to value inventories by adopting the principles which may be divergent to that recommended by AS-2. For example the high value durable tools may be valued on a basis different in cost accounts as compared to financial accounts. Similarly, other items such as dies/moulds/patterns may be valued in financial accounts on the basis of their useful life in number of years whereas the same may be valued on the basis of their useful/productive capacity expressed in terms of number of units it can produce. In financial accounts, finished goods inventories are valued inclusive of Excise Duties. In cost accounts, the stock has to be valued at Cost and Excise duty and taxes etc. are required to be excluded. These variations need to be disclosed under this para.*

The Note (1) requires that details are to be furnished in respect of each major input material constituting at least 2% of the total material cost i.e., w.r.t. input materials, chemicals etc. stores and spares, packing materials, tools and implements etc. and work-in-progress. Here 2% of material cost should be interpreted in relation to inventory value at the end of the year and not the consumption value for the year under reference.

The Note 3 to the para further requires that there are two requirements namely (i) brief note on method of inventory valuation is to be given; and (ii) elements of cost and the extent thereof in inventory valuation needs to be given.

Capital work in progress is not a part of inventory of revenue nature and as such it shall not be considered as indicated vide Note (4).

This para read with Para 18(a) (Non-Moving Stock at the end of the year) and para 18(b) will better indicate the composition of overall inventory.

2.4.19 (b) Physical Verification of Inventory

Sr. No.	Particulars	Periodicity	Shortage Value (Rs.)	Excess Value	Net (Rs.)
1	Raw material				
2	Chemicals, additives, consumables etc.				
3	Stores & Spares				
4	Packing Materials				
5	Tools & Implements				
6	WIP				
7	Finished Goods				
8	Scrap, Wastage				
9	Total				

[Comments:

Para 19(b) of the Annexure to the Cost Audit Report [4.19(b) above] : *This para requires disclosing the periodicity of verification of various elements of inventory and appears to be more focused and result oriented. It gives very important information as to the system of physical verification actually in practice in company. The periodicity of verification generally depends on "ABC Classification" of inventory items and as such it would be more appropriate to give a brief write up on periodicity of verification for different items of inventory. The shortage/ excess value and the net value should be the summation of excess value, shortage value and the net value of the various counts conducted during the period of accounting. This para shall also form the basis of reporting by the financial auditor under MAOCARO. Cost Auditor should also comment on the adequacy of the steps taken.*

This information should be compiled at item level for total inventory and the procedure and authorization for approval to adjust excess/shortage should be disclosed by the company. The corrective measures taken by the company such as internal enquiry held, improvement in present procedures and checks to avoid future variations should be disclosed by the company especially in case of very high variations.]

2.4.20 Sales of the Product Under Reference

Particulars	Current Year			Previous Year		
	Qty.	Rate	Amount	Qty.	Rate	Amount
1. Purchased goods:						
a) (specify)						
b)						
2. Loan license basis:						
a) (specify)						
b)						
3. Own manufactured						
a) (specify)						
b)						
4. Total sales						

Notes :

(1) Above details shall be furnished for major product groups/ varieties.

(2) Separate details shall be furnished for indigenous sales and export sales.

[Comments :

Para 20 of the Annexure to the Cost Audit Report [4.20 above] : *This para read with Note (1) requires sales details of the product under reference to be furnished for major product groups/varieties. The product groups/ varieties may be interpreted as "consolidated" information of the products forming a uniform or homogeneous group or a variety. Groups or varieties are normally formed based on some common characteristics, features, production process, application or use of the product, with reference to excise classification, etc. However, no strict rules can be framed for constituting a "group" or a "variety". Whatever may be the grouping followed by the company, it must be meaningful and consistent. Most of the companies normally "group" their products for the purpose of internal reporting or MIS purposes. A parity may be preferred in grouping of the products. Note (2) further requires that separate details should be furnished for indigenous sales and export sales.*

The company has to compile the proformae relating to cost of production/sales etc. under the respective Cost Accounting Record Rules. Since the information relating to sales is already appearing in the proformae compiled by the company relating to cost of production/sales, etc. under the respective Cost Accounting Records Rules, the same should not be repeated proforma-wise under this para. The value (amount) to be furnished must be the net sales figure, i.e. sales realization excluding duties and taxes. In any case the quantitative and value information has to be consolidated from the Proformae.

The Note (2) to Para 21 regarding margin per unit of output requires that margin per unit details should be furnished separately where the product (such as sugar, bulk drugs, formulations, etc.) is sold at different prices in accordance with government policy. Since, margin per unit is linked to sales realization, the required information regarding differential sales should be preferably given under also para also.

There may be three types of situations, which can be termed as Export sales :

(a) Transactions in which goods sold leave the country and the sales value is realized/realizable in foreign currency;

(b) Goods sold leave the country and the sales value is realized realizable in Indian currency.

(c) Transaction in which the goods sold do not leave the country and the sales value is realized in Indian currency i.e. rupees (deemed exports); and

2.4.21 Margin Per Unit of Output

Particulars	Current Year *			Two Previous Years Separately		
	Cost of Sales	Sales realisation	Margin (Rs.)	Cost of Sales	Sales realisation	Margin (Rs.)
1.Purchased goods:						
(a) (specify)						
(b)						
(c)						
2.Loan license basis:						
(a) (specify)						
(b)						
(c)						
3.Own manufactured:						
(a) (specify)						
(b)						
(c)						

Notes:

(1) Above details shall be furnished for major product groups/ varieties.

(2) Separate details shall be furnished for margin on indigenous sales and export sales. Where the product (such as sugar, bulk drugs, formulations, etc.) is sold at different prices in accordance with government policy, sales realisation and margin on such product at different prices shall be shown separately along with quantity and value.

[Comment :

Para 21 of the Annexure to the Cost Audit Report [4.21 above] : This para read with Note (1) requires details regarding margin per unit of output for the product under reference to be furnished for major product groups / varieties. It may be clarified that the information relating to margin per unit is appearing in the Proformae also. Therefore, the same should not be repeated proforma-wise under this para. Instead, the homogeneous group wise consolidated figures should be indicated in this para. The margin should be given as per proforma Sr. No. 35 Total Margin (including export benefits).

The groups/varieties for furnishing Margin both on indigenous sales and export sales should be the same as adopted in Para 20 above. Moreover, whatever may be the grouping followed by the company, it must be meaningful and consistent. Note (2) further requires that separate details should be furnished for indigenous sales and export sales.

The Note (2) to the Para 21 further requires that margin per unit details should be furnished separately where the product (such as sugar, bulk drugs, formulations, etc.) is sold at different prices in accordance with government policy. This information is very important from the point of view of the Government/ Administrative Ministry to ensure that statutory prices are reasonable and are not causing losses to the Industry.

2.4.22 Competitive Margin Against Imports

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Name of product			
2. Estimated demand of the product in the country *			
3. Total production in the country *			
4. Quantities imported in the country **			
5. Total production by the company			
6. %age share of the company in total inland production (item 5/ item 3)			
7. a. Cost of production per Unit (Inland sale)			
b. Cost of Sale per Unit (Inland sale)			
c. Cost of production per Unit (Export sale)			
d. Cost of Sale per Unit (Export sale)			
8. Quantity of the product imported by the company **			

Particulars	Current Year	1st Previous Year	2nd Previous Year
9. FOB value of quantity imported by the company **			
10. Weighted average FOB rate for quantities imported by the company (item 9/ item 8) **			
11. FOB value of quantity imported in the country **			
12. Weighted average FOB rate of quantities imported in the country (item 11/ item 4)**			
13. Competitive margin (item 12 less item 7(A)) **			
14. Major exporting countries (other than those listed in item 4 above)			
15. (A) Total import duty paid by the by the company (net of CENVAT) (B) Weighted average rate of import duty paid (item 15(A)/ item 8)			
16. Bound rate of duty under WTO agreement.			

Notes :

(1) * Indicate the source of information.

(2) ** Country-wise details should be furnished in respect of major countries covering at-least 80% of the total and balance should be shown under the head "Others".

[Comment:

Para 22 of the Annexure to the Cost Audit Report [4.22 above] : *This para is one of the salient features of the new cost audit report rules and the information contained therein is very useful for all the stakeholders in this era of globalization. In fact, Trade Associations, Chambers of Commerce, Ministry of Commerce etc. everybody can use this authentic information very usefully to enable government to not only promote the Indian exports but also to protect the Indian Industry from unlawful dumping by foreign units. This para also acts as a whistle blower for the Board of Directors, if the competitive margin is very low or in negative.*

This paragraph needs lot of information, most of which may not have any one authentic source. Therefore, Note (1) provides that the source of information be indicated. It was envisaged that information w.r.t. company's own performance shall be factual and authentic. Other information like total demand in the country, FOB value of imports in the country etc. can be subsequently worked out taking into consideration information available from all the resources as available in the cost audit reports.

It is further suggested that product description as mentioned in Harmonized Scheme for Customs Classifications may be taken as guide for the purpose of bringing uniformity in reporting by different companies and for ensuring ease of reporting details in this Paragraph. Use of this classification should be made keeping in view compatibility with Cost and Price data in use in the company, trade practices and data reporting elsewhere in the Cost Audit Report.

Note 2 to the paragraph requires that country-wise details should be furnished in respect of major countries covering at-least 80% of the total and balance should be shown under the head "Others". In fact, this para has been drafted envisaging that the entire information shall be available at one place in one table. Therefore, major country-wise information at Sl. No. 8 to Sl. No. 13 should be harmonized in such a way that entire information is available in one page only to make this more useful and meaningful. However, if any additional clarification is required to be given, the same may be given on separate sheet with proper indexation and giving cross reference both in the table of para 4.22 and also on the attached details.]

2.4.23 Value Addition and Distribution of Earnings

Particulars	Current Year	1st Previous Year	2nd Previous Year
A. **Value Addition** (for the product product under reference)			
1. Gross sales (excluding returns)			
2. Less: excise duty etc.			
3. Net sales			
4. Adjustments in stocks			
5. Less: cost of bought out materials and services			
6. Value added			
7. Add: income from any other other sources			
8. Earnings for distribution			
B. **Distribution of earnings to:**			
1. Employees as salaries and wages, retirement benefits etc.			
2. Shareholders as dividend			
3. Retained funds as depreciation etc.,			

***[Comment :** Para 23 of the Annexure to the Cost Audit Report [4.23 above] : The term "Value Addition" has been defined under the Cost Audit Report Rules as the difference between the net output value (net sales adjusted for work-in-progress and finished goods stock) and cost of bought out materials and services for the product under reference. Moreover, the Para 23(a) of the Annexure itself prescribes the method for calculation of value addition. Value added has to be established with reference to activity carried out during the year. This is to be established by addition of closing stock and reduction of opening stock, the net effect of which is to be considered under Point 4. Thus after considering the effect of adjustments in stocks, total input cost plus margin for the year gets established. However, there seems to be no row for this. Therefore, a new row 4(a) can be added to show the figure of total input cost plus margin Cost of bought out materials at point 5 above, should include all types of materials such as raw materials, components, packing materials, process materials, utilities, stores and spares, consumables, etc. In other words, all procurements, in whatever form, which are purchased from outside sources should be taken as bought out materials. The materials which are received from other units/factories (inter unit transfer) should also be treated as "bought out materials". The cost of these bought out materials and services is to be deducted to arrive at value added. The term value addition should be interpreted to mean the wealth creation due to the efforts or activities carried out* *by the company and hence only those items or costs, which are totally out-sourced and where no efforts of whatsoever nature are put in by the company should only be excluded as cost of bought out materials and services.*

Part B : Distribution of earnings : Points (1) to (4) deal with specific appropriations of the earnings. Point (5) is intended to specify residual appropriations items like Transfers to Reserves, addition to Profit & Loss Account balance (Profit), Interest and Financial charges etc. will be the major items to be shown separately. After showing these items separately, any other item such as royalty, technical know-how fee, etc., if significant, should be shown separately and the balance should be shown as "miscellaneous items".

When company is having only one unit manufacturing only the product under reference, the full details as contemplated by the Para can be given. When the company is having more than one unit and/or producing both product under reference and other product(s), the exact amounts relating to items B(2) and B(4) cannot be furnished since appropriations are made of the consolidated profit earned by the company from all the units. Under such circumstances information as per items B(2) and B(4) cannot be given separately for the product under reference.

From the drafting of this Para, it appears that the intention is to collect information regarding the taxes and duties paid by the business to the Government. It is also advisable that such revenue generation for the Government by the company should explicitly be presented preferably in form of the following table to be added as Part C of this Para 23 as under:

C. Taxes & Duties.

Sl No	**Particulars**	**Current Yr.**	**1st Prev. Yr.**	**2nd Prev. Yr.**
1.	Excise duty paid from PLA			
2.	Cess			
3.	State Excise Duty			
4.	Customs Duty			
5.	Service Tax			
6.	Central Sales Tax			
7.	Local Sales Tax			
8.	Electricity Duty			
9.	Octroi/Entry Tax			
10.	Works Contract Tax			
11.	Income Tax			
12.	Wealth Tax			
13.	Other (specify)			

2.4.24 Financial Position And Ratio Analysis

Sr. No.	Particulars	Current Year			Two Previous Years Separately		
		Product under reference	Factory as a whole	Company as a whole	Product under refrence	Factory as a whole	Factory as a whole
1	Capital employed						
2	Net Worth						
3	Profit						
4	Net Sales						
5	Operating expenses as a percentage of Net Sales:						
6	Profit as %age of capital employed						
7	Profit as %age of net worth						
8	Profit as %age of net sales						
9	Profit as %age of value addition						
10	Value addition as a %age of Net Sales						
11	Current assets to current liabilities						
12	Net working capital in terms of number of months of cost of sales excl. depreciation.						
13	Debt-equity ratio						
14	Raw materials stock in terms of number of months of consumption						
15	Stores & spares stock in terms of number of months of consumption						
16	Work-in-progress stock in terms of number of months of cost of production						
17	Finished goods stock in terms of number of months of cost of sales.						

Notes :

(1) Figures given for the **company as a whole** against serial number 1, 2, 3 and 4 shall be, duly reconciled with the financial accounts of the company

(2) The figures given **for the product** against serial number 1, 2, 4 and 5 shall be, duly reconciled with the cost accounts of the company.

(3) Figures given for the **factory as a whole** against serial number 1, 3, and 4 shall be, duly reconciled with the financial accounts of the company.

[Comments :

Para 24 of the Annexure to the Cost Audit Report [4.24 above] : *This para provides a comprehensive summary of the financial status or health of the company. A mere glance at this para gives an indication regarding the financial viability of the product vis-à-vis with that of factory as a whole and to that of Company as a whole as all the figures have been sought separately w.r.t. 'Product under reference', 'Factory as a whole' and Company as a whole'. If any company has only one factory and manufactures and sells only one product, the figures to be indicated in all the three columns shall be same. Where the activity of the company is manufacturing and marketing of product under reference as well as products not covered under Cost Audit, assessment of capital employed for the product under reference is necessary.*

The Note (1) at the end of this para specifies that the figures for capital employed, net worth, profit and net sales of the company as a whole are to be duly reconciled with the financial accounts of company for the relevant period. Similarly, Note (2) requires that figures for capital employed, net worth, net sales and each of the operating expense for the product under reference are to be duly reconciled with the cost accounts of company for the relevant period. The Note (3) at the end of this para, specifies that capital employed, profit and net sales are to be duly reconciled with the financial accounts of company for the relevant period. Therefore, it is necessary that figures are based on the audited financial statements for the year, i.e. Balance Sheet and Profit and Loss Account i.e., one more reason for enhancement in number of days available to the company from 90 days to 135 days. Moreover, audited figures give more authenticity to the cost audit report. In any case, Board of Directors may approve the audited figures only.

Sr. No. 1 (Capital Employed): The term 'Capital Employed' has been defined in explanation (a) as average of fixed assets at net book values (excluding intangible assets, effect of revaluation of fixed assets, capital works-in-progress) and current assets minus current liabilities and provisions existing at the beginning and close of the financial year. In other words, capital employed has to be calculated as under:

Total Fixed Assets net of depreciation	**
Less : Intangible Assets (Goodwill, Patents, know-how, Trade marks, etc.)	**
Less : Revaluation Reserve	**
Less : Capital work-in-progress, if included in above	**
Add : Current assets, loans and advances	**
Less : Current Liabilities and Provisions	**

All the above referred figures shall be average of opening and closing figures of the financial year.

Capital employed for the product under reference :

Where the activity of the company is manufacturing and marketing of the product under reference as well as products not covered under the cost audit, assessment of capital employed for the product under reference is necessary. As already stated above, Capital employed has been defined as the sum of net fixed capital and working capital.

Fixed capital for product under reference may be taken as the sum of specific net fixed capital and share of common net fixed capital. Specific fixed capital refers to net fixed assets exclusively used for the product under reference.

Common fixed capital may be grouped according to the cost centers with which they can be identified. Amount of common fixed capital may be apportioned on a reasonable basis to the different products of the company, including that of product under reference, e.g. Net fixed assets relating to utilities may be apportioned on the usage of such utilities. Thus the book value of boiler and its related assets may be apportioned to the products on the basis of steam usage of different products.

Similarly, specific working capital would refer to inventories, debtors and creditors which can be identified with the product. Common working capital may be apportioned on a reasonable basis, e.g. the inventory of coal may be apportioned to the products on the basis of actual steam usage, if the coal is entirely for the boiler.

The extent to which the apportionment is to be refined would depend on various factors like the size of the organization, its activities, other complexities and the percentage the product under reference constitutes in the total activities organization. Efforts must be however, made to make apportionment fair and reasonable.

Fixed Assets: *Fixed Assets are the assets held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business. Thus, whether a particular asset is a fixed asset, is determined not by the nature of said asset but by the purpose, for which it is held the said business. Therefore, 'Leasehold' assets are also shown as 'fixed assets' in the balance sheet. Similarly, fixed assets acquired on hire purchase are also shown at their cash value despite the fact that the company does not have the legal ownership of these assets.*

Current Assets: *Current Assets are cash, cash equivalents and other assets that could be converted to cash in less than one year. These assets are very important to business as source of funds for day to day operations. Current assets inter-alia include the stores and spare parts, loose tools, stock of raw materials, work-in-progress, finished stocks, sundry debtors, cash in hand and bank balance.*

Current Liability : *Liabilities which fall due for payment in a relatively short period of say normally less than twelve months, e.g. creditors, bank overdrafts, current taxation and dividends payable, also that part of long term loans due for repayment within one year.*

Long-term Liabilities : *Liability due for settlement more than 12 months after the date of the Balance Sheet.*

Notes :

(a) the company should keep cost centre-wise asset register to identify factor-wise fixed assets, as well as Fixed assets for activity under audit and other activity.

(b) In case of assets under for common use, suitable basis should be used to arrive at its value under required classification.

(c) Investment outside business in the nature of investment in subsidiary companies, investment in a unit/division of the company, investments made purely to deploy surplus funds to earn financial incomes are not to be considered.

(d) Current assets, loans and advances should exclude capital advances. Similarly, it should exclude items which are not meant for activity under consideration, e.g. large idle funds lying in current accounts.

(e) For classification of current assets/current liabilities, if they are not available separately for each factory and also for activity under cost audit, suitable ratios may be used for its proper classification.

Sr. No. 2 (Net Worth) : *The term 'net worth' has been defined as share capital plus reserves and surplus (excluding revaluation reserve) less accumulated losses and intangible assets. In other words, it has to be calculated as under :*

Share Capital (paid up capital – equity and reference	**
Add : Reserves and Surplus	**
Less : Revaluation Reserve	**
Less : Intangible Assets	**
Less : Profit & Loss Account (Dr. balance)	**
Less : Misc./deferred expenditure (balance sheet items)	**

Sr. No. 3 (Profit) : *The term 'profit' has been defined as operating profit after providing for depreciation and all other expenses except interest on borrowings including debentures but before providing for taxes on income. It has to be calculated as under:*

Profit before Tax (PBT)	**
Add : Interest on borrowings including debentures (net of interest income)	**
Add : Any other expense which is neither normal nor of recurring nature	**
Less : Interest, dividend and rent income on investments outside the business.	**
Less : Depreciation for the year, if not provided in the accounts	**
Less : Capital gains	**
Less : Any other income which is neither normal nor of recurring nature.	**

Sr. No. 4 : Net Sales – *The term 'sales' means sales excluding sales returns, excise duties, sales tax, octroi, other local taxes and expenses refundable/recoverable from buyers/customers. It has to be calculated as under:*

Sales (Net of sales returns)	**
Less : Excise Duty	**
Less : Sales Tax	**
Less : Octroi and other local taxes	**
Less : Sale of Waste, Scrap, etc. (if included in sales)	**
Less : Packing, Transport & Other charges, separately recoverable from the customer (if included in sales)	**

***Sr. No. 5 : Operating expenses as a percentage of Net Sales –** The operating expenses are the expenses associated with running of a business in the normal course. This ratio indicates the 'operating efficiency' i.e., operating expenses as a percentage of net sales. In other words, it indicates the margin available to the company. The rules require the Operating expenses as (a) to (i) to be adopted from consolidation of Proforma figures. Expense ratios are very important to determine the efficiency of any company especially as compared to earlier years. A decreasing ratio would generally indicate the increasing efficiency and larger profits.*

***Sr. No. 6: Profit as percentage of Capital Employed –** It is a measure of the return that a company is realizing from its capital employed. It is commonly used as a measure for 'profitability' for comparing performance. This ratio shows how well a company generates cash flow relative to capital employed. The company is said to be creating value, when the return on capital employed is greater than the cost of capital. The value is being destroyed, if the return on capital employed is less than cost of capital. It may be added here that profit is a period figure, whereas capital employed is a point figure. Hence the profit should be annualized before arriving at the ratio. Otherwise ratios for different periods will not be comparable.*

***Sr. No. 8 : Profit as a percentage of Net sales :** This ratio requires expressing profit as a percentage of net sales. Since both the figures are 'period' figures, there is not necessity for any adjustment.*

***Negative figures :** While computing the ratios if the denominator is negative, the ratio need not be calculated, and in place of figure of ratio the words "N.A." may be indicated.]*

***Sr. No. 12 : Net Working Capital in Terms of Number of Months of Cost of Sales Excluding Depreciation :** It is the Capital available for conducting the day to day operations of an organization normally the excess of current asset over current liabilities. Current assets and current liabilities are as considered in item 1 above.*

'Cost of sales' means total cost of goods sold, inclusive of bonus, gratuity, interest and selling and distribution cost. Other expenses/income omitted from cost shall be omitted for this calculation. Generally last proforma showing the total expenses would be helpful to determine the cost of sales.

As required under this point depreciation needs to be excluded from cost of sales. The information asked for is required in terms of 'number of months' instead of percentage, which should be noted.

***Sr. No. 13 : Debt Equity Ratio –** It is the ratio of total long term liabilities to total Shareholder Capital.*

Long Term Liabilities are the liabilities due for settlement more than 12 months after the date of the balance sheet.

When current liabilities as considered above, are excluded From total third party liabilities long term liabilities will be arrived at.

Equity = Preference Share Capital (Redeemable beyond a period of 1 year) + Equity Share Capital + Free Reserve - Debit Balance of P&L Account + Undistributed Profit.

Sr. No. 14 : Raw materials stock in terms of number of months of consumption.

- *Monthly consumption = yearly consumption / 12 months.*
- *Number of months = Average Raw material Stock for the period / Monthly consumption.*
- *Average Raw material Stock should be computed as :*

(Opening Stock + Closing Stocks for 12 months) / 13 (Total number of 13 figures are there i.e. opening stock + 12 months closing stock).

***Sr. No. 15 : to Sr. No. 17 –** The method as explained above should be used for computing "stores & spares stock", "Work-in-Progress" and "finished goods" stock.*

***Note :** The term 'Year' has the same meaning assigned to the term 'financial year' as in section 210(4) of the Companies Act, 1956 and refers to the period for which the accounting statements have been prepared. It may therefore be more or less than 12 months.*

2.4.25 Capitalization of Revenue Expenditure

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Raw Materials			
(a) Purchased			
- Indigenous			
- Imported			
(b) Self manufactured			
2. Direct wages & salaries			
3. Consumable stores			
4. Repairs & maintenance			
5. Depreciation			
6. Factory overheads			
7. Administration overheads			
8. Other expenses (specify)			
9. Total			
10. Capitalisation – Excisable value			
11. Capitalisation - Non Excisable value			

[Comments :

***Para 25 of the Annexure to the Cost Audit Report [4.25 above] :** Capitalization : Capital expenditures are the expenses creating future benefits or benefit that will last substantially beyond one year. The expenses, which materially enhance the value of an asset or prolong the useful life of the asset, or adapt an asset to a new or different use (enhanced functionality), are generally capitalized. Capitalization means the process by which revenue expenditure is capitalized if it produces significant future benefit. Many of the companies capitalize the amounts paid to acquire, create or enhance an intangible asset.*

Sometimes the companies produce / manufacture various items of plant & machinery, fabricated structures, storing racks, pallets and so on, which are then capitalized.

The captive consumption, i.e., the products manufactured by the company and used by the company itself will also fall under this head, e.g., in case of Diesel Engines (Generator sets) manufacturing company, the genset is installed by the company in its own plants.

This paragraph is very important, from the point of view of revenue authorities as it helps in preventing the distortion of taxable income through current deduction of expenditures relating to production of income in future years.

a) ***Accounting Practices :*** *Two methods are generally adopted for capitalization of revenue expenditure:*

(i) In financial accounts the expenditure under various heads is shown at 'gross' level and one *consolidated entry is passed debiting asset account and crediting expenses capitalized account. In this case, the figure of expenses capitalized would be readily available from the financial accounts as a separate disclosure of the figure.*

(ii) In financial accounts the expenditure under various heads is shown at 'net' level by crediting the respective revenue accounts and debiting the asset account. In this case, the figure of expenses capitalized would not be readily available from the financial accounts as a separate disclosure of the figure. Thus the capitalization details of the year should be scrutinized by the cost auditor to ascertain the exact quantum of capitalization of revenue expenditure during the year.

b) ***Expenses may be capitalized :*** In addition to in-house capitalization as discussed above, the following categories of expenditure may also be capitalized:

Research & Development Expenses

- Sales Promotion
- Cost of raising of capital and funds
- Cost of penetration into new markets
- Cost of defending Brands and patents.

Sl. Nos. 1 to 8 of the para 4.25 requires the cost break-up of capitalization of revenue expenditure. When a number of items are manufactured and capitalized of different asset categories, it is advisable to compile the statement under asset categories. This may form the internal working statement of the unit. Within each asset category, the total capitalization value should be bifurcated between excisable and non-excisable value.

In this regard, the ***provisions of excise law*** *are as under –*

a) As per Explanation 2 to Rule 2(f) of CENVAT Credit Rules, 2002 inputs include goods used in the manufacture of capital goods which are further used in the factory of manufacturer. Thus, if a unit under reference manufactures some capital goods within the factory, goods used to manufacture such capital goods will be eligible as inputs. Thus there is no excise liability in such cases, if capital goods are manufactured within the factory.

b) Excise Duty is payable on capital goods manufactured within the factory only in cases where

- *Capital goods are used exclusively for manufacture of final product which is fully exempt from the excise duty, or*
- *Capital goods which are not covered under definition of Capital Goods under Rule 2(b) of Cenvat Credit Rules, 2002 e.g. furniture or office equipment etc.*

Therefore capitalization – excisable value as per sr. no. 10 is the total value of items covered under category 'b' above.

Capitalization - *non- excisable value as per Sr. no. 11 is the total value of items as per 'a' above.*

Sr. No. 9 is the sum total of Sr. No. 10 and 11]

2.4.26 Related Party Transactions

Briefly describe the transfer pricing policy, followed by the company in respect of "related party relationship" as defined in the relevant cost accounting records rules made under clause (d) of sub-section (1) of section 209 of the Act. The following particulars may be furnished with regard to related party transactions :

Particulars of related party	Product/ activity	Quantity	Rate	Amount	Normal
Price					
1.					
2.					
3.					
4. etc.					

Note :

(1) Details should be furnished for sale and purchase transactions separately.

[Comments :

Para 26 of the Annexure to the Cost Audit Report [4.26 above] : *Company has to describe the transfer pricing policy followed by it in respect of "related party transactions". The term "related party transactions" has been defined under the respective cost accounting records rules (Study Note 3). Details to be incorporated in the paragraph in the following manner :*

Column 1 : Particulars of related party : *Name of the party and the relationship with the company should be furnished. Details need to be provided w.r.t. each related party for all transactions. However, where all transactions during the year of the same item have been carried out at same rates, these can be added and shown as one.*

Column 2 : Product / activity : *The product/activity alongwith exact nature of transaction needs to be explained.*

Column 6 : Normal price : *As per explanation (g) given under para 28 :*

"Normal Price" means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged is the sole consideration of sale and such sale is not made to a related party. In other words "Normal Price" is the arm's length price whether in course of transaction in Indian currency or in foreign currency.

The 'normal price' or the arm's length price and may be adopted from Company's own records, price lists, Catalogues etc. It may be added here that this arm's length price shall be based on the price of exactly similar product with exactly similar commercial terms and conditions.

2.4.27 Central Excise Reconciliation For The Product Under Reference

	Particulars	Chapter Heading --	Chapter Heading --	Chapter Heading --
A	**QUANTITATIVE DETAILS :**	Unit	Unit	Unit
1	Opening Stock			
2	Add : Production			
3	Less : Closing Stock			
4	Total Sales / Clearances			

	Particulars	Assessable Value (Rs.)	Rate of Duty	Amount of Duty (Rs.)
B	**DETAILS OF CLEARANCES**			
1	Total Clearances (Chapter heading-wise)			
2	Less : Duty Free Clearances (factory)			
3	Excisable Clearances (factory)			
4	Penalty / Fine / Interest payable if any			
5	Total Duty Payable (total 3 & 4)			

	Particulars	Inputs	Capital Goods	Total
C	**SUMMARY OF CENVAT CREDIT**			
1	Opening Balance			
2	Add : Availed During the year			
3	Add Refunds received during year			
4	Less : Closing Balance as per Excise Records			
5	Total Cenvat credit utilised during the year (1+2+3-4)			
6	Closing Balance as per Annual Accounts			
7	Difference between 4 - 6			
8	(State amount and reasons for difference)			

	Particulars	Amount (Rs.)
D	**RECONCILIATION OF DUTY PAID**	
1	Excise Duty Payable as per 'B'	
2	Total Excise Duty paid through	
	a) Cenvat Account -(Inputs)	
	b) Cenvat Account -(Capital Goods)	
	c) P.L.A.	
	Total (a+b+c)	

	Particulars	Amount (Rs.)
3	Difference between (1-2)	
4	(State amount and reasons for difference)	
5	Excise Duty as per RT – 12	
6	Difference between (2-5)	
7	(State amount and reasons for difference)	
E	**RECONCILIATION OF DUTY PAID AND RECOVERED:**	
1	Excise Duty paid as per P & L A/c	
2	Excise Duty Recovered as per P & L A/c	
3	Difference between duty paid and recovered	
4	(State amount and reasons for difference)	
F	**RECONCILIATION OF TURNOVER**	
1	Turnover as per RT 12	
2	Turnover as per Annual Accounts (Net off Duties & Taxes)	
3	Difference between (1- 2)	
4	(State amount and reasons for difference)	

Comments :

Para 27 of the Annexure to the Cost Audit Report [4.27 above] :

One of the main users of cost audit report is the Excise Department. This para seeks to provide a readily available comprehensive summary to the excise department. This also ensures that excise duty has been paid as per rules. At the same time, company can also rest assured that no discrepancy can arise at a later date.

The information required under this para is found very useful and help the companies to reconcile the excise records and the financial books and also will help to minimize the litigations under Central Excise. The information under this para will also be useful in the case of Valuation Audit under Sec. 14A, CENVAT Audit under sec. 14AA of the Central Excise Act, 1944 and EA 2000, (Audit by Excise officials).

A. Quantitative Details :

Requirement – The details should be furnished in respect of various excisable as well as exempted goods manufactured by the manufacturer. It is envisaged that details should be furnished chapter heading-wise.

Opening stock/closing stock – The stock at factory and at depots/branches etc. should be furnished separately, since, the stocks at depots and branches are of duty paid goods. The stocks at factory should match with Daily Stock Account (DSA) and total stock should match with Annual Accounts of the company.

Production – In respect of production, the quantity produced/manufactured and received for reprocessing etc. should be shown separately. The details in respect of intermediate products, by-products, if any, are also required to be given if such intermediate/by products are cleared/sold or captively consumed by the manufacturer. If these intermediate products/by-products are cleared by the manufacturer but are used captively by him only in further manufacture, then details are to be shown separately.

The production figures should match with DSA. The production quantity shown in Annual Accounts of the company will vary to the extent of –

(i) Quantity reproduced/reconditioned if the process amounts to manufacture, this should be shown in reconciliation.

(ii) Intermediate and by products sold on which duty is paid but not shown in Annual Accounts.

Clearances - Details in respect of quantity sold in the clearances where sales is not involved such as transfer to depots and/or to other units of the same manufacturer. Free issues, samples etc. should be shown separately.

B. Details of Clearances :

Total Clearances – The word "clearances" includes the clearances of the goods by way of sales, transfers to other units/factories of the same manufacturer, free supplies, stock transfers to the warehouse, deposit or C&F agents etc.

Where the intermediate products are cleared as well as consumed captively by the manufacturer, separate details are required to be furnished in such cases. The value shown here should necessarily be the assessable value of the goods. The value shown in this part may not tally with the turnover shown in the Annual Accounts since the assessable value and the sales value are different in certain cases. Therefore, a separate statement showing reconciliation of the assessable value and turnover value is prescribed in the part "F" of this statement.

Duty free clearances – The duty free clearances will mainly include the clearances for export, captive consumption, Clearances to 100% EOU, FPZ etc. This will also include duty free clearances under various exemption notifications.

Excisable Clearances – The value of the excisable clearances from factory include the clearances for sale as well as to depots/branches or transfers to other units/factories of the same manufactures etc. and also the goods captively consumed but on which duty is payable.

Excisable clearances = Total clearances – Duty free clearances.

Penalty/Fine/Interest – The fines, penalties, interest etc. is not a payment of Excise Duty. However, sometimes it is paid through PLA. In this circumstances, it should be shown separately.

Total Duty Payable – It is self explanatory.

C. Summary of Cenvat Credit :

Opening Balance – The opening balance should be taken from CENVAT credit (inputs) and CENVAT credit (capital goods) records maintained.

CENVAT availed during the year – this part of the statement deals with the Cenvat credit availed by the manufacturer in CENVAT records during the year. In respect of Capital Goods, the actual credit availed during the year only is required to be considered for this purpose.

Refunds – Refunds/rebates may be received in cash. The refunds/rebates received in cash should not be included under this item.

However, sometimes refunds/rebates are credited to CENVAT accounts as per the orders of excise authorities, which can be utilized for excise duty payment. Hence, it should be considered under this item.

Closing Balance – This figure represents the closing balance as per CENVAT account.

CENVAT credit utilized – It is derived figure representing CENVAT credit utilized for the clearances of goods.

Closing balance as per Annual Accounts – This figure represents the closing balance as per financial account.

Difference – There should not be any difference in closing balance as per the Cenvat credit account and balance as per Annual Accounts of the company. However, the differences may arise, only on account of wrong/incorrect/ incomplete entries in the books/records.

Amount and reason for difference – Reason-wise details should be furnished.

D. *Reconciliation of Duty paid :-*

This part of the statement deals with the Excise Duty payable and Excise Duty paid.

Excise *duty payable as per B – Excise duty payable will consist of excise duty payable on clearances of goods for sale, clearances to deports/branches, clearances to other units for further use in manufacture of goods, free issues, duty paid on clearance of inputs as such, capital goods etc. The amount should be taken as per B(5) of the statement.*

Total excise duty paid – Amount of Excise Duty paid will be a sum total of excise duty paid through PLA plus utilization of Cenvat credit.

a) Cenvat account – (inputs) – The figure should be taken from C(5) of the statement.

b) Cenvat account – (Capital Goods) – The figure should be taken from C(5) of the statement.

c) PLA – The figure should be taken from PLA.

Difference and Reasons for difference – Normally, there should not be any difference between the Duty Payable and Duty Actually paid during the financial year.

In case there is any difference between the Excise Duty payable and actually paid, the same needs to be explained with the reasons.

The issues where the department has issued demands but the same has not reached finality will not appear in this statement, e.g. Show Cause Notice, pending adjudication or the orders against which appeals are filed and application for stay has been made etc. where no provision is made in the books of accounts.

But where the duty so demanded has been paid under protest or otherwise it will reflect in this statement as a difference, since such demands are not to be considered in part "B" of the statement as Excise Duty payable on clearances. Such payments are in the nature of deposits and to be shown under current assets.

Excise duty as per RT 12 (now ER 1) – this represents the duty paid as per the monthly returns.

Difference and reasons for differences – Normally, there should not be any difference. The difference may braise on account of default in making payment or such other reasons like the duty paid for earlier period etc.

E. *Reconciliation of duty paid and recovered:*

Excise duty paid as per P&L Account – It should be taken from annual Accounts of the company. Amount of Excise duty paid also should match with the amount of Excise Duty paid as per Monthly Returns (ER-1).

Excise Duty Recovered – It should be taken from Books of Account of the company. It is necessary that the gross turnover should be duly accounted under various heads such as net sales, excise duty, sales tax, etc.

Difference and Reasons for difference – The amount of excise duty paid and recovered may not match due to following reasons –

- *Excise duty element in stock of excise duty paid goods at depots, branches, warehouse or with C & F agents.*
- *Excise duty paid on free issues, samples, which is not recovered from customers.*
- *Excise duty paid on inter factory transfers.*
- *Excise duty paid on the goods captively consumed.*
- *Excise duty payment arising out of Order in Original or Order in Appeal etc.*
- *Duty paid on finished goods stock.*

The difference should be stated reason-wise.

F. Reconciliation of Turnover:

Turnover as per RT12 (now ER-1) – Turnover as per RT-12 represents, the value of clearances as per monthly returns (ER-1) which means the assessable value as per Sec 4 or 4 (A) of the Central Excise Act, 1944 read with Central Excise Valuation Rules, 2000.

Turnover as per Books of Account – The turnover as per financial books, normally includes excise duty.

Difference and Reasons for difference – Normally turnover as per Annual Accounts and the value of clearances (turnover as per ER1) will not match due to:

i) The concept of turnover booking in the financial books and the value of clearances of goods and different.

ii) The value of the inter-factory transfers is not shown as turnover.

iii) The goods transferred to depots etc. will not form part of turnover but in this case whenever goods are actually sold, then turnover is booked in the books of accounts.

A proper reconciliation of these figures is expected to be given under this part of the statement.

The assessable value of the clearances as per ER-1 (Monthly/quarterly return) is net of the duties and taxes. Therefore, for the purpose of comparison, from the turnover amount as per Books of Account, necessary adjustments in respect of duties and taxes etc. should be made.

Generally the differences may be on account of the following reasons :-

- *Stock Transfers for onward sale.*
- *Clearances to other units for further use in the manufacture.*
- *Value of free issues etc.*
- *Duty paid on the basis other than sales value (MRP, specific rate of duty, tariff value etc.)*

The difference between the value of clearances as per ER-1 and Books of Account has to be given reason-wise.

2.4.28 Profit Reconciliation

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Profit or Loss as per financial accounts.			
2. Add: Incomes not considered in cost accounts:			
(a) (specify)			
(b)			
(c)			
3. Less: Expenses not considerd in cost accounts:			
(a) (specify)			
(b)			
(c)			
4. Add: Overvaluation of closing stock in financial accounts			
5. Add: Under-valuation of opening stock in financial accounts			
6. Less:Under-valuation of closing stock in financial accounts			
7. Less:overvaluation of opening stock in financial accounts			
8. Adjustment for others, if any (specify)			
9. Profit or Loss as per financial accounts			

[Comments :

Para 28 of the Annexure to the Cost Audit Report [4.28 above] :

1. *Para 28 prescribes the format for reconciling the profit or loss as per cost accounting records with the profit or loss as per financial accounts.*
2. *All the signs given for items nos. 2 to 7 should be reversed in case of loss as per cost accounting records.*
3. *Item no. 1 – Profit or Loss as per Cost Accounting Records – The Cost Accounting Records Rules provide for following two proformae wherein the profit and loss as per cost accounting records gets reflected.*
   a) *Statement showing Cost of Sales, Sales realization and Margin (say Statement X).*
   b) *Statement showing allocation of total actual expenses and income of the Company among various products under reference and other products/activities for the year. (say Statement Y).*

   Thus the profit/(loss) figure should be adopted from one of the above proformae.
4. *Amount of profit as shown in Statement X, when consolidated for all types/verities for the product under reference will be equal to the amount of profit under column 'share applicable to products under reference/ activity' in Statement Y.*

5. *It should be noted that both of the proforma as mentioned above should exclude the items of both income and expenditure which are in the nature of 'non-cost' (not considered in cost accounting).*
6. *Item 2 – Income not considered in cost accounts – Incomes which are 'Abnormal' in nature and 'purely financial' in nature may be considered as income not considered in cost accounts.*

   Abnormal Income – Unexpected heavy income in nature of windfalls or abnormal gains etc

   Income purely Financial in nature for e.g. –

   (a) *Interest received on investments, deposits outside the business.*

   (b) *Dividends received on investments outside the business.*

   (c) *Profit on sale of capital assets and investments.*

   (d) *Fees received on transfer of shares.*

   (e) *Gain on foreign exchange fluctuation.*

   (f) *Excess recovery of Excise.*

   (g) *Prior period income.*

   (h) *Trading profit.*
7. *Item 3 – Expenses not considered in cost accounts – Expenses which are 'Abnormal' in nature and 'purely financial' in nature may be considered as expenses not considered in cost accounts.*
8. *Abnormal Expenses – abnormally high rejections, abnormally high defective work, spoilages etc. losses due to theft, pilferage, or acts of nature like earthquake, fire, abnormal idle time, abnormal under-utilization of plant facilities, losses due to abnormal situations like strikes, war, accidents.*
9. *Expenses purely financial in nature for e.g. –*

   (a) *Loss on sale of capital assets and investments.*

   (b) *Stamp duty and expenses on issue and transfer of shares.*

   (c) *Discounts on Bonds and debentures.*

   (d) *Fines and penalties.*

   (e) *Loss on investments.*

   (f) *Donations.*

   (g) *Prior period expenses.*

   (h) *Trading loss.*

   (i) *Expenses on buy back of shares.*

Explanation:- for the purpose of these rules -

(a) **"CAPITAL EMPLOYED"** means average of fixed assets at net book values (excluding intangible assets, effect of revaluation of fixed assets, capital works-in-progress) and current assets minus current liabilities and provisions existing at the beginning and close of the financial year.

(b) **"NET WORTH"** means share capital plus reserves and surplus (excluding revaluation reserve) less accumulated losses and intangible assets.

(c) **"PROFIT"** means operating profit after providing for depreciation and all other expenses except interest on borrowings including debentures but before providing for taxes on income.

(d) **"NET SALES"** means sales excluding sales returns, excise duties, sales tax, octroi, other local taxes and expenses refundable/recoverable from buyers/customers.

(e) **"VALUE ADDITION"** means the difference between the net output value (net sales adjusted for work-in-progress and finished goods stock) and cost of bought out materials and services for the product under reference.

(f) **"NON MOVING STOCKS"** means value of raw materials and components, finished and semi-finished which have not moved for more than twelve months. The period shall be twenty four months in case of consumable stores and spare used in workshop, tool rooms or repairs and maintenance.

(g) **"NORMAL PRICE"** means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged is the sole consideration of sale and such sale is not made to a related party.

NOTES :-

(1) If there is any change in the share capital due to merger, acquisition, buy back of shares, bonus issue etc. during the year under reporting, special mention may be made with the reasons therefore.

(2) The profit arrived at for the factory, company and the product shall not include interest and dividend received on investments outside the business, capital gains, and any other income which is neither normal nor of recurring nature. The profit so arrived shall be the normal operating profit earned during the current financial period of the company.

(3) Wherever, there is any significant variation in the current year's figure over the previous year's figure, reasons thereof shall be given.

(4) If the company has more than one factory producing the product under reference, separate details shall be indicated in the prescribed annexures in respect of each factory.

(5) If the factory is engaged in the production of the product under reference and any other activities, separate details shall be indicated in the prescribed annexure for the factory as a whole and for the product under reference.

(6) Figures shall be given for the year under audit and for the two preceding years in respect of paragraphs 4 to 26

Signature	Signature	Signature
Name	Name	Name
Cost Auditor	Company Secretary	Director
Seal	Stamp	Stamp
Date	Date	Date

2.5 PROFORMA

Name of the company :

Name and address of the factory :

Name of the product :

Statement showing the cost of production, cost of sales, sales realisation and margin in respect of the product(s) under reference produced during the year/period :

A. Quantitative Information:

Sr. No.	Particulars	(unit of measurement to be specified)	
		Current Year (Units)	Previous Year (Units)
1.	(i) Installed capacity		
	(ii) Capacity enhanced during the year by leasing arrangement etc.		
2.	Actual production / output : (i) Self; (ii) third parties, if any;		
3.	Production as percentage of installed capacity		
4.	Captive consumption, if any		
5.	Quantity sold (a) Domestic (b) Export		
6.	Closing Stock (finished goods)		
7.	Opening Stock (finished goods)		

B. Cost Information:

Sr. No.	Particulars	Qty	Rate per unit	Amo-unt	Cost per unit	
		unit	(Rs.)	(Rs.)	Current Year (Rs.)	Previous Year (Rs.)
1.	Material consumed : (item-wise covering at least 80% of items by value)					
	1. Purchased : (a) Indigenous (specify) (b) Imported (specify) 2 Self manufactured (specify)					

Sr. No.	Particulars	Qty	Rate per unit	Amo-unt	Cost per unit	
		unit	Rs.	Rs.	Current Year (Rs.)	Previous Year (Rs.)
2	Process chemicals (specify)					
	Utilities 1. Purchased : (a) Indigenous (specify) (b) Imported (specify) 2. Self manufactured (specify)					
4.	Direct wages and salaries					
5.	Consumable stores and spares					
6.	Depreciation					
7.	Lease rent, if any					
8.	Repairs and maintenance:					
	(a) Building (b) Plant and Machinery (c) Others, if any					
9.	Other works overhead					
10.	Total Works Overheads (2 to 9)					
11.	Royalty, if any					
12.	Technical assistance/ know-how fee					
13.	Research and development					
14.	Quality control					
15.	Administrative overhead (relating to production activities) (a) Salaries and wages (b) Others (specify) (c) Total(a+b)					
16.	Total (1+ 10 to 15)					
17.	Adjustment for variances (where standard costing system is followed)					
18.	Add: Opening stock					
	Less: Closing Stock					
	(Work-in-progress)					
19.	Less: Credits (from wastage and by-products)/ Recoveries, if any					

Sr. No	Particulars	Qty	Rate per unit	Amo-unt	Cost per unit	
		unit	(Rs.)	(Rs.)	Current Year (Rs.)	Previous Year (Rs.)
20.	Packing cost Primary (a) Materials (b) Others (c) Total					
21.	Cost of production (16 to 20)					
22.	Finished Goods purchased, if any					
23.	Opening Stock Closing Stock (finished products)					
24.	Total (21+22 +23)					
25.	Quantity and cost transferred for : (i) captive consumption, if any (ii) sales (iii) others, if any					
26.	Packing cost Secondary (a) Materials (b) Others (c) Total					
27.	Other expenses : (a) Administrative overheads (others) (b) others (specify)					
28.	Selling and distribution expenses (a) Salaries and wages (b) Freight and transport charges (c) Commission to selling agents (d) Advertisement expenses (e) Royalty on sales, if any (f) Warranty expenses after adjusting income from chargeable services (g) Others (h) Total (a to g)					
29.	Interest and finance charges: (a) for manufacturing activity (b) others (c) total					

Sr. No	Particulars	Qty	Rate per unit	Amo-unit	Cost per unit	
		unit	(Rs.)	(Rs.)	Current Year (Rs.)	Previous Year (Rs.)
30.	Total cost of sales (excluding excise duty) of packed quantity sold (24 to 29)					
31.	Sales realisation Less: Excise duty and other statutory levies					
32.	Net sales realisation					
33.	Margin(32 – 30)					
34.	Add: export benefits and incentives, if any					
35.	Total margin (including export benefits)					
36.	Ex-factory price (excluding sales tax etc.)					
37.	Maximum retail price (excluding sales tax etc.)					
38.	Maximum retail price, if any, prescribed by the Government/ statutory/regulatory body etc.					

Notes :

1. Separate proforma shall be prepared for each type/variety/ description of product(s) under reference.
2. Separate proforma shall be prepared for the quantity used for captive consumption, quantity sold within the country and the quantity exported. Expenses incurred on export and the incentive earned thereon shall be indicated in the proforma applicable for the quantity produced and exported.
3. Separate proforma shall be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference.
4. The administrative overheads shall be included in the cost of production only to the extent they contribute in putting the goods produced to their present location and condition. The balance of administrative overheads, if any, shall be included in the cost of goods sold. The proforma may be amended accordingly, if required.
5. The proforma may be suitably modified to cover the special features, if any, of the product under reference on the basis of proforma prescribed for working out cost of sales, margin, etc. of the said product in the relevant Cost Accounting Records Rules.
6. Indicate whether the prices of the product under reference are ex-factory prices, F.O.R prices, door delivery prices or any other terms. In case of ex-factory prices, whether cost of dispatch packing materials, freight, insurance and delivery charges are recoverable from the customers separately.

[Comments :

Proforma :

Cost Audit Report Rules have prescribed a very simple and uniform proforma for all the products/activities covered under Cost Audit Report Rules. It further provides the flexibility to modify the proformae. This is a very important milestone towards the uniform Cost Accounting Records Rules.

In addition to separate proforma for each type/variety/description of product under reference, Note (3) requires that separate proforma shall be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference.

The Proforma(e) are required to be approved by the Board of Directors and are also required to be duly authenticated by the company and the Cost Auditor as prescribed in Rule 7 of the Notification.]

Signature	Signature	Signature
Name	Name	Name
Cost Auditor	Company Secretary	
Director		
Seal	Stamp	Stamp
Date	Date	Date

F.No.52/10/CAB-2001

(A.Ramaswamy)

Joint Secretary to the Government of India,

Note - The principal rules were published vide G.S.R. number 511(E), dated the 4th November, 1996.

2.6 Review of Cost Audit Report by the Company / cost Audit Branch

Under the provisions of sub-section (4) of Section 233-B of the Companies Act, the cost auditor has to send his report to the Central Government and shall at the same time forward a copy of the report to the Company. The form in which the report has to be made is given in the Cost Audit Report Rules, 2001 which has already been discussed earlier. Section 233-B also lays down the follow-up action the Central Government has to take on the Cost Audit. The provisions of the Act regarding the follow-up action to be taken would be meaningful only in the case of such companies whose product under cost audit cover a substantial part of the activity of the company.

As soon as the Cost Audit Report is received by the company, the report has to be reviewed by the company, particularly where any adverse remark has been made by the cost auditor. Proper review is necessary, particularly to see whether the report contains any qualification by the Cost Auditor like -

1. The cost auditor has stated that he has not received all the information and explanations which were necessary for the purpose of cost audit;

2. The proper cost accounting records have not been kept by the company;

3. The proper returns required for the purpose of cost audit have not been received from the branches not visited by the cost auditor;
4. The books of accounts do not give the information required by the Companies Act, 1956 in the manner so required; and
5. In the opinion of the cost auditor, company's cost accounting records have not been properly kept so as to give a true and fair view of the cost of production, cost of sales and margin of the product under reference as prescribed under the Cost Accounting Records Rules.

Moreover, review is necessary where the observations and suggestions as mentioned in Para 3 of the **Form of Cost Audit Report** contains any adverse remark, for example –

(a) where the persistent deficiencies in the cost accounting system including inventory valuation pointed out in earlier reports have not been rectified;

(b) inadequacy of the budgetary control system;

(c) matters which appear to the cost auditor to be clearly wrong in principle or apparently unjustifiable;

(d) moreover, it contains any adverse remark regarding clause (d) under Para 3 of the Form of Cost Audit Report.

The rules provide that the opinions expressed by the cost auditor shall be on verified data, reference to which shall be made here and shall, wherever practicable, be included after the company has been afforded an opportunity to comment on them.

After taking note of the observations of the cost auditor, the Company shall within thirty days from the date of receipt of the report furnish to the Central Government full information of explanation on every reservation or qualification contained in the report vide s. 233-B (7). The responsibility for sending a report lies suo moto with the company and there is no need for the Central Government to call for a report from the company. It may be added here that the company should send at Nil report to the Central Government, even if there are no qualifications in the report in their opinion. The company should state that they have received the report and no comments are required from them under section 233-B(7) of the Act. It must be reiterated that the cost auditor's opinion should be based on verified data, and the company should have been given an opportunity by the cost auditor to comment on the opinion e.g. if the cost auditor wants to report that priced stores ledgers have not been maintained or an expenditure has been incurred on repairs which according to him is abnormal and therefore has to be treated as deferred revenue expenditure. The company should be informed in writing about his intention to make the proposed observation and the reply of the company should be obtained in writing. Even after considering the reply the cost auditor feels that his observation should stand, he should make it clear in the report and also explain as to why he does not agree with the company's stand or reply.

In view of the above, a company while making a report under section 233-B(7) cannot say that the observations made by a cost auditor is factually incorrect unless it can prove that an opportunity has not been given by the cost auditor about his intention to make a reservation or qualification in the report.

The Central Government shall consider the cost audit report and also the information and explanation furnished by the company after sub-section (7) of Section 233-B of the Companies Act. After considering the same, if it is of the opinion that further explanation is required from the company it can call for the same, and the company is obliged to furnish the same within such time as may be specified.

The Central Government while considering the report of the cost auditor also with the explanations and information by the Company, generally looks into the following aspects:

i) Whether the report is complete in all respect and all documents and annexure as required to be attached under the provisions of the Cost Audit Report Rules or any other circular or administrative instruction, have been attached and furnished.

ii) Whether the report has been submitted in time i.e. within 180 days of the close of the financial year to which the report relate. In case of delayed submission of the report, the Cost Auditor has to explain the delay; if it is on account of delayed submission of documents by the company, the fact should have been reported already and also clearly mentioned by the cost auditor that he has already made a report about the delayed receipt of documents from the company.

iii) Whether any qualification has been made in the report in the certificate of the cost auditor, like records not maintained, cost of production as stated does not give a true and fair view, etc.

iv) Whether all information required to be furnished as per Para 1 to 28 of the Annexure has been furnished.

v) Whether any observations been made by the cost auditor in Cost Audit Report which is of an adverse nature requiring explanation by the company. Even if some suggestions for improvement have been made by the Cost Auditor, the company has to offer their comments on the suggestions as to how far they can be implemented.

vi) In addition, all the cost information contained in the cost sheet and other parts of the report is reviewed to ensure that it is by and large fair and does not contain any discrepancy.

2.7 Disposal of Cost Audit Reports by the Central Government

After considering the report the Central Government is empowered to take such action on the report in accordance with the provisions of the Companies Act or any other law in force as may be considered necessary.

It is pertinent to note that the powers of the Central Government to take action on the Cost Audit Report are unfettered. The action need not be confirmed to violation of Companies Act only. Many a times, issues are referred to administrative ministries also, for taking necessary action.

The Central Government after considering the report and explanation of the company may feel that the whole or a portion of the Cost Audit Report be made known to the members (shareholders), it can direct the company that the whole or portion of the report be circulated along with the notice of the annual general meeting taking place after submission of the Cost Audit Report.

It may be seen from the above that the follow-up action to be taken on a Cost Audit Report is laid down in the Act, and it is mandatory and the Central Government has to create the necessary administrative set up to deal with the Cost Audit Report. Such a mandatory provision regarding follow-up action does not exist in case of the report of the financial auditor. The Board of Directors of the Company place the audited accounts in the Annual General Meeting of the Company and the shareholders discuss the report and adopt the same. Beyond that no further action is required to be taken under the Companies Act. Copies of the audited Annual Accounts are filed with the Registrar of Joint Stock Companies who can review the audited accounts on selective basis according to the facilities available with him at his convenience.

The Central Government takes up violations of the provisions of the Companies Act through the concerned Registrar of Joint Stock Companies in whose jurisdiction the company is located for taking necessary action for launching prosecution against the company and its officers. All prosecutions under the Companies Act are launched through the Registrar of Joint Stock Companies only.

2.8 Other End Users of Cost Audit Report

The Cost Audit Reports are extensively used by the revenue authorities.

The Central Excise Department takes keen interest in the Cost Audit Reports submitted under section 233-B. In order to enable them to obtain the Cost Audit Report directly from the companies, an amendment was made to the Central Excises in 1980, making it obligatory for every assessee to produce to the Central Excise Officers or the audit parties, the Cost Audit Report if any under section 233-B of the Companies Act. The extract of the amendment is given below.

Extract of Notification No. 159/80 dated 18.10.80 of Central Excises Act, 1944

In exercise of the powers conferred by section 37 of the Central Excises Act, 1944 (1 of 1944), the Central Government hereby makes the following rules further to amend the Central Excise Rules, 1944, namely:

1. These rules may be called the Central Excise (13th amendment) Rules, 1980
2. For sub-rule (6) of the rule 173-G of the Central Excise Rules, 1944 the following sub-rule shall be submitted, namely:

Every assessee shall, on demand, produce to the Excise Officers, or the audit parties deputed by the Collector or the Comptroller and Auditor General of India:

i) The accounts and returns (where the same are maintained or prepared in pursuance of these rules or not), and

ii) The cost audit reports, if any, under section 233-B of the Companies Act, 1956 (1 of 1956) for the scrutiny of the officers of audit parties, as the case may be:

Cost Audit Report could be made use of by the Central Excise department in the following areas :

i) In the case of goods produced for captive consumption the assessable value thereof determined by taking into account the “Cost of production of manufacture” including profits if any which the assessee would have normally earned on the sale of such goods. The Cost Audit Report should normally give the cost of production of captively manufactured goods. If the cost sheets of these items are not required to be attached to the Cost Audit Report, the company must be having the required data, (which has been duly audited) as part of the statutory Cost Accounting Records. Normally profit can be determined by taking into consideration the “capital employed” for the product which is available in the Annexure to the Cost Audit Report. An appropriate percentage of profit on capital employed can be adopted for arriving at the quantum of normal profit that can be adopted to determine the assessable value.

ii) The invoice price is taken as the assessable value in order to ensure that the price actually charged and the net sales realization as entered in the book, actually tally, a cross check could be made with the Cost Audit Report or the data in the statutory cost accounting records. According to statutory requirement the data on net sales realization of each variety and size of the product should be maintained for arriving at the profit or loss on each variety/size of the product.

iii) The production which is declared for the Central Excise purposes could be checked with the data in Cost Audit Report in cases where there is reason to believe that production is understated.

Another important use of the cost audit report is that the data in the report can be utilised to prepare consolidated report for the industry as a whole. The cost data of all the units in an industry can be tabulated element wise for the industry as a whole for a number of years in order of study and analyse the trends in cost. The industrywise cost profile can also be published so that comparative efficiency/inefficiency of the units can be studied and traced to their causes for taking remedial actions. But publication of the trends in cost of various units would require the concurrence of the companies. It is doubtful whether the companies would give such concurrence. But at the same time, units in the Public Sector could attempt a study of all the units under their control. Similarly in the case of the National Textile Corporation and the State Sugar Corporation, such a computation, of trend in cost would be very useful if the Cost Audit Reports are available continuously for a longer number of years. For this purpose, cost audit must be made an annual feature.

Section 139(9) (E) of the Income-Tax Act, 1961 contains a provision that the Cost Audit Report should be submitted by the company along with the tax return. Otherwise the returns will be considered defective. It appears from the above that Income-Tax department also is finding the report useful to them, probably in the area of valuation of inventory of finished goods and work-in-progress.

2.9 Disclosure of Information and Confidentiality

Under the provisions of Section 233-B of the Companies Act, 1956, the report of the Cost Auditor is to be made to the Central Government with a copy to the company. No other person can have access to the Cost Audit Report. The reason for restricting the availability of the Cost Audit Report to the Central Government and the Company, is that the Cost Audit Report contains important confidential information which if divulged would affect the competitiveness in trade and business of a company whose information is divulged. For example the Cost Audit Report contains :

i) A detailed note on the manufacturing process of the company.

ii) Quantities and rates of various items of input materials i.e. the entire recipe is given.

iii) Quantities and rates of utilities consumed.

iv) Average sales realization, discounts allowed for each item of product and the sales promotion expenses.

v) Details of export market, quantity exported, FOB realization, etc.

vi) Any other energy saving measure or technical improvement in process, which a company might have implemented, arising out of its own research.

The information relating to items (ii) and (iii) above especially recipe of important materials and utilities are secrets of process industry, particularly of companies manufacturing drugs, tyres and tubes and other important chemicals. Even though, there is a provision under sub-section (10) of Section 233-B of the Companies Act that the Central Government can direct a company to circulate the full or part of the Cost Audit Report to the shareholders. This power has not been exercised so far.

2.10 **APPENDIX I**

COST AUDIT REPORT RULES 2001

(Bare Rules)

MINISTRY OF LAW, JUSTICE AND COMPANY AFFAIRS

(DEPARTMENT OF COMPANY AFFAIRS)

NOTIFICATION

New Delhi, the 27th December, 2001

G.S.R. 924(E).- In exercise of the powers conferred by sub-section (4) of section 233B, read with sub-section (1) of section 227 and clause (b) of sub-section (1) of section 642, of the Companies Act, 1956 (1 of 1956), and in supersession of the Cost Audit (Report) Rules, 1996, except as respect things done or omitted to be done, before such supersession, the Central Government hereby makes the following rules, namely:-

1. **Short title and commencement . –**

   (1) These rules may be called the Cost Audit Report Rules, 2001.

   (2) They shall come into force on the date of their publication in the Official Gazette.

2. **Definitions –** In these rules, unless the context otherwise requires,-

   (a) "Act" means the Companies Act, 1956 (1 of 1956);

   (b) "Cost Auditor" means an auditor directed to conduct an audit under sub-section (1) of section 233B of the Act;

   (c) "Form" means the Form of the Cost Audit Report and includes auditor's observations and suggestions, Annexure and Proforma to the Cost Audit Report;

   (d) "Report" means Cost Audit Report duly audited and signed by the Cost Auditor in the prescribed form of Cost Audit Report;

   (e) "Product under reference" means the **product or activity** to which the Report relates;

   (f) All other words and expressions used in these rules but not defined, and defined in the Act and rules made under clause (d) of sub-section (1) of section 209 of the Act shall have the same meanings as assigned to them in the Act or rules, as the case may be.

3. **Application –** These rules shall apply to every company in respect of which an audit of the cost accounting records has been ordered by the Central Government under sub-section (1) of section 233B of the Act. The Cost Audit Report submitted on or after 1st October, 2002, irrespective of the financial year of the company to which it relates, shall be in the form prescribed under these rules.

4. Form of the Report –

(1) Every Cost Auditor, who conducts an audit of the cost accounting records of the company shall submit the report (a hard copy and a soft copy) along with auditor's observations and suggestions, Annexure and Proforma to the Central Government in the prescribed form and at the same time forward a copy of the report to the company.

(2) Every Cost Auditor, who submits a report under sub-rule (1), shall also give clarifications, if any, required by the Central Government on the Cost Audit Report submitted by him, within thirty days of the receipt of the communication addressed to him calling for such clarifications.

5. Time limit for submission of Report - The Cost Auditor shall forward his report referred to in sub-rule (1) of rule 4 to the Central Government and to the concerned company within one hundred and eighty days from the close of the company's financial year to which the report relates.

6. Cost Auditor to be furnished with the cost accounting records etc. – Without prejudice to the powers and duties the Cost Auditor shall have under sub-section (4) of section 233B of the Act, the company and every officer thereof, including the persons referred to in sub-section (6) of section 209 of the Act, shall make available to the Cost Auditor within one hundred and thirty five days from the close of the financial year of the company, such cost accounting records, cost statements, other books and documents, Annexure and Proforma to the Report, duly completed, as would be required for conducting the cost audit, and shall render necessary assistance to the Cost Auditor so as to enable him to complete the cost audit and submit his report within the time limit specified in rule 5.

7. Authentication of Annexure to the Cost Audit Report – The Annexure and Proforma prescribed with the Cost Audit Report shall be approved by the Board of Directors before submitting the same to the Central Government by the Cost Auditor. The Annexure and Proforma, duly audited by the Cost Auditor, shall also be signed by the Company Secretary and at least one Director on behalf of the company. In the absence of Company Secretary in the company, the same shall be signed by at least two Directors.

8. Penalties –

(1) If default is made by the Cost Auditor in complying with the provisions of rule 4 or rule 5, he shall be punishable with fine, which may extend to five thousand rupees.

(2) If the company contravenes the provisions of rule 6 or rule 7, the company and every officer thereof who is in default, including the persons referred to in sub-rule (6) of section 209 of the Act, shall, subject to the provisions of section 233 B of the Act, be punishable with fine which may extend to five thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first day during which such contravention continues.

9. Saving of action taken or that may be taken for contravention of Cost Audit (Report) Rules, 1996 - It is hereby clarified that the supersession of the Cost Audit (Report) Rules, 1996, shall not in any way affect –

(i) any right, obligation or liability acquired, accrued or incurred thereunder ;

(ii) any penalty, forfeiture or punishment incurred in respect of any contravention committed thereunder ;

(iii) any investigation, legal proceeding or remedy in respect of any such right, privilege, obligation, liability, penalty, forfeiture or punishment as aforesaid, and; any such investigation, legal proceeding or remedy may be instituted, continued or enforced and any such penalty, forfeiture or punishment may be imposed as if those rules had not been superseded.

FORM OF THE COST AUDIT REPORT

[See rule 2(c) and rule 4]

I/We, ... having been appointed as Cost Auditor(s) under Section 233B of the Companies Act, 1956 (1 of 1956) of .... (mention name of the company) having its registered office at ....(mention registered office address of the company) (hereinafter referred to as the company), have examined the books of account prescribed under clause (d) of sub-section (1) of section 209 of the said Act, and other relevant records in respect of the unit .... (mention name and location of the unit) for the period/year .... (mention the financial year) relating to .... (mention name of the product or activity) maintained by the company and report, in addition to my/our comments in para 3 relating to auditor's observations and suggestions, that -

1. (i) I/We have/have not obtained all the information and explanations, which to the best of my/ our knowledge and belief were necessary for the purpose of this audit;

   (ii) proper cost accounting records, as prescribed under clause (d) of sub-section (1) of section 209 of the Companies Act, 1956, have/have not been kept by the company;

   (iii) proper returns adequate for the purpose of my/our Cost Audit have/have not been received from the branches not visited by me/us;

   (iv) the said books and records give/do not give the information required by the Companies Act, 1956 in the manner so required;

   (v) the cost statements in respect of product or activity under reference as specified in the Annexures/ Proformae of Schedules I, Schedule II or Schedule III of the concerned Cost Accounting Records (**...........................) Rules duly audited by me/us are kept in the company.

2. In my/our opinion, the company's cost accounting records have/have not been properly kept so as to give a true and fair view of the cost of production, cost of sales and margin of the product under reference as prescribed under the rules.

3. Based on my/our examination of the records of the company subject to aforesaid qualifications, if any, I/We give my/our **observations and suggestions** on the following -

   (a) the adequacy or otherwise of the cost accounting system including inventory valuation in vogue in the company and suggestions for the improvement thereof. The Cost auditor shall also indicate the persistent deficiencies in the system, pointed out in earlier reports but not rectified;

   (b) the adequacy or otherwise of the budgetary control system, if any, in vogue in the company;

   (c) matters which appear to him to be clearly wrong in principle or apparently unjustifiable;

   (d) cases, where price charged for related party transactions as defined in the respective Cost Accounting Records Rules is different from normal price, impact of such lower/higher price on margin of the product under reference shall be specified;

   (e) areas where the company is incurring losses or where there is considerable decline in profitability, the cost auditor should comment on the reasons thereof including indicative break-even point. The cost auditor shall also comment on the default, if any on the payments due to the Government, financial institutions and banks, penal interest levied thereon and its impact on the cost of sales and profitability;

(f) steps required to strengthen the company under the competitive environment especially with regard to need for protection from cheaper imports, if any;

(g) export commitments of the company vis-à-vis actual exports for the year under review. Also comment on comparative profitability and pricing policy of the company for domestic and export sales. Give impact of exports benefits/ incentives offered by the Government on export profitability;

(h) the scope and performance of internal audit of cost records, if any, and comment on its adequacy or otherwise.

4. The Cost Auditor shall suggest measures for making further improvements in the performance in respect of cost control and cost reduction.

5. The Cost Auditor may also give his other observations and suggestions, if any, relevant to the cost audit.

Dated : this ---- date of -------- 200-----at ------------------------(mention name of place of signing this report).

SIGNATURE & SEAL OF THE COST AUDITOR(S)

MEMBERSHIP NUMBER

Notes:

(1) Delete words not applicable.

(2) **Specify the title of the concerned Cost Accounting Records Rules made under clause (d) of sub-section (1) of section 209 of the Companies Act, 1956 which are applicable to the product or activity of the company.

(3) If as a result of the examination of the books of account, the Cost Auditor desires to point out any material deficiency or give a qualified report, he shall indicate the same against the relevant para (i) to (vi) only in the prescribed form of the Cost Audit Report giving details of discrepancies he has come across.

(4) The report, suggestions, observations and conclusions given by the Cost Auditor under this paragraph shall be based on verified data, reference to which shall be made here and shall, wherever practicable, be included after the company has been afforded an opportunity to comment on them.

ANNEXURE TO THE COST AUDIT REPORT

[See rule 2(c) and rule 4]

1. GENERAL:

(1) (a) Name and address of the registered office of the company whose accounts are audited.

(b) Name and address of the place where the cost accounting records are maintained viz. registered office, head office or factory.

(2) Name of the product and location of the unit to which the Annexure pertains.

(3) The Company's financial year to which the Cost Audit Report relates.

(4) Date of first commencement of commercial production of the product under reference.

(5) Location of other sites manufacturing or producing or processing or mining the product or carrying out the activity under reference.

(6) Name and address of the Cost Auditor.

(7) Membership number of the Cost Accountant. In case of firm of Cost Accountants, name and membership number of all the partners.

(8) Reference number and date of Government Order under which the Audit is conducted.

(9) Reference number and date of the Government letter approving the appointment of the Cost Auditor.

(10) Date of Board of Directors' meeting wherein the Annexure and Proforma to the cost audit report were approved.

(11) The number of Audit Committee meetings held by the company, and attended by the Cost Auditor during the year under reference.

(12) Name, qualification and designation of the officer heading the cost accounting section or department of the company.

(13) In case of loan license/ job work arrangement by the company, mention the name of the third party and location of the factory, where the product has been produced/manufactured.

(14) If there is any foreign technical collaboration for the product under reference, the following details shall be given:

(a) name and address of the foreign collaborators;

(b) main terms of agreement;

(c) amount of royalty, lump sum payment, technical aid fee payable and the basis of calculating the same;

(d) whether the technical collaborator has contributed to the share capital. If so, the paid up share capital so held.

(15) If the company is engaged in other activities besides the manufacture of the product under reference,

the following details in respect of each such product or activity shall be given:

(a) list of the products or activities;

(b) list of the products or activities for which Cost Accounting Records Rules have been prescribed under section 209(1)(d) of the Act.;

(c) whether Cost Audit Order has been issued by the government in respect of any of the products or activities. If so, number and date of the order.

(16) A printed copy of the Annual Report, containing audited Profit and Loss Account, Balance Sheet and Auditor's Report in respect of the company's financial year for which the report is rendered, shall be enclosed with the Cost Audit Report.

2 Cost Accounting System:

(1) Briefly describe the cost accounting system existing in the company, keeping in view the requirements of the Cost Accounting Records Rules applicable to the class of companies manufacturing the product under reference and also its adequacy or otherwise to determine correctly the cost of production, cost of sales, sales realisation and margin of the product under reference.

(2) Briefly specify the changes, if any, made in the costing system; basis of inventory valuation; method of overhead allocation; apportionment to cost centers/departments and final absorption to the product under reference etc., during the current financial year as compared to the previous financial year.

3. Process of Manufacture:

A brief note regarding the process of manufacture along with flow chart covering production, utility and service department of the product.

4. Quanitative Details :

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Installed capacity *			
2. Capacity enhanced during the year by year by leasing arrangement etc.			
3. Total available capacity			
4. Production during the year:			
(a) self manufactured			
(b) third party on job work etc.			
(c) loan license basis			
5. Total production quantity			
6. Production as per Excise Records			
7. Capacity utilisation percentage			

8. Opening stock (finished quantity)			
9. Total available quantity			
10. Quantity captively consumed			
11. Quantity sold:			
(a) domestic at controlled price			
(b) domestic at market price			
(c) export under advance license			
(d) export under other obligation			
(e) export at market price			
(f) total			
12. Closing stock (finished quantity)			

Notes :

1. It should be clarified whether the installed capacity is on single shift or multiple shift basis.
2. In order to have a meaningful comparisons of production and installed capacity, wherever necessary these details should also be expressed in appropriate units, e.g. standard hours or equipment/ plant/ vessel occupancy hours, crushing hours, spindle/ loom shifts, equivalent production, production in terms of standard hours etc.

5(A). MAJOR INPUT MATERIALS / COMPONENTS CONSUMED:

Particulars	Current Year			Two Previous Years Separately		
	Qty.	Rate	Amount	Qty.	Rate	Amount
1. Indigenous:						
(a) (specify)						
(b)						
(c)						
2. Self manufactured:						
(a) (specify)						
(b)						
(c)						
3. Imported:						
(a) (specify)						
(b)						
(c)						

Note : Details should be furnished in respect of major input materials each constituting at least 2% of the total raw material cost.

5(B). STANDARD/ ACTUAL CONSUMPTION OF INPUT MATERIALS PER UNIT:

Particulars	Unit	Standard	Actuals		
			Current Year	1st Previous Year	2nd Previous Year
1. (specify)					
2.					
3.					

Note : Details should be furnished in respect of major input materials each constituting at least 2% of the total raw material cost for each major type/ variety/ size etc. of product under reference.

6. BREAK-UP OF COST OF INPUT MATERIALS IMPORTED DURING THE YEAR :

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. FOB Price in currency/ foreign rupees			
2. Insurance & freight			
3. Customs duty			
4. Clearing charges			
5. Inland freight			
6. Other expenses			
7. Total			

Note : Details should be furnished in respect of major input materials each constituting at least 2% of the total material cost.

7 (A). POWER, FUEL AND UTILITIES :

Particulars	Current Year			Two Previous Years Separately		
	Qty.	Rate	Amount	Qty.	Rate	Amount
1. Indigenous: (purchased):						
(a) (specify)						
(b)						
(c)						
2. Self generated/ produced						
(a) (specify)						
(b)						
(c)						
3. Imported:						
(a) (specify)						
(b)						
(c)						

Note : Details should be furnished in respect of major items each constituting at least 2% of the total material cost.

7 (B). STANDARD/ ACTUAL CONSUMPTION OF POWER, FUEL AND UTILITIES IN TERMS OF QUANTITY PER UNIT OF PRODUCTION :

Particulars	Unit	Standard	Actuals		
			Current Year	1st Previous Year	2nd Previous Year
1. (specify)					
2.					
3.					

Note : Details should be furnished in respect of each major type/ variety/ size etc. of product under reference.

8. SALARIES AND WAGES:

Particulars	Current Year	1st Previous Year	2nd Previous Year
A. Quantitative Details :			
1. Direct Workers:			
a. Average number during the year			
b. Man days available			
c. Mandays actually worked for:			
(i) own production			
(ii) job work			
d. Reason-wise analysis of idle man-days (a-b) i) absenteeism ii) shortage of raw materials iii) power shortage/ failures iv) Others (specify)			
2. Indirect Workers :			
a. Average number during the year			
b. Man days available			
c. Mandays actually worked for:			
(i) own production			
(ii) job work			
d. Reason-wise analysis of idle man-days (a-b) i) absenteeism ii) shortage of raw materials iii) power shortage/ failures iv) Others (specify)			

B. Cost Detail :			
1. Direct labour cost on production			
2. Indirect employee costs on production			
3. Employee costs on administration			
4. Employee costs on selling and distribution			
5. Other employees costs, if any (specify)			
6. Total employee costs			
7.a Payments under any VRS scheme			
7.b. Amount provided during the year			

9. REPAIRS AND MAINTENANCE:

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Land and Building			
2. Plant and machinery			
3. Staff quarters and colony			
4. Others (to be specified asset category wise)			
5. Total amount			
6. Amount capitalized / deferred during the year			
7. Net amount (5 - 6) 8. Deferred amount of earlier years, if any			
9. Total amount provided in the cost records (7 + 8)			

10. FIXED ASSETS REGISTER AND DEPRECIATION

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Whether fixed assets register register maintained cost centre-wise			
2. Method of providing depreciation			
3. Amount of depreciation under section 205(2) of the Companies Act, 1956 or any other relevant Act, as the case may be			
4. Amount of depreciation provided in the financial records			
5. Amount of depreciation absorbed in the cost records			
6. Shortfall / Excess, if any (3 and 5)			

11. GROSS BLOCK, DEPRECIATION AND LEASE RENT:

Particulars	Gross Block	Depre-ciation	Lease Rent paid, if any	Total (b+c)	1st Previous Year	2nd Previous Year
	a	b	c	d		
Name of major cost centers/ products:						
(a) (specify)						
(b)						
Total						

12. OVERHEADS

Particulars	Current Year		Two Previous Years Separately	
	for the product under reference	for factory as a whole	for the product under reference	for factory as a whole
1. Factory Overheads a) (specify) b)				
2. Administration OHs a) (specify) b)				
3. Selling Overheads a) (specify) b)				
4. Distribution OHs a) (specify) b)				

Note :The break-up under each head should be furnished in respect of major items constituting at-least 80% of the overhead cost under each head.

13. RESEARCH AND DEVELOPMENT EXPENSES

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Process development and improvement			
2. Existing product development			
3. New product development			
4. Others, if any			
5. Total amount			
6. Amount capitalized / deferred during the year			
7. Net amount (5-6)			
8. Deferred amount provided in the years, if any			
9. Total amount provided in the cost records (7 + 8)			
10. Amount paid to related parties			

14. ROYALTY AND TECHNICAL KNOW HOW CHARGES

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Royalty on production/ Sales			
2. Lump sum payment of royalty, if any			
3. Technical know how charges			
4. Others, if any			
5. Total amount			
6. Amount capitalized/ deferred during the year			
7. Net amount (5-6)			
8. Deferred amount of earlier years, if any			
9. Amount provided in the financial accounts (7+8)			
10 Amount absorbed in the cost records			
11 Shortfall/ Excess, if any			
12 Amount paid to related parties			

Note : The details should be furnished in respect of each agreement separately.

15. QUALITY CONTROL EXPENSES

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. ISO number, if any			
2. Name of certifying agency			
3. Salaries & Wages			
4. Other direct expenses			
5. Others, if any (specify)			
6. Total amount			

16. POLLUTION CONTROL EXPENSES:

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Effluent treatment 1			
2. Control of air pollution			
3. Control of ash pound/ ash mound			
4. Penalty, if any			
5. Others, if any			
6. Total amount			

17. ABNORMAL NON-RECURRING COSTS:

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. (specify)			
2.			
3.			
Total			

18.(A) NON-MOVING STOCK (at the end of the year) :

Particulars	*Current Year*	*1st Previous Year*	*2nd Previous*
a1 Total direct material consumption			
a2. Closing stock of direct material			
a3. Value of non-moving stock			
a4. Percentage of a3 to a2			
b1. Total indirect material consumption			
b2. Closing stock of indirect material			
b3. Value of non-moving stock			
b4. Percentage of b3 to b2			
c1. Work-in-progress			
c2. Closing stock			

Particulars	*Current Year*	*1st Previous Year*	*2nd Previous*
c3. Value of non-moving stock			
c4. Percentage of c3 to c2			
d1. Finished Goods			
d2. Closing stock			
d3. Value of non-moving stock			
d4 ercentage of d3 to d2			
e1 Total :			
e2 Closing stock			
e3 Value of non-moving stock			
e4 Percentage of e3 to e2			

18.(B) WRITTEN OFF STOCK (during the year) :

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Direct Materials (Raw Material & Components etc)			
2. Indirect Materials			
3. WIP			
4. Finished Goods			
Total			

19.(A) INVENTORY VALUATION (at the end of the year) :

	Basis of valuation	Current Year			Previous Year		
		Quantity (unit)	Rate (Rs.	Amount (Rs.)	Quantity (unit)	Rate (Rs.)	Amount Rs.
Input material:							
(i) Purchased							
- Indigenous							
(ii) Self manufactured							
2. Chemicals, additives and consumables							
3. Stores and spares							
4. Packing materials							
5. Tools and implements and Jigs, Dies and Fixtures.							

	Basis of valuation	Current Year			Previous Year		
		Quantity (unit)	Rate (Rs.	Amount (Rs.)	Quantity (unit)	Rate (Rs.)	Amount Rs.
6. Work-in progress: (i) material cost (ii) conversion cost (details to be given)							
7. Finished goods: (i) unpacked (ii) packed							
8. Scrap/ wastage							
9. Others, if any							
10. Total value of inventory as per cost accounts							
11. Total value as per financial accounts							
12. Reasons for major difference, if any							

(1) In respect of item at Sr. No. 1 and 6 details be furnished in respect of each major input material constituting at least 2% of the total material cost.

(2) In respect of items at Sr. No. 2 to 5, total amount be given without any quantitative details.

(3) Give in brief the method of inventory valuation system indicating the elements of cost included therein and the extent thereof.

(4) Capital work-in-progress to be shown separately.

19(B) PHYSICAL VERIFICATION OF INVENTORY :

Sr. No.	Particulars	Periodicity	Shortage Value (Rs.)	Excess Value	Net (Rs.)
1	Raw material				
2	Chemicals, additives, consumables etc.				
3	Stores & Spares				
4	Packing Materials				
5	Tools & Implements				
6	WIP				
7	Finished Goods				
8	Scrap, Wastage				
9	Total				

20. SALES OF THE PRODUCT UNDER REFERENCE:

Particulars	Current Year			Previous Year		
	Qty.	Rate	Amount	Qty.	Rate	Amount
1. Purchased goods:						
a) (specify)						
b)						
2. Loan license basis:						
a) (specify)						
b)						
3. Own manufactured						
a) (specify)						
b)						
4. Total sales						

Notes :

(1) Above details shall be furnished for major product groups/ varieties.

(2) Separate details shall be furnished for indigenous sales and export sales.

21. MARGIN PER UNIT OF OUTPUT:

Particulars	Current Year *			Two Previous Years Separately		
	Cost of Sales	Sales realisation	Margin (Rs.)	Cost of Sales	Sales realisation	Margin (Rs.)
1.Purchased goods:						
(a) (specify)						
(b)						
(c)						
2.Loan license basis:						
(a) (specify)						
(b)						
(c)						
3.Own manufactured:						
(a) (specify)						
(b)						
(c)						

Notes :

(1) Above details shall be furnished for major product groups/ varieties.

(2) Separate details shall be furnished for margin on indigenous sales and export sales. Where the

product (such as sugar, bulk drugs, formulations, etc.) is sold at different prices in accordance with government policy, sales realisation and margin on such product at different prices shall be shown separately alongwith quantity and value.

22. COMPETITIVE MARGIN AGAINST IMPORTS:

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Name of product			
2. Estimated demand of the product in the country *			
3. Total production in the country *			
4. Quantities imported in the country **			
5. Total production by the company			
6. %age share of the company in total inland production (item 5/ item 3)			
7. a. Cost of production per Unit (Inland sale)			
b. Cost of Sale per Unit (Inland sale)			
c. Cost of production per Unit (Export sale)			
d. Cost of Sale per Unit (Export sale)			
8. Quantity of the product imported by the company **			
9. FOB value of quantity imported by the company **			
10. Weighted average FOB rate for quantities imported by the company (item 9/ item8) **			
11. FOB value of quantity imported in the country *		*	
12. Weighted average FOB rate of quantities imported in the country (item 11/ item 4)			**
13. Competitive margin (item 12 less item 7(A)) **			
14. Major exporting countries (other than those listed in item 4 above)			
15. (A) Total import duty paid by the by the company (net of CENVAT)			
(B) Weighted average rate of import duty paid (item 15(A)/ item 8)			
16. Bound rate of duty under WTO agreement.			

Notes :

(1) * Indicate the source of information.

(2) ** Country-wise details should be furnished in respect of major countries covering at-least 80% of the total and balance should be shown under the head "Others".

23. VALUE ADDITION AND DISTRIBUTION OF EARNINGS

Particulars	Current Year	1st Previous Year	2nd Previous Year
A. Value Addition (for the product product under reference)			
1. Gross sales (excluding returns)			
2. Less: excise duty etc.			
3. Net sales			
4. Adjustments in stocks			
5. Less: cost of bought out materials and services			
6. Value added			
7. Add: income from any other other sources			
8. Earnings for distribution			
B. Distribution of earnings to:			
1. Employees as salaries and wages, retirement benefits etc.			
2. Shareholders as dividend			
3. Retained funds as depreciation etc.,			
4. Government as taxes **(specify)**			
5. Others, if any (specify)			
6. Total			

24. FINANCIAL POSITION AND RATIO ANALYSIS :

Sr. No.	Particulars	Current Year			Two Previous Years Separately		
		Product under reference	Factory as a whole	Company as a whole	Product under refrence	Factory as a whole	Factory as a whole
1	Capital employed						
2	Net Worth						
3	Profit						
4	Net Sales						
5	Operating expenses as a percentage of Net Sales:						

Sr. No.	Particulars	Current Year			Two Previous Years Separately		
		Product under reference	Factory as a whole	Company as a whole	Product under refrence	Factory as a whole	Factory as a whole
6	Profit as %age of capital employed						
7	Profit as %age of net worth						
8	Profit as %age of net sales						
9	Profit as %age of value addition						
10	Value addition as a %age of Net Sales						
11	Current assets to current liabilities						
12	Net working capital in terms of number of months of cost of sales excl. depreciation.						
13	Debt-equity ratio						
14	Raw materials stock in terms of number of months of consumption						
15	Stores & spares stock in terms of number of months of consumption						
16	Work-in-progress stock in terms of number of months of cost of production						
17	Finished goods stock in terms of number of months of cost of sales.						

Notes :

(1) Figures given for the company as a whole against serial number 1, 2, 3 and 4 shall be, duly reconciled with the financial accounts of the company

(2) The figures given for the product against serial number 1, 2, 4 and 5 shall be, duly reconciled with the cost accounts of the company.

(3) Figures given for the factory as a whole against serial number 1, 3, and 4 shall be, duly reconciled with the financial accounts of the company.

25. CAPITALISATION OF REVENUE EXPENDITURE:

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Raw Materials			
(a) Purchased			
- Indigenous			
- Imported			
(b) Self manufactured			
2. Direct wages & salaries			
3. Consumable stores			
4. Repairs & maintenance			
5. Depreciation			
6. Factory overheads			
7. Administration overheads			
8. Other expenses (specify)			
9. Total			
10. Capitalisation – Excisable value			
11. Capitalisation - Non Excisable value			

26. RELATED PARTY TRANSACTIONS:

Briefly describe the transfer pricing policy, followed by the company in respect of "related party relationship" as defined in the relevant cost accounting records rules made under clause (d) of sub-section (1) of section 209 of the Act. The following particulars may be furnished with regard to related party transactions :

Particulars of related party	Product/ activity	Quantity	Rate	Amount	Normal
Price					
1.					
2.					
3.					
4. etc.					

Note :

(1) Details should be furnished for sale and purchase transactions separately.

27. CENTRAL EXCISE RECONCILIATION FOR THE PRODUCT UNDER REFERENCE :

	Particulars	Chapter Heading --	Chapter Heading --	Chapter Heading --
A	**QUANTITATIVE DETAILS :**	Unit	Unit	Unit
1	Opening Stock			
2	Add : Production			
3	Less : Closing Stock			
4	Total Sales / Clearances			

	Particulars	Assessable Value (Rs.)	Rate of Duty	Amount of Duty (Rs.)
B	**DETAILS OF CLEARANCES**			
1	Total Clearances (Chapter heading-wise)			
2	Less : Duty Free Clearances (factory)			
3	Excisable Clearances (factory)			
4	Penalty / Fine / Interest payable if any			
5	Total Duty Payable (total 3 & 4)			

	Particulars	Inputs	Capital Goods	Total
C	**SUMMARY OF CENVAT CREDIT**			
1	Opening Balance			
2	Add : Availed During the year			
3	Add Refunds received during year			
4	Less : Closing Balance as per Excise Records			
5	Total Cenvat credit utilised during the year (1+2+3-4)			
6	Closing Balance as per Annual Accounts			
7	Difference between 4 - 6			
8	(State amount and reasons for difference)			

	Particulars	Amount (Rs.)
D	**RECONCILIATION OF DUTY PAID**	
1	Excise Duty Payable as per 'B'	
2	Total Excise Duty paid through	
	a) Cenvat Account -(Inputs)	
	b) Cenvat Account -(Capital Goods)	
	c) P.L.A.	
	Total (a+b+c)	

	Particulars	Amount (Rs.)
3	Difference between (1-2)	
4	(State amount and reasons for difference)	
5	Excise Duty as per RT – 12	
6	Difference between (2-5)	
7	(State amount and reasons for difference)	
E	**RECONCILIATION OF DUTY PAID AND RECOVERED:**	
1	Excise Duty paid as per P & L A/c	
2	Excise Duty Recovered as per P & L A/c	
3	Difference between duty paid and recovered	
4	(State amount and reasons for difference)	
F	**RECONCILIATION OF TURNOVER**	
1	Turnover as per RT 12	
2	Turnover as per Annual Accounts (Net off Duties & Taxes)	
3	Difference between (1- 2)	
4	(State amount and reasons for difference)	

F	**RECONCILIATION OF TURNOVER**	
1	Turnover as per RT 12	
2	Turnover as per Annual Accounts (Net off Duties & Taxes)	
3	Difference between (1- 2)	
4	(State amount and reasons for difference)	

28. PROFIT RECONCILIATION:

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Profit or Loss as per financial accounts.			
2. Add: Incomes not considered in cost accounts:			
(a) (specify)			
(b)			
(c)			
3. Less: Expenses not considerd in cost accounts:			
(a) (specify)			
(b)			
(c)			
4. Add: Overvaluation of closing stock in financial accounts			
5. Add: Under-valuation of opening stock in financial accounts			

Particulars	Current Year	1st Previous Year	2nd Previous Year
6. Less:Under-valuation of closing stock in financial accounts			
7. Less:overvaluation of opening stock in financial accounts			
8. Adjustment for others, if any (specify)			
9. Profit or Loss as per financial accounts			

Explanation:- for the purpose of these rules,-

(a) "CAPITAL EMPLOYED" means average of fixed assets at net book values (excluding intangible assets, effect of revaluation of fixed assets, capital works-in-progress) and current assets minus current liabilities and provisions existing at the beginning and close of the financial year.

(b) "NET WORTH" means share capital plus reserves and surplus (excluding revaluation reserve) less accumulated losses and intangible assets.

(c) "PROFIT" means operating profit after providing for depreciation and all other expenses except interest on borrowings including debentures but before providing for taxes on income.

(d) "NET SALES" means sales excluding sales returns, excise duties, sales tax, octroi, other local taxes and expenses refundable/recoverable from buyers/customers.

(e) "VALUE ADDITION" means the difference between the net output value (net sales adjusted for work-in-progress and finished goods stock) and cost of bought out materials and services for the product under reference.

(f) "NON MOVING STOCKS" means value of raw materials and components, finished and semi-finished which have not moved for more than twelve months. The period shall be twenty four months in case of consumable stores and spare used in workshop, tool rooms or repairs and maintenance.

(g) "NORMAL PRICE" means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged is the sole consideration of sale and such sale is not made to a related party.

NOTES :-

(1) If there is any change in the share capital due to merger, acquisition, buy back of shares, bonus issue etc. during the year under reporting, special mention may be made with the reasons therefore.

(2) The profit arrived at for the factory, company and the product shall not include interest and dividend received on investments outside the business, capital gains, and any other income which is neither normal nor of recurring nature. The profit so arrived shall be the normal operating profit earned during the current financial period of the company.

(3) Wherever, there is any significant variation in the current year's figure over the previous year's figure, reasons thereof shall be given.

(4) If the company has more than one factory producing the product under reference, separate details

shall be indicated in the prescribed annexures in respect of each factory.

(5) If the factory is engaged in the production of the product under reference and any other activities, separate details shall be indicated in the prescribed annexure for the factory as a whole and for the product under reference.

(6) Figures shall be given for the year under audit and for the two preceding years in respect of paragraphs 4 to 26

Signature	Signature	Signature
Name	Name	Name
Cost Auditor	Company Secretary	Director
Seal	Stamp	Stamp
Date	Date	Date

PROFORMA

Name of the company :

Name and address of the factory :

Name of the product :

Statement showing the cost of production, cost of sales, sales realisation and margin in respect of the product(s) under reference produced during the year/period :

A. Quantitative Information:

Sl. No.	Particulars	(unit of measurement to be specified)	
		Current Year (Units)	Previous Year (Units)
1.	(i) Installed capacity		
	(ii) Capacity enhanced during the year by leasing arrangement etc.		
2.	Actual production / output : (i) Self; (ii) third parties, if any;		
3.	Production as percentage of installed capacity		
4.	Captive consumption, if any		
5.	Quantity sold (a) Domestic (b) Export		
6.	Closing Stock (finished goods)		
7.	Opening Stock (finished goods)		

B. Cost Information:

Sr. No.	Particulars	Qty unit	Rate per unit	Amo- unit	Cost per unit	
			(Rs.)	(Rs.)	Current Year (Rs.)	Previous Year (Rs.)
1.	Material consumed : (item-wise covering at least 80% of items by value)					
	1. Purchased : (a) Indigenous (specify) (b) Imported (specify) 2 Self manufactured (specify)					
2	Process chemicals (specify)					
	Utilities 1. Purchased : (a) Indigenous (specify) (b) Imported (specify) 2. Self manufactured (specify)					
4.	Direct wages and salaries					
5.	Consumable stores and spares					
6.	Depreciation					
7.	Lease rent, if any					
8.	Repairs and maintenance:					
	(a) Building (b) Plant and Machinery (c) Others, if any					
9.	Other works overhead					
10.	Total Works Overheads (2 to 9)					
11.	Royalty, if any					
12.	Technical assistance/ know-how fee					
13.	Research and development					
14.	Quality control					
15.	Administrative overhead (relating to production activities) (a) Salaries and wages (b) Others (specify) (c) Total(a+b)					
16.	Total (1+ 10 to 15)					
17.	Adjustment for variances (where standard costing system is followed)					

Sr. No.	Particulars	Qty unit	Rate per unit	Amo-unit	Cost per unit	
			(Rs.)	(Rs.)	Current Year (Rs.)	Previous Year (Rs.)
18.	Add: Opening stock					
	Less: Closing Stock					
	(Work-in-progress)					
19.	Less: Credits (from wastage and by-products)/ Recoveries, if any					
20.	Packing cost Primary (a) Materials (b) Others (c) Total					
21.	Cost of production (16 to 20)					
22.	Finished Goods purchased, if any					
23.	Opening Stock Closing Stock (finished products)					
24.	Total (21+22 +23)					
25.	Quantity and cost transferred for : (i) captive consumption, if any (ii) sales (iii) others, if any					
26.	Packing cost Secondary (a) Materials (b) Others (c) Total					
27.	Other expenses : (a) Administrative overheads (others) (b) others (specify)					
28.	Selling and distribution expenses (a) Salaries and wages (b) Freight and transport charges (c) Commission to selling agents (d) Advertisement expenses (e) Royalty on sales, if any (f) Warranty expenses after adjusting income from chargeable services (g) Others (h) Total (a to g)					
29.	Interest and finance charges: (a) for manufacturing activity (b) others (c) total					

Sr. No.	Particulars	Qty unit	Rate per unit	Amo-unit	Cost per unit	
			(Rs.)	(Rs.)	Current Year (Rs.)	Previous Year (Rs.)
30.	Total cost of sales (excluding excise duty) of packed quantity sold (24 to 29)					
31.	Sales realisation Less: Excise duty and other statutory levies					
32.	Net sales realisation					
33.	Margin(32 – 30)					
34.	Add: export benefits and incentives, if any					
35.	Total margin (including export benefits)					
36.	Ex-factory price (excluding sales tax etc.)					
37.	Maximum retail price (excluding sales tax etc.)					
38.	Maximum retail price, if any, prescribed by the Government/ statutory/regulatory body etc.					

Notes :

1. Separate proforma shall be prepared for each type/variety/ description of product(s) under reference.
2. Separate proforma shall be prepared for the quantity used for captive consumption, quantity sold within the country and the quantity exported. Expenses incurred on export and the incentive earned thereon shall be indicated in the proforma applicable for the quantity produced and exported.
3. Separate proforma shall be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference.
4. The administrative overheads shall be included in the cost of production only to the extent they contribute in putting the goods produced to their present location and condition. The balance of administrative overheads, if any, shall be included in the cost of goods sold. The proforma may be amended accordingly, if required.
5. The proforma may be suitably modified to cover the special features, if any, of the product under reference on the basis of proforma prescribed for working out cost of sales, margin, etc. of the said product in the relevant Cost Accounting Records Rules.
6. Indicate whether the prices of the product under reference are ex-factory prices, F.O.R prices, door delivery prices or any other terms. In case of ex-factory prices, whether cost of dispatch packing materials, freight, insurance and delivery charges are recoverable from the customers separately.

Signature	Signature	Signature
Name	Name	Name
Cost Auditor	Company Secretary	Director
Seal	Stamp	Stamp
Date	Date	Date

F.No.52/10/CAB-2001

(A.Ramaswamy)

Joint Secretary to the Government of India,

Note.- The principal rules were published vide G.S.R. number 511(E), dated the 4th November, 1996.

The Cost Audit Report (Amendment) Rules, 2006

G.S.R.148(E).- In exercise of the powers conferred by sub-section (4) of section 233B read with sub-section (1) of section 227 and clause (b) of sub-section (1) of section 642 and section 610A of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules further to amend the Cost Audit Report Rules, 2001, namely:-

1. (1) These rules may be called the Cost Audit Report (Amendment) Rules, 2006.

   (2) They shall come into force on the date of their publication, in the Official Gazette.

2. In the Cost Audit Report Rules, 2001, -

   (i) after sub-rule 2 of rule 4, the following sub-rules shall be inserted, namely: -

3. The Forms prescribed in these rules may be filed through electronic media or through any other computer readable media as referred under section 610A of the Companies Act, 1956 (1 of 1956).

4. The electronic-form shall be authenticated by the authorized signatories using digital signatures, as defined under the Information Technology Act, 2000 (21 of 2000).

5. The Forms prescribed in these rules, when filed in physical form, may be authenticated by authorized signatory by affixing his signature manually.”

   (i) in the Form for the heading “FORM OF THE COST AUDIT REPORT”, “FORM II - THE COST AUDIT REPORT” shall be substituted;

   (ii) before the existing form, the following form shall be inserted, namely:-

FORM I - Form for filing cost audit report and other **documents with the Central Government**

FORM I - Form for filing cost audit report and other documents with the Central Government

FORM I

Form for filing cost audit report and other documents with the Central Government

[Pursuant to section 233B(4), 600(3)(b) of the Companies Act, 1956 and rule 2(c) and rule 4 of the Cost Audit (Report) Rules, 2001]

Note - All fields marked in * are to be mandatorily filled.

I. General information of the company

1(a). *Corporate identity number (CIN) or foreign company registration number of the company ______ Pre-Fill

(b). Global location number (GLN) of company ______

2(a). Name of the company ______

(b). Address of the registered office or of the principal place of business in India of the company ______

3. Cost audit report (CAR) pertains to:

(a). *Name of the industry ______

(b). *Product or activities ______

(c). Central excise tariff chapter heading ______

(d). *Name and location of the unit ______

(e). *State where unit is located ______

(f). *Financial year From ______ (DD/MM/YYYY) To ______ (DD/MM/YYYY)

4. *Location of other sites manufacturing or producing or processing or mining the product or carrying out the activity under reference (refer CAR annexure 1.5)

______

5(a). *Income-tax permanent account number (PAN) of cost auditor ______

(b). *Name of the cost auditor or firm ______

(c). *Membership number of cost auditor ______

6. *Cost audit order number ______ dated ______ (DD/MM/YYYY)

7. *Service request number (SRN) of relevant Form 23C seeking approval of appointment of the cost auditor ______ dated ______ (DD/MM/YYYY)

8. *Whether the cost audit report has been qualified or contains adverse remarks ○ Yes ○ No

9. *Whether there is any transaction with the related parties during the period to which the cost audit report pertains ○ Yes ○ No

II. Quantitative information (for the product or activitity under reference)

Unit of measurement (UoM)

Sl. No.	Pariculars	CAR annexture reference	Current year	Previous year
1.	Total available capacity	4.3		
2.	Total production quantity	4.5		
3.	Capacity utilisation percentage	4.7		
4.	Total available quantity	4.9		
5.	Quantity captively consumed	4.10		
6.	Quantity sold (domestic)	4.11 (a+b)		
7.	Quantity sold (exports)	4.11 (c+d+e)		
8.	Closing stock (finshed goods)	4.12		

III. Expot commitments (amount in Rs. thousands) - [(As per cost auditor's certificate - para 3(g)]

A Export comitments

B. Actual exports towards forwards export commitment

IV. 'Standard and actual consumption per unit (for the product or activity under reference)

Sl. No.	Particulars	Unit (specify)	Standard (Quantity/ unit)	Actuals (Quantity / unit)	
				Current year	Previous year
	Consumption of input materials as per unit ([Annexture 5(B)] - Specify details of major input materials, components				
1.					
2.					
3.					
4.					
5.					
	Consumption of power, fuel and utilities per unit [Annexture 7(B)]				
1.					
2.					
3.					
4.					
5.					

.

V. Key information from Cost Audit Report (for the product or activity under reference)

Sl. No.	Particulars	CAR annexture reference	Unit (Specify)	Current year	Previous year
1.	Total employee costs	8B.6	Rs. in thousands		
2.	Total repairs and maintenance	9.5	Rs. in thousands		
3.	Depreciation absorbed	10.5	Rs. in thousands		
4.	Total overheads	12 (1 to 4)	Rs. in thousands		
5.	Total research and development expenes	13.5	Rs. in thousands		
6.	Total royalty and technical know how charges	14.5	Rs. in thousands		
7.	Total quality control expenses	15.6	Rs. in thousands		
8.	Total pollution control expenses	16.6	Rs. in thousands		
9.	Total abnormal non-recurring costs	17	Rs. in thousands		
10.	Total closing stock	18.(A).e2	Rs. in thousands		
11.	Total value of non-moving stock	18.(A).e3	Rs. in thousands		
12.	Non-moving stock to closing stock	18.(A).e4	percentage		
13.	Total written off stock	18.(B).5	Rs. in thousands		
14.	Total value of inventoryas per cost account	18 (B) 5	Rs. in thousands		
15.	Total value of inventory as per financial accounts	19(A).10	Rs. in thousands		
16.	Estimated demand of the product in the country	19.(A).11	Rs. in thousands		
17.	Total production in the country				
18.	Quanititites imported in the country	22.4			
19.	Percentae share of the company in total inland production	22.6	percentage		
20.	Net sales (excluding excise duty)				
21	Adjustments in stocks	23.5	Rs. in thousands		
22.	Cost of bought out materials and services	23.5			
23.	Value added	23.6	Rs. in thousands		
24.	Capital employed (for the product)	24.1	Rs. in thousands		
25.	Net worth (for the product)	24.2	Rs. in thousands		
26.	O Profit O Loss for the product	24.3	Rs. in thousands		

27.	Operating expenses as a percentage of net sales (for the product)	24.3	Rs. in thousands		
(a)	Material cost	24.5a	Percentage		
(b)	Factory overheads	24.5b	Percentage		
(c)	Royalty on production	24.5c	Percentage		
(d)	Salaries and wages				
(e)	Research and development expenses	24.5d	Percentage		
(f)	Quality control	24.5f	Percentage		
(g)	Administrative overheads	24.5g	Percentage		
(h)	Selling and distribution	24.5h	Percentage		
(i)	Interest	24.5h	Percentage		
28.	O Profit O Loss as a percentage of employed	24.6	Percentage		
29.	O Profit O Loss as a percentage of netowrth	24.7	Percentage		
30.	O Profit O Loss as a percentage of net sales	24.8	Percentage		
31.	Value adition as a percentage of net sale	24.10	Percentage		
32.	Excise duty (ED) payable	27.D.1	Rs. in thousands		
33.	ED paid through cenvat - inputs	227.D.2.a	Rs. in thousands		
34.	ED paid through cenvat - capital goods	27.D.2.b	Rs. in thousands		
35.	Personal Ledger Account (PLA)	27.d.2.c	Rs. in thousands		
36.	Total	27.D.2	Rs. in thousands		

VI. Margin per unit of output (for the product or activity under reference) - Annexture 21

Sr. No.	Particulars	Current Year			Previous Year		
		Cost of Sales (Rs. / unit)	Sales realisation (Rs. / unit	Margin (Rs./unit)	Cost of Rs./unit)	Sales realisation (Rs. / unit	Margin (Rs./ unit)
	Purchased goods ○ Yes ○ No If yes, specify details of major product						
1.							
2.							
	Loan license basis ○ Yes ○ No If yes, specify details of major product						
1.							
2.							
	Own manufactured ○ Yes ○ No If yes, specify details of major product						
1.							
2.							
3.							
4.							
5.							

Attachments List of attachments

1. *Cost audit report as per the Cost Audit (Report) [Attach]

2. Optional attachment(s) - if any [Attach]

[Remove attachment]

Declaration

To the best of our knowledge and belief, the information given in the form and its attachments is correct and complete .

We have been authorised by the board of directors' resolution dated * [ ] (DD/MM/YYYY) to sign and submit this form.

To be digitally signed by

Managing director or director or manager or secretary (In case of an Indian company) or an authorised representative (In case of a foreign company) [ ]

Director of the company [ ]

Cost of auditor [ ]

[**Modify**] [Check Form] [Proscruity] [submit]

For office use only:

This e-Form is hereby registered

Digital signature of the authorising officer [ ] [ ]

2.11 SPECIMEN QUESTIONS WITH ANSWERS

Question No. 2.1 :

(b) A company manufacturing bulk drugs and formulations charges selling and distribution expenses as a percentage on sale values. As the cost auditor of the company, would you accept this absorption basis as equitable?

(c) A company producing Sulphuric Acid has not given any credit for waste heat arguing that it is not possible to arrive at any value for the waste heat. As a cost auditor now would you deal with this?

(d) Steam produced by the boiler house in a sugar mill has been valued at the market price of coal and debited entirely to sugar activity. Actually the steam produced is used for power generation by the turbine and about 20% of the steam is used for Alcohol production. It is argued by the company that both power generation by turbine and alcohol production are activities incidental to sugar manufacturing. As the cost auditor what would be your recommendation?

Answer :

(a) The method of absorbing selling and distribution overheads as a per cent of sales value for both bulk drugs and formulations together is not correct because:

(i) Some quantity of bulk drug might have been consumed captively in the company's own formulations.

(ii) The incurrence of Selling and Distribution expenses will not be same for the two groups of products. Formulations require a variety of expenses in promotion like literature, sampling, seminars, doctors meet etc. while bulk drug may not need these.

(iii) Freight & depot costs for formulations will be much higher than bulk drugs.

(iv) The correct method will be to identify each expense separately for bulk drug and formulations as far as possible. The residual common items can be prorated on sales value basis.

(b) As per Note 4 of Proforma "A" of Schedule II of the Cost Accounting Records (Sulphuric Acid) Rules, 1980, credit for waste heat from Sulphuric Acid Plant should be technically estimated based on thermal equivalency and valued, and the same should be shown as a deduction from the cost of production under the heading, "Credit for Recoveries" if any, including waste heat.

(c) Cost of steam generated and consumed by the turbine will be taken as steam cost in power generation. As steam does not get used up in power generation but collected back as exhaust steam, the loss in the enthalpic value of the steam is alone charged to power and the balance is taken as process steam. Of this 20% is charged to alcohol manufacture and the balance to sugar production processes.

Question No. 2.2 :

A company under Cost Audit has three sources of power supply:

(i) Electricity Board

(ii) Heavy Power Generator

(iii) A bank of 100 Windmills.

In the Power Cost statement the generator power and the windmill power are valued at Electricity Board energy bill rate which consists of maximum demand charges and energy charges.

Is this method acceptable for cost statements for Cost Audit and also for para 7 of Cost Audit Report Rules.

Answer :

Electricity Board Power Bill consists of two elements maximum demand charges and energy charges i.e. units X Electricity Board per unit rate.

The maximum demand charges are levied and collected by EB on the total connected load multiplied by a rate per KVA. Hence, this is a fixed charge. Even if power is not drawn from the EB this charge will have to be paid in full.

Hence, units of power generated by generator and wind mill will have to be charged to the user departments only at cost of generation. This is because inter-divisional profit on captively consumed services should not be included in costs of products particularly when such costs are used for valuation of inventories of Finished Goods & WIP. Where costs of generation of power are lower than valuation at EB power rate a profit will result.

Para 7 of the Cost Audit Report Rules and also Cost Accounting Record Rules do not specifically mention about the price at which captive power is to be charged. As per strict accounting principles profit should not be considered at all.

Question No. 2.3 :

Production was affected in a factory during a year for the following reasons:

(a) 40% power cut for three months on account of which production was affected by 50% during that period.

(b) Workers' strike for three months resulting in total stoppage of production. The office staff was working during this period and workers suffered loss of pay.

What are the elements of cost to be considered for computing the abnormal loss, if it has to be reported in the Annexure to the Cost Audit Report ?

Answer :

Expenditure incurred, however essential, is not treated as cost unless it is a normal expenditure. Abnormal expenditure is, therefore, generally excluded from cost, and is treated as an item in financial profit reconciliation. What should be excluded is not only a question of fact, but also a matter of judgment. The amount involved should also be material.

The expenditure recurring year after year is treated as normal, although it may not be incurred directly for production, e.g. off-season allowance in sugar industry.

If the cost auditor and the company are not in agreement on items to be excluded, the company may include such items of cost in the cost proformae prepared as per relevant rules, but the cost auditor should quantify the amount and indicate the same in item 13 of the Annexure to the Cost Audit Report

Abnormal loss during power cut is attributable to the following costs which should be excluded from the product cost for the period –

(a) Proportionate depreciation for the number of shifts not worked.

(b) That portion of factory and administrative overheads which could not be avoided during the power cut period.

Abnormal loss during the strike period may be caused due to the following factors –

(a) Factory and administrative overheads (period costs) relating to the strike period .

(b) Additional security expenses incurred, if any, during the strike period.

(c) Depreciation on plant and machinery and other production assets for the strike period.

Question No. 2.4 :

The following figures are taken from the account of AB Ltd. :

(Rupees in lakhs)

	31.3.2008	31.3.2007	31.3.2006
Gross fixed assets	4615	4212	3845
Cumulative depreciation	1312	1263	1224
Capital works-in-progress	273	225	317
Investments in shares and debentures	724	712	693
Inventories	625	580	511
Sundry debtors	334	317	292
Advances for purchase of capital equipment	24	61	47
Other loans and advances	65	58	53
Other current assets	32	29	26
Sundry Creditors	214	187	174
Provision for expenses	29	34	28
Net sales	3924	3212	2931
Depreciation	54	47	44
Interest	614	497	416
Profit before taxes	232	145	197

Compute the following ratios as defined in the Cost Audit Report Rules, 2001, for the years ended 31.3.2008 and 31.3.2007 :

(a) Profit as a percentage of capital employed;

(b) Profit as a percentage of net sales.

Answer :

Working Note :

Capital works in progress, investment outside the business and advances for purchase of capital equipment do not enter into the computation of capital employed.

Statement showing computation of capital employed

(Rupees in lakhs)

	31.3.2008	31.3.2007	31.3.2006
Gross fixed assets	4615	4212	3845
Less Depreciation	1312	1263	1224
Net fixed assets (A)	3303	2949	2621
Gross current assets :			
Inventory 625	580	511	
Sundry debtors	334	317	292
Other loans and advances	65	58	53
Other current assets	32	29	26
Total current assets	1056	984	882
Current liabilities	214	187	174
Provisions 29	34	28	
Total current liabilities	243	221	202
Net current assets (B)	813	763	680
Total capital employed (A+B)	4116	3712	3301
Average capital employed :			
2007-08 : (3712 + 4116)/2	3914		
2006-07 (3301 + 3712)/2	—	3506	
Profit before taxes	232	145	
Interest	614	497	
Profit as defined in GARR	846	642	
Net Sales	3924	3212	
Profit as a % of :			
— Capital employed	21.6	18.3	
— Net Sales	21.6	20.0	

Question No. 2.5 :

The Abridged Balance Sheet and Profit & Loss Accounts of Apex Papers Ltd. for the years 1999-2000 and 1998-99 are given below :-

(Rs. in Lakhs)

Balance Sheet	1999-2000	1998-99
Share Capital	6500	6500
Reserves & Surplus	37063	35122
Secured Loans	38545	42000
Unsecured Loans	5720	6800
	87828	90422
Gross Block 105060	105060	105250
Depreciation	(40232)	(36200)
Capital Works in Progress	4515	1600
Investments 115	115	115
Current Assets, Loans & Advances	28870	32457
Current Liabilities & Provisions	(10500)	(12800)
	87828	90422

Profit & Loss A/c.	1999-2000	1998-99
Sales net of Excise Duty & Sales Tax	50659	45066
Other Income : Profit on Sale of Assets	105	64
Dividends received	15	13
Sale of Scrap & Waste	280	320
Total	51059	45463
Expenses :		
Raw Materials, Stores & Spares and purchased finished goods	30695	26924
Salaries, Wages & Other employee costs	2003	1721
Power & Fuel	3788	3144
Repairs & Maintenance	484	424
Other Manufacturing, administrative and selling expenses		
(purchased goods & services)	1902	1621
Interest	4138	
Depreciation	4032	
Total	47042	
Profit before taxes	4017	3498

Provision for taxes & dividend	2076	1840

Analysis of financial accounts and Cost Accounting

Records reveal the following additional information:

(a) Revaluation Reserve included in Reserves & Surplus	11140	12250
(b) Loans repayable in 12 months included under 'Secured Loans'	4250	4750
(c) Trading goods included in Inventory	3120	2712
(d) Sundry Debtors for Trading activity included under Current Assets	2080	2820
(e) Sundry Creditors for Trading goods included under Current Liabilities	1540	1810
(f) Trading goods included in Sales	14240	13625
(g) Cost of Trading goods included under Material Costs	10680	9810

(h) The following expenses are allocated/ apportioned to Trading Activity:

Salaries & Wages	10%
Selling Expenses	Rs. 280 lakhs (Prev. Yr. Rs. 214L)
Depreciation	5%
Interest	20%

Compute the following ratios for reporting in para 3 of the Cost Audit Report for the year 1999 – 2000 : (Ignore opening & closing stocks)

(a) Profit as a percentage of capital employed for the product;

(b) Value Addition as a percentage of sales.

Answers **Rs. (Lakhs)**

Capital employed (for the product)		31-3-2000	31-3-1999	
Gross block	1,05,060		1,05,250	
Less : Depreciation	40,232		36,200	
Revaluation Reserve	11,140		12,250	
Net fixed assets (A)		53,688		56,800
Current Assets, Loans & Advances	28,870		32,457	
Less : Inventories & Sundry Debtors allocated to trading	5,200	23,670	5,532	26,925
Current Liabilities & Provisions	10,500		12,800	
Term loans due in 12 months	4,250		4,750	
	14,750		17,550	
______________activity	1,540	(13,210)	1,810	(15,740)
_________sets (B)		10,460		11,185
Total capital employed (A+B)	64,148			67,985
Average capital employed for 1999-2000 = (64,148 + 67,985)/2	66,066			

Profit

(a) Profit from Trading activity : (Figures for 1998-99 are not relevant for the problem)

Sales		14,240
Less : Materials	10,680	
Salaries & Wages	200	
Selling expenses	280	
Depreciation	202	
Interest	828	
Total cost		12,190
Profit from trading		2,050

(b) Profit for the product under audit

Total profit for the Company		4,017
Less : Trading profit	2,050	
Profit on sale of assets	105	
Dividend	15	2,170
Add : Interest (80% of Rs. 4,138)		1,847
Profit for product as per Para 3		3,310
		5,157

Value addition :

Note : Value addition is defined as the difference between the Net sale value and cost of bought out goods and services. This would be equal to the total of profit before Taxes, Interest, Depreciation, Employee costs and Turnover tax (or additional sales tax) not recoverable, wherever applicable. Accordingly value addition is worked out here adopting this route.

Profit before interest & taxes for the product as worked out above	Rs. 5,157 lakh
Add : Employee costs (90% of 2003)	1,803
Depreciation (95% of 4,032)	3,830
Value addition	10,790

Sales :

Total sales net of ED	50,659
Less : Trading activity	14,240
Sales of product under audit	36,419

Ratios

(a) Profit	5,157	
Capital employed	66,066	
Profit as % of cap. Employed for the product		7.80%

(b) Value addition	10,790	
Net sales	36,419	
Value addition as % of sales		29.63%

Question No. 2.6

The following figures relate to usage of power for a product:

	1994-95	1993-94	1992-93
Total power consumed in KWH	2402474	2494872	2175677
Rate/KWH (Rs.)	2.29	2.12	1.90
Total production in million kgs.	337.730	333.084	300.865

Compute necessary productivity measures and compare the efficiency of power usage during the three years.

Answer :

		1994-95	1993-94	1992-93
Total power consumed in KWH		2402474	2494872	2175677
Rate/KWH (Rs.)		2.29	2.12	1.90
Total power cost (Rs.)		55,01,665	52,89,129	41,33,786
Total production in million kgs.		337.730	333.084	300.865
Power cost/MT (Rs.)		16.29	15.88	13.74
Power usage MT (KWH)		7.11	7.49	7.23
Variances over previous years :				
Rate (Rs.)	4,08,420(A)	5,48,872(A)		
Volume (Rs.)	73,774(A)	4,42,678(A)		
Usage (Rs.)	2,69,658(F)	1,63,793(A)		
Total (Rs.)	2,12,536(A)	11,55,343(A)		

Question No. 2.7 :

There was a strike from 13.9.2007 to 16.11.2007 in a company of which you were the cost auditor for the year ending 31.3.2008. Although the company began working from 17.11.2007 production could effectively begin only from 5.12.2007. The expenses incurred during the year ended 31.3.2008 were :-

	Rupee lakhs
Salaries and wages (direct)	*300*
Salaries and wages (indirect)	*200*
Power (Variable)	*120*
Depreciation	*180*
Other fixed expenses	*240*

Detailed examination of the records reveals that of the above the following relate to the period 13.9.2007 to 16.11.2007:-

	Rupee lakhs
Salaries and wages (indirect)	*70*
Depreciation	*60*
Other fixed expenses	*90*

Calculate the amount which, in your opinion, should be treated as abnormal for exclusion from the product costs.

Answers :

(b) Calculation of fixed expenses incurred during 17.11.2007 to 4.12.2007

Rupee lakhs	
Total expenses 2007-98	*1,040*
Variable expenses (Electricity)	*12 0*
Fixed expenses 2007-08	*920*
Fixed expenses during strike period	*220*
Fixed expenses during non-strike period	*700*

Since the strike period was for 65 days, the non-strike period is 300 days. Hence, fixed expenses attributed to 18 days i.e. 17.11.2007 to 4.12.2007 is 6% of Rs. 700 lakhs i.e. 42 lakhs.

Therefore :	*Expenses incurred during 13.9.2007 to 16.11.2007*	*Rs.220 lakhs*
	Fixed expenses incurred during 17.11.2007 to 4.12.2007	*Rs. 42 lakhs*
	Total	*Rs. 262 lakhs*

Thus in my opinion, Rs. 262 lakhs is to be treated as abnormal cost and to be excluded from product cost.

Question 2.8

A company, manufacturing cotton textiles wrote-off in the same year the expenditure on replacement of copper rollers used for printing fabrics and stainless steel frames used for dying yarn. Whether the cost auditor can qualify the report for these?

Answer

The relevant Cost Accounting Records Rules require that such expenses are to be treated as deferred revenue expenses and amortized over the effective economic life of those items. The cost auditor should therefore point out in his report that the treatment followed is not in accordance with the relevant Cost Accounting Records Rules and could also quantify the impact on cost, due to the deviation from the laid down procedures.

2.12 Self-examination Question

1 Write notes on "qualified cost audit report". Under what circumstances such qualified report is submitted? What precaustions are to be taken by the cost auditor while submitting a qualified report?

2 Discuss the points to be covered in Para No. 1 of the Annexure to the Cost Audit (Report) Rules, 1996.

3 Write the not to indicate the points which the cost auditor has to comment on while dealing with Para 2 (cost accounting system) of the Annexure to the Cost Audit Report prescribed under the Cost Audit (Report) Rules 1996.

4 The cost audit report require that the cost auditor should report on the adequacy of the cost accounting system of the company under audit. List out the points which you consider are major to assess such adequacy.

5 State the provision regarding "financial position" under Para No. 3 of the Annexure to the Cost Audit (Report) Rules 1996.

6 (a) Define "Capital employed" as given in Cost Audit (Report) under Para No. 3 of the Annexure to the significance of items excluded therefrom.

(b) How is "profit" defined in the rules and why is to be related to:capital employed" and not to "net worth" which is the real owner of the funds?

(c) In a multiproduct unit how you will proceed to determine capital employed?

7 Capacity utilization is an important parameter to assess the production efficiency contemplated in cost audit. Briefly explain how capacity utilization is assessd and how efficiency of utilization can be improved.

8 Underutilisation of capacity in a factory may result from imbalance in production facilities in some areas. Explain the possible reasons for such imbalance, with examples. Should the Cost Auditor make any observations in this regard in the Cost Audit Report?

9 (a) Determination of production capacity of an industrial organisation becomes necessary for some purposes. Identify them.

(b) Discuss the measures for detrmining installed capacity as per the recommended guidelines of the ICWAI

10 Indicate the points which a cost auditor has to comment on, while dealing with Para No. 4 (production) of the Annexure to the Cost Audit (Report) Rules, 1996.

11 (a) In the Annexure of the Cost Audit Report Rules, details of production and percentage of production to installed capacity has to be given. How do you go about ascertaining –

(i) installed capacity,

(ii) actual production.

(b) In a company manufacturing electric motor, you noticed that the licensed an d installed capacity are indicated in number in the Annual Audited Accounts of the Company. Would you, as cost auditor, of the company for the electric motors accept this capacity as such? If not, Why? How would you present it as per requirement of Cost Audit (Report) Rules, 1996. Illustrate with examples.

12 Study of the process of manufacture is considered as one of the essential first steps in cost audit planning. For effective cost audit planning what are essential points one must remember in undertaking a study of the process.

13 "Direct materials" constitute significant part of cost of any product. Discuss how the requirements of the Cost Audit (Report) Rules relating to such materials, help in evaluating the performance of a company in this area.

14 The sharp increases in cost of power and fuel prices and decline in their availability, this input has gained critical importance. List out the aspects which you feel are important in auditing.

15 On whom is the action for disposal of Cost Audit Report lies? Why?

16 What is the further responsibility of the company after the submission of Cost Audit Report?

17 Is further action meaningful in the case of Cost Audit of products which forms an insignificant portion of the activity of the company?

18 Is the company obliged to send a report under subsection (7) of section 233-B even in case where they are of the opinion that there are no reservation or qualification made by the Cost Auditor? If so, state the reasons for the same.

19 Can a Cost Auditor make an adverse or qualified report or introduce the clause of reservation without getting the data or observation verified by the company? Give examples.

20 What are the three documents which the Central Government considers, before taking action n the Cost Audit Report?

21 Is the further follow up action of the Central Government restricted to Companies Act only?

22 What are the other areas where action can be initiated? Give examples.

23 Is it mandatory for the Government to take action on the report or whether it can simply file the report?

24 What are the areas that are looked into by the Government in the Cost Audit Report in its review.

25 Who conducts the review of the Cost Audit Report?

26 Under what circumstances shareholders of the company can have access to the Cost Audit Report? Explain the provisions of the relevant section.

27 What is the difference in treatment in the disposal Cost Audit Report, and the report of the Financial Auditor?

28 What is the scope of the penal clause for the company if it violets the provisions of the Act?

29 The Central Excise Rules have been amended given power for the excise officers to call for the Cost Audit Report. Detail this amendment and the nature of end use to which the Cost Audit Report can be put into.

30 Can an industrywise cost profile be made from the data in the Cost Audit Report and published?

31 Some public undertakings have special advantage in studying the trends of cost of various units under their control? Discuss.

32 How far are the income authorities interested in the Cost Audit Report?

33 Is the Cost Auditor punishable under the Act? If so under what circumstances?

34 Is the financial auditor also punishable for any violation of the same type? If not state the reasons for the same.

35 "Parliament members also cannot have access the Cost Audit Report". Is it true?

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STUDY NOTE - 3

Cost Accounting Record Rules

This Study Note includes:

- Procedure for Prescription of Cost Accounting Record Rules
- General Provisions under the various Cost Accounting Records Rules
- Cost Accounting Records (Telecommunication) Rules, 2002

3.1 Procedure for Prescription of Cost Accounting Record Rules

3.1.1 Introduction

3.1.1.1 Cost Accounting Record Rules are the prescribed details by the Central Government w.r.t. utilization of material, labour or other items of cost in respect of a class of companies notified under the provisions of Companies Act, 1956. The Cost Accounting Record Rules are aimed at inducing the companies to have control over their operations and costs with a view to achieve optimum utilization of resources in the economy. These Rules inculcate a system so that such records are maintained under generally accepted cost accounting principles in a systematic way and on a uniform basis among the various companies of an industry. This ensures the availability of uniform and authentic database with the industry, which can be helpful to the Government in taking appropriate decision, whenever required

3.1.1.2 Section 642 of the Companies Act, 1956 confers powers on the Central Government to make rules, which form part of subordinate legislation of the Government. The nature of records to be maintained under Section 209(1)(d) are to be prescribed by the Central Government in exercise of the powers conferred on them by the provisions of Section 642 of the Companies Act.

3.1.1.3 The Central Government has the power under Section 209(1)(d) to prescribe particulars relating to utilization of material, labour or other items of cost in respect of any class of companies engaged in production, processing, manufacturing or mining activities. This provision has been interpreted as meaning that the type of industry or exact nature of cost accounting record will have to be prescribed by the Central Government. Therefore, these requirements for maintaining the particulars relating to "utilization of material, labour or other items of cost" are prescribed through Cost Accounting Records Rules.

3.1.1.4 Section 209(1)(d) also specifies that the rules are to be prescribed for any class of company engaged in production, processing, manufacturing or mining activities. The class of companies may represent companies manufacturing a particular product like sugar, vanaspati, motor vehicles, textiles, bulk drugs, etc. The cost accounting records rules are prescribed separately with respect to each class of companies manufacturing a particular product i.e., industry as a whole.

3.1.1.5 These rules contain the particulars relating to utilisation of material or labour or other items of cost as may be prescribed to include such details in the books of accounts. The broad categories under which the detailed cost records required are materials, labour, utilities, overheads, depreciation, royalty/technical know-how, research & development expenses, incentives on exports, interest and other borrowing costs, captive consumption, pollution control, inter-company transaction etc. It also contains various proformae to enable the industry to calculate the cost of production and cost of sales uniformly and effectively.

3.1.1.6 It may be mentioned that Cost Audit Order under Section 233-B of the Companies Act is ordered only when Cost Accounting Records Rules are already prescribed for a company manufacturing a particular product, under the powers conferred under the Companies Act, 1956. Moreover, in the absence of any commonly prescribed Rules or the uniform cost accounting principles, the component-wise cost calculated by different companies may not be strictly comparable due to usage of different methods, procedures and practices adopted by various accountants. The cost accounting record rules form the vary basis for compilation of cost audit reports.

3.1.2 Prescription of Cost Accounting Record Rules

3.1.2.1 *Identification of the class of companies manufacturing a product:* The Central Government selects the products (class of company manufacturing a particular product) for which the cost accounting record rules are proposed to be notified. The Government generally considers the following factors in making the final selection :

i) Products/services of mass consumption i.e., consumer oriented;

ii) Products which are under statutory pricing mechanism or under some sort of statutory price control;

iii) Products which are very critical for infrastructural development or products which are basic industrial raw materials or inputs as any price increase in these products may affect the whole economy;

iv) Products which are very critical for economy and substantial subsidies are granted by the government;

v) Products which are subject to any 'Regulatory Authority' mechanism or where inputs are required by respective Regulatory Authority;

vi) Products which have a likely high profit margin or unfair trade practices due to limited competition in the market or cartelization;

vii) Products, where government revenue needs to be protected;

viii) Any other product for which representations are received from Consumer Association, Chamber of Commerce etc. or assurance has been made in Parliament for prescription of Cost Accounting Records Rules.

3.1.2.2 *Preparation of preliminary draft Rules:* The officers of Cost Audit Branch visit the sample representative units in the industry to study and understand the manufacturing process, practices, different stages involved and type of records maintained by them etc. This is necessary to ensure that only bare minimum additional record is prescribed, if any required. The Cost Audit Branch prepares the first preliminary draft of Cost Accounting Records Rules and circulates them to the industry representatives, practicing cost accountants, experts in the field, Tariff Commission, Cost Accounts Branch under Ministry of Finance, Administrative Ministry and both the accounting bodies namely Institute of Cost & Works Accountants of India (ICWAI) and Institute of Chartered Accountants of India (ICAI) for their comments.

3.1.2.3 On receipt of the comments, all the suggestions and comments are studied in detail and the draft cost accounting records rules are revised and finally discussed in an Informal Advisory Committee Meeting inter-alia attended by reps. of all the aforesaid bodies namely Cost Accounts Branch, Tariff Commission, Administrative Ministry, ICAI, ICWAI, Expert, Industry Member etc. The final draft is agreed in this meeting.

3.1.2.4 The agreed draft rules are then put up for the approval of Union Minister in charge of Ministry of Corporate Affairs. After the receipt of administrative approval from the Union Minister, the rules are forwarded to Ministry of Law and Justice for legal vetting and clearance from the legal angle. If the finally vetted draft rules are at major variance from originally proposed rules, these rules are again put up for administrative approval. Otherwise, these rules are sent for Hindi translation.

3.1.2.5 After the receipt of Hindi translation, the rules are sent for printing or notification in Official Gazette to Government printing press. Generally, the rules provide that these shall come into effect from the day it is notified in the Official Gazette.

3.1.2.6 Each rule is given a GSR (General Statutory Rules) No. and date of publication in the Gazette.

3.1.2.7 Section 642 (3) of the Companies Act, 1956 provides that 'Every rule made by the Central Government under sub-Section (1) shall be laid as soon as may be after it is made before each House of Parliament while it is in session for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be, so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule'.

3.1.2.8 In view of aforesaid provision, the copies of the notified rules duly authenticated are placed in both Houses of Parliament for a total period of 30 days as required under Section 642(3) of the Companies Act, 1956. If both the Houses agree in making any modification in the rules, the rule shall thereafter have effect only in such modified form.

3.1.2.9 It may be seen from the above that specific prior approval of Parliament is not required for notifying the rules as it represent subordinate legislation. However, the rules shall have the same effect as an Act made by the Parliament and contravention of the same shall be punishable with fine as provided in the rules.

3.1.3 Cost Accounting Records Rules and its Applicability

3.1.3.1 The Cost Accounting Records Rules are applicable only to selected companies incorporated under the Companies Act, 1956 (whether private or public) and not to other forms of business such as partnership, proprietary, etc.

3.1.3.2 A wholly owned subsidiary of a company, to which Cost Accounting Records Rules are applicable, is also covered by the said record rules provided that the product of such subsidiary company forms a part/component of cost of production of the product or use of utility/services for the holding company.

3.1.3.3 In the case of company manufacturing a product covered by the record rules but the said product is entirely used as in-house input (captive consumption) for another end product not covered, it may be clarified that the relevant Cost Accounting Record Rules are applicable to such product (produced but not sold) and prescribed records have to be maintained with respect to said product under reference.

3.1.3.4 Small scale units are generally exempted from the requirements of cost accounting records rules, even if they belong to the industries or class of companies for which, the maintenance of cost accounting records have been prescribed. The application clause of the rules clearly provide that these rules shall not apply to a company -

(a) The aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed the limits as specified for a small scale industrial undertakings under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) the aggregate value of the turnover made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

3.1.3.5 The existing limit for the aggregate value of the installed plant and machinery on the last date of the preceding financial year is rupees one crore for being categorized as small scale unit. Therefore, a unit has to fulfill both the aforesaid requirements to claim exemption from the requirements of Cost Accounting Records Rules i.e., aggregate value of turnover not to exceed rupees ten crores and the aggregate value of the installed plant and machinery on the last date of the preceding financial year not to exceed rupees one crore. However, it may be clarified that in case of companies manufacturing "formulations", covered under Drug Price Control Order, small scale units are also covered under the provisions of cost accounting records rules.

3.1.4 List of Notified Cost Accounting Records Rules for Different Industires

3.1.4.1 *List of industry/products covered by Cost Accounting Record Rules :* The industry/products for which Cost Accounting Records Rules have been notified so fare are given below with reference to the Amendments wherever made:

LIST OF INDUSTRIES AND THE PRODUCTS COVERED UNDER SECTION 209(1)(D) OF THE COMPANIES ACT, 1956					
No.	**Industry**	**Products**	**GSR NO. and Date**	**Effective from**	**Remarks**
1	Cement	Cement, Clinker	536 (E) dt. 11.9.1997*	11.9.1997 *	The Rules, 1997 notified in suppression of GSR 1402 dt. 12.9.66
2	Cycles	Cycles, component of cycles	311 dt. 2.3.1967	1.04.67	
3	Tyres & Tubes	Rubber tyres and tubes for all types of vehicles	1260 dt 10.8.1967	1.10.67	
4	Air-Conditioners	Air conditioning system or device by which air is controlled for the fulfillment of required condition of the confined space through controlling temperature, humidity, air purity and air motion for human comforts	1447 dt. 16.9.1967	1.10.67	Application clause and title from 'Room-Airconditioners' to Air-conditioners' changed vide GSR 668(E) dt. 28.9.1999
5	Refrigerators	Refrigerators	1448 dt. 18.9.1967	1.10.67	

6	Batteries other than Dry Cell Batteries	Batteries of all types other than Dry Cell Batteries	1467 dt. 20.9.1967	1.01.68	Application clause and title from 'Automobile Batteries' changed vide GSR 667(E) dt 28.7.1999.
7	Electric Lamps	Electric lamps of all types	1503 dt. 27.9.1967	1.01.68	Application clause changed vide GSR670(E) dt 28.9.1999
8	Electric Fan	Any type of electric fan	2298 dt. 15.9.1969	1.01.70	
9	Electric Motors	All types of electric motors	2574 dt. 24.10.1969	1.01.70	
10	Motor Vehicles	(a) All types of passenger cars, jeeps and station wagons (b) All types of commercial vehicles, delivery and pick up vans (c) Motor cycles, scooters, scooterets & mopeds (d) Three-Wheeler Vehicles (e) All types of tractors (f) Heavy Earth Moving Equipments	537 (E) dt. 11.9.1997*	11.9.1997*	The Rules, 1997 notified in suppression of GSR 1465 dt. 17.5.1969 No (e) added vide GSR 328(E) dt.3.6.1998. Cost Accounting Records Tractors) Rules,1971 applicable before 1.4.1999 merged vide GSR 329(E) dt. 3.6.98 No.(f) added vide GSR 280(E) dt. 24.4.2001
11	Aluminium	1. Alumina 2. Aluminium 3. Aluminium ingots in any form or alloy 4. Aluminum rolled products including foil 5. Aluminum extruded products 6. Properzirod or Aluminum wire rod 7. Any other alluminium product or its alloy	334 dt. 25.2.1972	1.04.72	Application clause amended vide GSR NO 703(E) dt. 28.9.2001

12	Vanaspati	Refined vegetable oils and vegetable oil products as also Industrial Hard Oil.	1529 dt. 27.11.1972	1.01.73	Application clause amended vide GSR 287 dt. 29.5.1992
13	Bulk Drugs	Bulk Drugs under any system of medicine including Ayurvedic, Homeopathic, Siddha and Unani systems of medicine and Intermediates there of	130(E) dt. 14.3.1974	1.04.74	Application clause amended vide GSR NO 707(E) dt. 28.9.2001
14	Sugar	Sugar by vacuum pan process and excludes jaggery and khandsari	388(E) dt. 15.7.1997*	15.7.1997*	The Cost Accounting Records Rules, 1997 notified in suppression of GSR 982(E) 4.9.1974
15	Industrial Alcohol	1. Absolute Alcohol 2. Rectified spirit 3. Denatured and special denatured spirit 4. Power alcohol	532 (E) dt. 17.9.1997*	17.9.1997*	The Rules,1997 notified in suppression of GSR 594(E) dated 30.12.1975
16	Jute Goods	Jute goods - Yarn, Twine, Fabrics or any other product made wholly from, or containing not less than 50 % by weight of, jute including bimlipattam jute or mesta fibres	590(E) dt. 29.12.1975	1.01.76	
17	Paper	Paper - used for printing, writing and wrapping, newsprint, paperboard, and exercise note books	601(E) dt. 31.12.1975	1.01.76	
18	Rayon	1. Viscose staple fibre in all forms 2. Viscose filament yarn 3. Viscose tyre yarn / cord/ Fabric 4. 100% Viscose Yarn Fabric 5. Acetate yarn / fibre 6. Rayon film (Cellophane Film)	606 dt. 20.4.1976	1.05.76	Application clause amended vide GSR 694 dt. 31.8.2000
19	Dyes	Acid dyes, basic dyes, direct dyes, sulphur dyes, vat dyes, azoic dyes, ingrained dyes, metal complex dyes, disperse dyes, reactive dyes, oil dyes, and water soluble dyes	605 dt, 22.4.1976	1.05.76	

20	Polyester	1. Polyester fibre 2. Polyester filament yarn 3. Polyester Chips 4. Polyester Fibre Fill (PFF) 5. Partially Oriented Yarn (POY) 6. Processed Polyester yarn (texturised, twisted, dyed, crimped,etc.) 7. 100% Polyester fabric	126(E) dt. 24.3.1977	1.04.77	No (3) to (7) inserted vide GSR 692(E) dt. 31.8.2000
21	Nylon	1. Nylon chip 2. Nylon fibre 3. Nylon filament yarn 4. Nylon partially oriented yarn 5. Nylon tyre yarn or cord 6. Nylon tyre cord fabric 7. 100% Nylon fabrics	157(E) dt. 1.4.1977	1.04.77	Application clause amended vide GSR 695(E) dt. 31.8.2000
22	Textiles	Any art silk cloth, cloth, cotton yarn or cotton cloth, processed yarn and processed cloth, man-made fibre yarn or man made fibre cloth, silk yarn or silk cloth, wool, woolen yarn or woollen cloth, yarn or other textiles products.	417(E) dt. 28.6.1977	1.07.77	Application clause amended vide GSR 29(E) dated 19.1.1994
23	Dry Cell Batteries	All types of dry cell batteries & components thereof	45(E) dt. 31.1.1979	1.02.79	
24	Steel Tubes and Pipes	Steel Tubes & Pipes (including stainless steel) both black & galvanized	506(E) dt. 10.5.1984	26.05.84	
25	Engineering	1. Power driven pumps 2. Internal combustion engines 3. Diesel Engines 4. All type of automotive parts and accessories 5. Power Transformers 6. Electric generator 7. Machine tools	688 dt. 25.6.1984	7.07.84	No. 4 to 7 added GSR 279(E) dt. 24.4.2001

26	Electric Cables and Conductors	(a) Power cables (All types- PILC, PVC, XLPE etc.) (b) VIR/Rubber covered cables & flexible wires of all types (c) PVC Insulated cables, flexible wires of all types including switchboard wires & cables (d) Enamelled covered wires & strips (e) Wire & strips covered with paper, glass, silk & any other types of insulating materials (f) AAC/ACSR Conductors (g) Telecommunication cables	767 dt. 7.7.1984	21.07.84	
27	Bearings	Bearings of various types e.g. ball & roller bearings, needle bearing of various sizes	664 dt. 1.7.1985	13.07.85	
28	Milk Food	Infant Milk Food or Milk Food as malted milk food, energy food or food drink under any brand name. For the purposes of these rules. (a) "Infant Milk Food" includes all types of milk food intended for the routine, complementary or supplementary food of infants and children up to the age of five years and other types of modified milk foods for infants which are intended for the feeding of infants and children during the treatment of gastro-intestinal disorders; (b) "Milk Food" means any food produced by mixing whole milk, partly skimmed milk or milk powder with ground barely malt or any other malted cereal grain, wheat flour or any other cereal flour or malt extract, with or without addition of flavouring agents and spices, edible common salt, sodium or potassium bicarbonate minerals and vitamins, cocoa powder, sugar or sweetening agents or other edible materials."	704(E) dt. 28.9.2001*	29.9.2001*	CAR (Infant Milk Food) Rules 1974 and CAR (Milk Food) Rules,1986 merged vide GSR 704(E) dt. 28.9.2001 Applicability Clause changed vide GSR 661 (E) dated 8.10.2004

29	Chemical	01. Acetic Acid 02. Acetic Anhydride 03. Acetone 04. Aluminium Fluoride 05. Aniline 06. Benzene 07. Boric Acid 08. Butadiene 09. Butanol 10. Calcium Carbide 11. Carbon Black 12. Caustic Soda 13. Chloro Methanes 14. Diacetone Alcohol 15. Diethylene Glycol 16. 2-Ethyl Hexanol 17. Ethylene 18. Ethylene Dichloride 19. Ethylene Glycol 20. Ethylene Oxide 21. Formaldehyde 22. Isopropanol 23. Linear Alkyl Benzene 24. Maleic Anhydride 25. Methanol 26. Methyl Ethyl Ketone 27. Methyl Isobutyl Ketone (MIBK) 28. Nitrobenzene 29.Ortho Nitro Cholro Benzene 30. Para Nitro Chloro Benzene 31. Penta Erithritol 32. Phenol 33. Polyethylenes viz. LDPE, HDPE, LLDPE 34. Polypropylene 35. Polythylene Glycol 36. Propylene 37. Soda Ash 38. Sodium Tripoly Phosphate 39. Sulphuric Acid 40. Resins (excluding natural resins), Paints, Varnishes and Plastics 41. Synthetic Rubber 42. Titanium/Dioxide 43. Toluene 44. Xylences	596 dt. 8.8.1987	8.08.87	Application clause amended vide GSR 562 (E) dated 2.9.2004
30	Formulations	All formulations under any system of medicine including Ayurvedic, Homeopathic, Siddha and Unani	452 dt. 22.4.1988	4.06.88	Applicability clause revised vide GSR 706(E) dt. 28.9.2001

31	Steel Plant	Steel & steel products , Steel products includes Ingot Steel, Blooms, Billets, Slabs (code as well as semi-finished); steel products produced by backward integration like Coal based Sponge Iron, Gas based hot briquetted Iron, steel products produced by forward integration like Beams, Angles, Tees, Sees, Channels, Pilings, Rails, Crane Rails, Joint Bars, Bare (Round Squares, Hexagonal, Octagonal, Flat, Triangular, Half Round); Wire, Wire Ropes, Nails, Wire Febrics, Plates, Pipes and Tubes, HR Coils/Sheets, CR Coils/ Sheets	574 dt. 31.7.1990	8.09.90	'Steel Products' defined vide circular no. 52/378/CAB-86-(CLB) dt. 29.6.1992 The words 'Steel Plant' substituted for 'Mini Steel Plants' vide GSR 281(E) dt.24.4.2001
32	Insecticides	1. Insecticides 2. Fungicides 3. Redenticides 4. Nematicide 5. Weedicide 6. Plant growth Regulant 7. Herbicides 8. Fumigants 9. Bio- pesticides	258 (E) dt. 3.3.1993	4.03.93	
33	Fertilizers	1. Straight Nitrogenous Fertilizers 2. Straight Phosphatic Fertilizers 3. Straight Potassic Fertilizers 4. N. P. Fertilizers 5. N. P. K. Fertilizers 6. Micro Nutrients 7. Fortified Fertilzers	261(E) dt. 5.3.1993	5.03.93	
34	Soaps & Detergents	Cleansing material used for cleaning, laundry/ washing, bathing/toilet purposes and includes soaps and detergents (Whether in the form of cake, powder or liquid)	677(E) dt. 29.10.1993	29.10.93	

35	Cosmetics & Toiletries	Powders, Creams, Toothpastes, Toothpowders, Shaving Creams, After shave lotions, Shaving soaps, Shaving foams, Perfumes, Hair oils, Hair creams, Oxidation hair dyes, Mouthwash, Cologne, Shampoos- soap based, Shampoos-synthetics, detergent based, Room fresheners, Deodorants, Surfactants	678(E) dt. 29.10.1993	29.10.93	
36	Footwear	Shoes, boots, sandals, chappals, slippers, play shoes & moccasins	186(E) dt. 12.4.1996	12.04.96	
37	Shaving Systems	1. Shaving blades 2. Razors 3. Any part or component there of 4. Any other shaving instrument	202(E) dt. 6.5.1996	6.05.96	
38	Industrial Gases	Oxygen Gas, Nitrogen Gas, Acetylene Gas, Hydrogen Gas, Nitrous oxide Gas, Argon Gas, Helium Gas, Carbon di-oxide Gas	271(E) dt. 9.7.1996	9.07.96	
39	Mining and Metallurgy	List of products (metals and non-metals, their minerals, ores and alloys) 1. Uranium 2. Thorium 3. Zirconium 4.Titanium 5.Lead 6. Copper 7. Zinc 8.Nickel 9. Cobalt 10. Chromium 11. Gallium 12. Germanium 13. Platinum 14 Molybdenum	276(E) dt. 24.4.2001	24.04.2001	

40	Electronic Products	1. All Consumer electronics such as television both black & white and colour, video cassette recorder, video cassette player, audio compact disc player, video compact disc player, digital video compact disc player, radio receiver, tape recorder & combination, electronic watch and electronic clock, etc. 2. Industrial electronics including all control instrumentation and automation equipment. 3. Computer including personal computer, laptop, note book, server, workstations, supercomputers, data processing equipment and peripherals like monitors, keyboards, disk drivers, printers, digitizers, SMPs, modems, networking products and add-on cards. 4. Communication and broadcasting equipment including cable television equipment. 5. Strategic electronics and systems such as navigation & surveillance systems, radars, sonars, infra-red detection and ranging system, disaster management system, internal security system, etc. 6. Other electronic component and equipment such as picture tube, printed circuit board, etc.	277(E) dt. 24.4.2001	24.04.2001	

41	Electricity	Generation of electricity from : (a) thermal power (b) gas turbine (c) hydro-electric power (d) atomic power (e) solar power (f) wind power(g) and other source of energy; (2) Transmission and bulk supply of electricity (3) Distribution and bulk supply of electricity	G.S.R. No 913(E) dt. 21.12.2001	21.12.2001	Amended vide G.S.R. 709 (E) dated 7th December 2005 & G.S.R. 387 (E) dated 27th June 2006.
42	Plantation	1. Tea and tea products 2. Coffee and coffee products 3. Other commercial plantation products including seeds thereof.	G.S.R.685 (E) dated 8.10.2002	8.10.2002	
43	Petroleum	crude oil, gases (including Compressed Natural Gas or Liquified Natural Gas and re-gasification thereof) or any other petroleum products:	G.S.R.686 (E) dated 8.10.2002	8.10.2002	
44	Telecommuni -cation	(1) Basic telephony: - (a) Telephone access (b) Local call (c) Subscriber trunk dialing (STD) (d) International subscriber dialing (ISD) (2) Cellular mobile; (3) Telex; (4) Telegraphy; (5) Voice mail /Audiotex service; (6) Internet operations including gateway service/E-mail; (7) Packet switched public data network (PSPDN) service; (8) Wireless in local loop (WILL) service; (9) Public mobile radio trunk service; (10) Very Small Aperture Terminal service;	G.S.R.689 (E) dated 8.10.2002	8.10.2002	

		(11) Global mobile personnel communication services; (12) Leased circuits; (13) Internet ports ; (14) National Long Distance Operator; (15) Internet Telephony; (16) Radio Paging; (17) Any other telecommunication service for commercial use.			

* Amendment Rules

3.1.5 Amendments to Cost Accounting Records Rules

3.1.5.1 The Cost Accounting Records Rules for the respective industries have been amended from time to time. The following amendments in respect of Industry/Class of Companies/Product have been made so far:

Sr. No.	Industry	Amended by GRS No.	Dated
1	Cost Accounting Records (Cycle) Rules, 1967	311 1244 84 774 1270 15 538 298(E) 326(E) 425(E) 709(E)	2.3.1967 7.8.1967 4.1.1968 3.6.1977 10.10.1979 5.1.1983 22.7.1989 24.3.1993 3.6.1998 3.8.1998 28.09.2001
2	Cost Accounting Records (Tyres & Tubes) Rules, 1967	1260 1192 2012 775 1271 16 539 299(E) 426 555(E) 710 (E)	10.8.1967 21.3.1968 6.11.1968 3.6.1977 10.10.1979 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.7.1999 28.09.2001

3	Cost Accounting Records (Air Conditioners) Rules, 1967	1447 1506 784 18 541 301(E) 428(E) 668(E) 712 (E)	16.9.1967 5.8.1968 3.6.1977 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.9.1999 28.09.2001
4	Cost Accounting Records (Refrigerators) Rules, 1967	1448 1505 781 19 542 302(E) 429(E) 669(E) 713 (E)	18.9.1967 5.8.1968 3.6.1977 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.9.1999 28.09.2001
5	Cost Accounting Records (Batteries other than Dry Cell Batteries) Rules, 1967	1467 1507 778 20 543 303(E) 430(E) 667(E) 714 (E)	20.9.1967 5.8.1968 3.6.1977 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.9.1999 28.09.2001
6	Cost Accounting Records (Electric Lamps) Rules, 1967	1503 779 1272 21 544 304(E) 431(E) 670(E) 715 (E)	27.9.1967 3.6.1977 10.10.1979 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.9.1999 28.09.2001
7	Cost Accounting Records (Electric Fans) Rules, 1969	2298 785 1273 22 545 305(E) 432(E) 556(E) 716 (E)	15.9.1969 3.6.1977 10.10.1979 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.7.1999 28.09.2001

8	Cost Accounting Records (Electric Motors) Rules, 1969	2574 786 1274 23 546 306(E) 433(E) 731(E) 717 (E)	24.10.1969 3.6.1977 10.10.1979 5.1.1983 22.7.1989 24.3.1993 3.8.1998 29.10.1999 28.09.2001
9	Cost Accounting Records (Aluminium) Rules, 1972	334 777 26 549 309(E) 435(E) 703 (E)	25.02.1972 3.06.1977 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.09.2001
10	Cost Accounting Records (Vanaspati) Rules, 1972	1529 780 27 550 287 310(E) 436(E) 705 (E)	27.11.1972 3.6.1977 5.1.1983 22.7.1989 29.5.1992 24.3.1993 3.8.1998 28.09.2001
11	Cost Accounting Records (Bulk Drugs) Rules,1974	130(E) 789 1275 28(E) 505(E) 551 311(E) 437(E) 707 (E)	14..3.1974 3.6.1977 10.10.1979 5.1.1983 26.5.1984 22.7.1989 24.3.1993 3.8.1998 28.09.2001
12	Cost Accounting Records (Jute Goods) Rules, 1975	590(E) 97(E) 793 32 42 555 315(E) 439(E) 721 (E)	29.12.1975 26.2.1976 3.2.1977 5.1.1983 8.1.1983 22.7.1989 24.3.1993 3.8.1998 28.09.2001

13	Cost Accounting Records (Paper) Rules, 1975	601(E) 187 1528 33 556 316(E) 440(E) 722 (E)	31.12.1975 3.6.1977 18.12.1979 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.09.2001
14	Cost Accounting Records (Rayon) Rules, 1976	606 788 34 557 317(E) 441(E) 694(E) 723 (E)	20.4.1976 3.6.1977 5.1.1983 22.7.1989 24.3.1993 3.8.1998 31.8.2000 28.09.2001
15	Cost Accounting Records (Dyes) Rules, 1976	605 791 1276 35 558 318(E) 442(E) 724 (E)	22.4.1976 3.6.1977 10.10.1979 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.09.2001
16	Cost Accounting Records (Polyester) Rules, 1977	126(E) 37 561 321(E) 444(E) 692(E) 727 (E)	24.7.1977 5.1.1983 22.7.1989 24.3.1993 3.8.1998 31.8.2000 28.09.2001
17	Cost Accounting Records (Nylon) Rules, 1977	157(E) 38 560 320(E) 445(E) 695(E) 726 (E)	1.4.1977 5.1.1983 22.7.1989 24.3.1993 3.8.1998 31.8.2000 28.09.2001
18	Cost Accounting Records (Textiles) Rules, 1977	417(E) 1277 40 1206 562 322(E) 29(E) 344(E) 446(E) 693(E) 728 (E)	28.6.1977 10.10.1979 5.1.1983 22.11.1984 22.7.1989 24.3.1993 19.1.1994 30.3.1994 3.8.1998 31.8.2000 28.09.2001

19	Cost Accounting Records (Dry Cell Batteries) Rules, 1978	45(E) 39 563 323(E) 447(E) 729 (E)	31.1.1979 5.1.1983 22.7.1989 24.3.1993 3.8.1998 28.09.2001
20	Cost Accounting Records (Steel Tubes and Pipes) Rules, 1984	506(E) 565 325(E) 449(E) 732 (E)	10.5.1984 22.7.1989 24.3.1993 3.8.1998 28.09.2001
21	Cost Accounting Records (Engineering Industries) Rules, 1984	688 1205 566 326(E) 450(E) 279(E) 731 (E)	25.6.1984 16.10.1984 22.7.1989 24.3.1993 3.8.1998 24.4.2001 28.09.2001
22	Cost Accounting Records (Electric Cables and Conductors) Rules, 1984	767 1152 567 327(E) 451(E) 733 (E)	7.7.1984 28.9.1984 22.7.1989 24.3.1993 3.8.1998 28.09.2001
23	Cost Accounting Records (Bearings) Rules, 1985	664 1046 568 328(E) 452(E) 734 (E)	1.7.1985 29.10.1985 22.7.1989 24.3.1993 3.8.1998 28.09.2001
24	Cost Accounting Records (Milk Food) Rules,1986	866 569 329(E) 453(E) 704(E) 661(E)	25.9.1986 22.7.1989 24.3.1993 3.8.1998 28.09.2001 8.10.2004
25	Cost Accounting Records (Chemical Industries) Rules, 2004	596 732 570 34(E) 330(E) 454(E) 278(E) 735 (E) 562(E)	8.8.1987 4.8.1988 22.7.1989 3.1.1992 24.3.1993 3.8.1998 24.4.2001 28.09.2001 2.09.2004

26	Cost Accounting Records (Formulations) Rules,1988	452 571(E)_ 331(E) 455(E) 706 (E)	22.4.88 22.7.89 24.3.1993 3.8.1998 28.09.2001
27	Cost Accounting Records (Steel Plant) Rules, 1990	574 332(E) 456(E) 281(E) 736 (E)	31.7.1990 24.3.1993 3.8.1998 24.4.2001 28.09.2001
28	Cost Accounting Records (Insecticides) Rules, 1993	258(E) 691(E) 774(E) 457(E) 737 (E)	3.3.1993 4.11.1993 5.12.1995 3.8.1998 28.09.2001
29	Cost Accounting Records (Fertilizers) Rules, 1993	261(E) 458(E) 738 (E)	3.3.1993 3.8.1998 28.09.2001
30	Cost Accounting Records (Soaps and Detergents) Rules, 1993	677(E) 459(E) 739 (E)	29.10.1993 3.8.1998 28.09.2001
31	Cost Accounting Records (Cosmetics and Toiletries) Rules, 1993	678(E) 460(E) 740 (E)	29.10.1993 3.8.1998 28.09.2001
32	Cost Accounting Records (Footwear) Rules, 1996	186(E) 461(E) 741 (E)	12.4.1996 3.8.1998 28.09.2001
33	Cost Accounting Records (Shaving Systems) Rules, 1996	202 462(E) 742 (E)	6.5.1996 3.8.1998 28.09.2001
34	Cost Accounting Records (Industrial Gases) Rules, 1996	271(E) 463(E) 743 (E)	9.7.1996 3.8.1998 28.09.2001
35	Cost Accounting Records (Sugar) amended Rules, 1997	388(E) 464(E) 719 (E)	15.7.1997 3.8.1998 28.09.2001
36	Cost Accounting Records (Cement) Rules, 1997	536(E) 466(E) 708 (E)	11.9.1997 3.8.1998 28.09.2001
37	Cost Accounting Records (Motor Vehicles) Rules, 1997	537(E) 328(E) 465(E) 280(E) 718 (E)	11.9.1997 3.6.1998 3.8.1998 24.4.2001 28.09.2001

38	Cost Accounting Records (Industrial Alcohol) Rules, 1997	552(E) 467(E) 720 (E)	17.9.1997 3.8.1998 28.09.2001
39	Cost Accounting Records (Mining and Metallurgy) Rules, 2001	276(E) 744 (E)	24.4.2001 28.09.2001
40	Cost Accounting Records (Electronic Products) Rules, 2001	277(E) 745 (E)	24.4.2001 28.09.2001
41	Cost Accounting Records (Electricity Industry) Rules,2001	913(E)	21.12.2001
42	Cost Accounting Records (Plantation Products) Rules, 2002	685 (E)	8.10.2900
43	Cost Accounting Records (Petroleum Industry) Rules, 2002	686 (E)	8.10.2002
44	Cost Accounting Records (Telecommunication) Rules, 2002	689 (E)	8.10.2002

3.2 General Provisions Under the Various Cost Accounging Records Rules

3.2.1 Introduction

3.2.1.1 Even though, separate Cost Accounting Records Rules have been prescribed for different industries, these rules follow more or less a common pattern except providing for special characteristics of that industry. All the rules require the books of account to be kept in a manner that the cost of production and cost of sale of each type of product for every quarter of the financial year and for the financial year as a whole can be properly calculated in the prescribed forms (which differ from industry to industry).

3.2.1.2 The rules further require that the books of account should be kept maintaining particulars relating to the utilization of materials, labour and other items of cost in so far as they are applicable to the manufacture or production of product under reference. If a company is manufacturing other products also in addition to the product covered by the rules, the cost accounting records rules provide that the cost records should be kept in such a manner that the cost of such other products is not added in the cost of production of the product under reference.

3.2.1.3 It may be clarified that the law does not insist on the necessary maintenance of separate books of accounts for cost accounting records rules. The particulars relating to 'utilization of material or labour or to other items of cost' can also be maintained in same set of books along with the financial accounts. It has been clarified by the Cost Audit Branch that cost records should be maintained on a "regular and continuous basis, so that it is possible to determine the cost of production, cost of sales, profit margin etc., of the product on regular intervals, at lst quarterly during the financial year and it should not be an year and exercise.

3.2.1.4 Small scale companies are exempted from maintenance of cost accounting records (except those companies which are subject to price control under the Drugs [Price Control] Order) as notified from time to time under the Industries (Development and Regulation) Act, 1955 even if they belong to industries for which rules regarding maintenance of cost accounts are prescribed. To avail of this exemption, a company should satisfy both the following conditions.

(a) Its installed machinery and plant should have an aggregate value not exceeding Rs. 1 crore as on the last day of the preceding financial year. For calculating the aggregate value of machinery and plant, its historical cost to the company in the case of owned items and historical cost to the owner in the case of items on hire purchase or lease should be considered.

(b) The turnover of the company from the sale or supply of all its products during the preceding financial year should not exceed Rs. 10 crores. Suppose, a company has only Rs. 50,000 as turnover of a product covered by cost accounting records rules. However, its total turnover from all the products exceeds Rs. 10 crores. The company will be required to maintain cost accounting records relating to the relevant product.

3.2.1.5 Although the Cost Accounting Records Rules prescribed for different industries differ from one another, the different provisions contained in such Records Rules can be broadly classified into following three parts:

Part I : Consisting of descriptive rules with short titles, commencement, definition, application clause, maintenance of records and penal provisions. In some of the Cost Accounting Records Rules, an Appendix has also been given containing the list of products/items for which the record rules shall reply.

Part II : Consisting of Schedule with detailed provisions in respect each element of cost like materials, salary and wages, utilities, depreciation, repairs and maintenance, other overheads, royalty or technical know-how fee, research & development expenses, interest and other borrowing costs, related party transactions etc.

Part III : Consisting of various cost statements or proformae to be maintained for utilities, intermediate and final products. The prescribed cost statements in case of process industries require that the cost of production of each process be shown separately. Similarly, the rules prescribed in case of engineering industries require the cost statements to indicate the costs of different components or sub-assemblies and then also show the cost of final assembly.

3.2.1.6 The broad points covered by the respective Cost Accounting Records Rules for different industries are almost identical. For specific requirements of each industry, the relevant cost accounting record rules should be referred together with amendments made from time to time. The general provisions regarding short title, commencement, application, maintenance of records etc. are as follows :

3.2.2 Short Title and Commencement

1) These rules may be called Cost Accounting Records (Name of the Product) Rules. XXXX (Year of notification)

2) They shall come into force on the date of publication in the official gazette.

3.2.3 Application Clauses Under Respective Cost Accounting Records Rules

The application clause as contained under respective cost accounting records rules is produced as under:

1. Cement

(1) These rules shall apply to every company engaged in the production or manufacture of Clinker or Cement or both.

(2) The provision of sub rule (1) shall not apply to a company

(a) the aggregate value of the machinery and plant does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year and

(b) the aggregate value of the turnover made by the Company from the sale or supply of all its products during the preceding financial year does not exceed rupees ten crore.

2. Cycles:

They shall apply to every company engaged in the production or manufacture of cycles and components thereof excepting those companies falling under the category of small scale industrial undertakings.

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed where in dose not exceed the limit as specified for a small scale industrial undertaking under the industries (Development and Regulation Act 1951 (65 of 1951), as on the last date of the presenting financial year; and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

3. Tyres & Tubes

They shall apply to every company engaged in the production or manufacture of rubber tyres and tubes or both for all types of vehicles. Except those companies falling under the category of small scale industrial units:]

Explanation: For the purpose of this rule, the expression "small scale industrial undertaking" means a company:

(a) the aggregate value of the machinery and plant installed wherein does not exceed The limit as specified for a small scale industries (Development and regulation) Act.1951 (65 of 1951), as on the last date of the preceding financial year. and

(b) the aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees

4. Air-Conditioners

They shall apply to every company engaged in the production or manufacturer of air conditioning system or device by which air is controlled for the fulfillment of required condition of the confined space through controlling temperature, humidity, air purity and air motion for human comforts excepting those companies falling under the category of small scale industrial units.

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industries (Development and regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

5. Refrigerators

They shall apply to every company engaged in the production or manufacture of refrigerators in any form excepting those companies falling under the category of small-scale industrial undertaking.

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industries (Development and regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

6. Batteries other than Dry Cell Batteries

They shall apply to every company engaged in the production or manufacturing of [Batteries of all types other than Dry Cell Batteries excepting those companies falling under the category of "small scale industrial units."

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed where in dose not exceed the limit as specified for a small scale industrial undertaking under the industries (Development and Regulation Act, 1951 (65 of 1951), as on the last date of the presenting financial year and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

7. Electric Lamps

They shall apply to every company engaged in the manufacture of electric lamps of all types excepting those companies falling under the category of "small scale industrial units."

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed where in dose not exceed the limit as specified for a small scale industrial undertaking under the industries (Development and Regulation Act 1951 (65 of 1951), as on the last date of the presenting financial year and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

8. Electric Fans

They shall apply to every company engaged in the production and manufacture of any type of Electrical Fans excepting those companies falling under the category of small scale industrial undertakings.

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) the aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industries undertaking under the industries (Development and Regulation Act 1951 (65 of 1951), as on the last date of the preceeding financial year and

(b) the aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

9. Electric Motors

They shall apply to every company engaged in the manufacture of any type of electric motor excepting those companies falling under the category of "small scale industrial units."

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) the aggregate value of the machinery and plant installed wherein dose not exceed the limit as specified for a small scale industries undertaking under the industries (Development and Regulation Act, 1951 (65 of 1951), as on the last date of the presenting financial year and

(b) the aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

10. Motor Vehicles

They shall apply to every company engaged in the manufacture of [motor vehicles, whether passenger or commercial including the manufacture of the following vehicles, namely:

(a) All types of passenger cars, jeeps and station wagons:

(b) All types of commercial vehicles, delivery and pick-up vans:

(c) Motor-cycles, scooters, scooterettes and Mopeds:

(d) Three-wheeler vehicles:

(e) Any type of tractor

(f) Heavy earth moving equipments

Provided that these rules shall not apply to company:

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified *for* a small scale industries undertaking under the Industries (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year.

(b) The aggregate value of the turnover made by company from the sale or supply of all its products.

11. Aluminum

They shall apply to every company engaged in the production, processing or manufacturing of any of the following products, namely: -

1. Alumina
2. Aluminium
3. Aluminium ingots in any form or alloy
4. Aluminum rolled products including foil
5. Aluminium extruded products
6. Properzirod or Aluminum wire rod
7. Any other Aluminium products or its alloy.

excepting those companies falling under the category of small-scale industrial undertakings.

Explanation - For the purpose of this rule, the expression "small scale Industrial Undertaking" means a company -

(a) the aggregate value of the machinery and plant installed wherein dose not exceed the limit as specified for a small scale industries undertaking under the industries (Development and Regulation Act 1951 (65 of 1951), as on the last date of the preceeding financial year. and

(b) the aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

12. Vanaspati

These rules shall apply to every company, except the Small Scale Industrial Undertaking, engaged in production, processing and manufacturing of refined vegetable oils and vegetable oil products as also Industrial Hard Oil.

Explanation - For the purpose of this rule, the expression Small Scale Industrial Undertaking means a company

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year.

(b) The aggregate value of the turnover made by the company from the sale or supply of all its products during the preceding financial year does not exceed Rupees ten crores.

The expression "refined vegetable oil" means any edible vegetable oil which is obtained by expelling or solvent extraction, deacidified with alkali or with physical refining or both or by miscella refining using permitted food grade solvent, bleached with absorbent earth and/or activated carbon and deodorized with steam. Provided that where vegetable oil is produced, processed or manufactured by the undertaking, the cost of production thereof would also be disclosed.

The expression "vegetable oil product" means any vegetable oil subjected to a process of hydrogenation in any form or mixture thereof with any other substance for edible purposes:

Provided that terms extracted oil, solvent extracted oil, refined oil, vanaspati, margarine and bakery shortening should conform to the respective quality standards as laid down by the Prevention of Food Adulteration Act 1954/ The Solvent-Extracted Oil, De-oiled Meal and Edible Flour (Control), Order, 1967 and The Vegetable Oil Products (Control) Order, 1947.

13. Bulk Drugs

They shall apply to every company engaged in the production, processing or manufacturing of bulk drugs under any system of medicine including Ayurvedic, Homeopathic, Siddha and Unani systems of medicine and intermediates thereof excepting those companies falling under the category of Small Scale Industrial Undertaking.

Explanation - For the purpose of this rule, the expression 'Small Scale Industrial Undertakings' means a company-

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industrial undertaking under the industries (Development and Regulation Act, 1951 (65 of 1951), as on the last date of the preceding financial year.

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

14. Sugar

(1) These rules shall apply to every company engaged in the production or manufacture of Sugar by vacuum pan process and excludes jaggery and khandsari.

(2) The provision of sub-rule (1) shall not apply to a company:

  (a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year.

  (b) The aggregate value of the turnover made by the company from the sale or supply of all its products during the preceding financial year does not exceed Rupees ten crores.

15. Industrial Alcohol

They shall apply to every company engaged in the production or manufacture of Industrial alcohol which includes any grade or grades in the following categories namely:

(i) Absolute Alcohol;

(ii) Rectified Spirit;

(iii) Denatured and special denatured spirit;

(iv) Power Alcohol.

Provided that these rules shall not apply to company:

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year.

(b) The aggregate value of turnover made by the company from the sale or supply of all its products during the preceding financial year does not exceed rupees ten crore.

16. Jute Goods

They shall apply to every company engaged in the production processing or manufacture of jute goods excepting those companies falling under the category of Small Scale Industrial Undertakings.

Explanation - For the purpose of this rule, the expression Small Scale Industrial Undertaking means a company

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year.

(b) The aggregate value of the turnover made by the company from the sale or supply of all its products during the preceding financial year does not exceed Rupees ten crores.

17. Paper

They shall apply to every company engaged in the production, processing or manufacturing of paper used for the purpose of printing, writing or wrapping, newsprint, paper board and exercise note books of companies manufacturing paper excepting those companies falling under the category of Small Scale Industrial units.

Explanation . For the purpose of this rule, the expression small scale Industrial Undertaking means a company.

(a) The aggregate value of the machinery and plant does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year; and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

18. Rayon

They shall apply to every company engaged in the production, processing or manufacturing of any of the following rayon products:

(i) Viscose Staple Fibre in all forms;

(ii) Viscose Filament Yarn;

(iii) Viscose Tyre Yarn/Cord/Fabric

(iv) 100% Viscose Yarn Fabric;

(v) Acetate Yarn/Fibre; and

(vi) Rayon Film (Cellophane film)

excepting those companies falling under the category of small scale industrial units.

Explanation . For the purpose of this rule, the expression .small scale Industrial Undertaking means a company.

(a) The aggregate value of the machinery and plant does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act 1951 (65 of 1951), as on the last date of the preceding financial year; and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

19. Dyes

They shall apply to every company engaged in the producing, processing or manufacturing of dyes excepting those companies falling under the category of small scale industrial units.

Explanation - For the purpose of this rule, the expression small scale industrial undertaking means a company

(a) The aggregate value of the machinery and plant installed wherein does not exceed limit as specified for a small scale industries undertaking under the Industrial (Development and Regulation) Act, 1951 (65 of 1951) as on the last date of the preceding financial year; and

(b) The aggregate value of the realisation made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

Definition: - In these rules unless the context otherwise requires:

(a) *Dye (dyestuff):* means an organic compound which may be used to impart colour to a substance and may be classified as Acid Dyes, Basic Dyes, Direct Dyes, Sulphur Dyes, Vat Dyes, Azoic Dyes, Ingrained Dyes, Metal Complex Dyes, Disperse Dyes, Reactive Dyes, Oil Dyes, and Water Soluble Dyes.

(b) *Intermediate:* means any compound which is manufactured from primary or basic raw material and which is used in the production, processing or manufacturing of any dye.

20. Polyestor

Application - They shall apply to every company engaged in the production, processing or manufacturing any of the following Polyester products :

(1) Polyester Fibre

(2) Polyester Filament Yarn

(3) Polyester chips

(4) Polyester Fibre Fill (PFF)

(5) Partially Oriented Yarn (POY)

(6) Processed Polyester yarn (texturised, twisted, dyed, crimped, etc.)

(7) 100% Polyester Fabric.

except those companies falling under the category of small scale industrial units:

Explanation: For the purpose of this rule, the expression “small scale industrial undertaking” means a company

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industries undertakings under the Industries (Development and Regulations Act, 1951 (65 of 1951) as on the last date of the preceding financial year.

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees

21. Nylon

They shall apply to every company, engaged in the production, processing or manufacturing any of the following Nylon products, namely:

(1) Nylon chip

(2) Nylon fibre

(3) Nylon filament yarn

(4) Nylon partially oriented yarn

(5) Nylon tyre yarn or cord.

(6) Nylon tyre cord fabric

(7) 100% Nylon fabrics.

excepting those companies falling under the category of "small scale industrial units".

Explanation: For purpose of this rule, the expression 'small scale industrial unit' means a Company -

(a) aggregate value of machinery and plant installed wherein does not exceed the limit specified for a small scale industries undertaking under the Industrial (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year; and

(b) the aggregate value of the realisation made by the Company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

22. Textiles

These rules shall apply to every company engaged in the production, processing or manufacturing of any art silk cloth, cloth, cotton yarn or cotton cloth, processed yarn and processed cloth , man-made fibre yarn or man made fibre cloth, silk yarn or silk cloth, wool ,woollen yarn or woollen cloth, yarn or other textiles products: Provided that these rules shall not apply to such of the above said companies as falling under the category of small scale industrial undertakings.

Explanation: For purpose of this rule the expression "small scale industrial undertaking" means a company

(a) The aggregate value of the machinery and plant does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation)Act 1951 (65 of 1951), as on the last date of the preceding financial year; and

(b) The aggregate value of the realization made by the company from the sale of supply of all its products during the preceding financial year does not exceed ten crore rupees.

Definitions.-In these rules, unless the context otherwise requires-

(a) "art silk cloth" means any fabric made wholly from art silk yarn or partly from silk, yarn and partly from any other yarn provided such fabric 'contains not less than 60 per cent of art silk yarn;

(b)"cloth" has the same meaning as in sub-clause (4) of Clause 3 Textiles (Development and Regulation) Order, 1993;

(c) "Cotton yarn or cotton cloth" has the same meaning as in sub-clause (6) of clause 3 of the Textiles (Development and Regulation) Order, 1993;

(d) "man made yarn" and "man made fibre cloth" has the same meaning as in sub clause(10) of clause 3 of the Textiles (Development and Regulation) Order, 1993;

(e) "other textile products" has the same meaning as in sub-clause(14) of clause 3 of the Textiles (Development and Regulation) Order, 1993;

(f) " processed yarn and process of cloth" means and yarn and / or cloth as defined in sub clause (b) and (j) of this rule which has undergone one or more of the process such as bleaching, dying, printing, mercerizing, finishing and the like.

(g) This also includes the cloth processed by "processor" as defined in sub-clause(19) of clause 3 of the Textiles (Development and Regulation) Order, 1993;

(h) "silk yarn and silk cloth" has the same meaning as in sub-clause(21) of clause 3 of the Textiles (Development and Regulation) Order, 1993;

(i) "wool" " has the same meaning as in sub-clause(24) of clause 3 of the Textiles (Development and Regulation) Order, 1993;

(j) "yarn" " has the same meaning as in sub-clause(26) of clause 3 of the Textiles (Development and Regulation) Order, 1993;

(k) "yarn" " has the same meaning as in sub-clause(27) of clause 3 of the Textiles (Development and Regulation) Order, 1993;

23. Dry Cell Batteries

They shall apply to every company engaged in the production, processing or manufacturing of any type of dry cell batteries and components thereof, excepting those companies falling under the category of small scale industrial undertakings.

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed where in does not exceed the limit as specified for a small scale industries undertaking under the industries (Development and Regulation Act, 1951 (65 of 1951), as on the last date of the preceding financial year.

(b) the aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

24. Steel Tubes and Pipes

These rules shall apply to every company engaged in the production, processing or manufacture of Steel Tubes and Pipes (including Stainless Steel) both black and galvanized and in various sizes, shapes and qualities excepting those companies falling under the category of 'Small Scale Industrial Units'.

Explanation For the purpose of this rule, the expression "small scale industrial undertaking" means a company

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industries (Development and regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year. And

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the proceeding financial year dose not exceed ten crore rupees."

25. Engineering

These Rules shall apply to every company engaged in the production, processing or manufacture of the classes of engineering goods as specified in the Appendix to the Cost Accounting Records (Engineering Industries) Rules, 1984 and those added thereto by the Central Government from time to time by notification in the Official Gazette excepting those companies falling under the category "Small Scale Industrial Units".

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industries undertaking under the (Industrial Development and regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year and 2 and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

APPENDIX

List of engineering goods for which the Rules shall apply:

1. Power driven pumps.
2. Internal combustion engines.
3. Diesel Engines.
4. All type of automobile parts and accessories
5. Power Transformers
6. Electric Generator
7. Machine Tools

26. Electric Cables and Conductors

They shall apply to every company, except those falling under the category of small scale industrial unit, engaged in the production, processing or manufacturing of electrical cables, conductors, wires and strips of any type in the following categories, namely:

(a) Power cables (All types-namely: PILC, PVC, XLPE etc.);

(b) VIR/Rubber covered cables and flexible wires of all types:

(c) PVC Insulated Cables, Flexible wires of all types including switch board wires and cables;

(d) Enameled covered wires and strips;

(e) Wire and strips covered with paper, glass, silk and any other types of insulating materials;

(f) AAC/ACSR conductors;

(g) Telecommunication cables.

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industries (Development and regulation) Act.1951 (65 of 1951), as on the last date of the preceding financial year. And

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees

27. Bearings

These rules shall apply to every company engaged in the production, processing or manufacture of bearings of various types viz. Ball and Roller Bearing, Needle Bearings and of various sizes, excepting those companies falling under the category of 'Small Scale Industrial Units'.

Explanation: For the purpose of this rule, the expression "Small Scale Industrial Undertaking" means a Company -

(a) The aggregate value of the machinery and plant installed where in dose not exceed the limit as specified for a small scale industrial undertaking under the industries (Development and Regulation Act 1951 (65 of 1951), as on the last date of the presenting financial year. and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year dose not exceed ten crore rupees.

28. Milk Food

These rules shall apply to every company engaged in the production, processing or manufacture of Infant Milk Food or Milk Food as malted milk food, energy food or food drink under any brand name excepting those companies falling under the category of "Small Scale Industrial Units.

Explanation - For the purpose of this rule, the expression "small scale industrial undertaking" means a company -

(a) The aggregate value of the machinery and plant installed where in dose not exceed the limit as specified for a small scale industrial undertaking under the industries (Development and Regulation Act 1951 (65 of 1951), as on the last date of the presenting financial year and

(b) The aggregate value of the realization made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

For the purposes of these rules.

(a) "Infant Milk Food" includes all types of milk food intended for the routine, complementary or supplementary food of infants and children up to the age of five years and other types of modified milk foods for infants which are intended for the feeding of infants and children during the treatment of gastro-intestinal disorders;

(b) "Milk Food" means any food produced by mixing whole milk, partly skimmed milk or milk powder with ground barely malt or any other malted cereal grain, wheat flour or any other cereal flour or malt extract, with or without addition of flavouring agents and spices, edible common salt, sodium or potassium bicarbonate minerals and vitamins, cocoa powder, sugar or sweetening agents or other edible materials

29. Chemicals

These rules shall apply to every company engaged in the production, processing or manufacture of products as specified in the Appendix to these rules :

Provided that these rules shall not apply to a company, -

(a) Wherein, the aggregate value of machinery and plant installed as on the last date of the preceding financial year, does not exceed the limit as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) The aggregate value of the turnover made by the company from sale or supply of all its products or activities during the preceding financial year does not exceed ten crores of rupees.

APPENDIX

List of products for which the rules shall apply:

01. Acetic Acid
02. Acetic Anhydride
03. Acetone
04. Aluminium Fluoride
05. Aniline
06. Benzene
07. Boric Acid
08. Butadiene
09. Butanol
10. Calcium Carbide
11. Carbon Black
12. Caustic Soda
13. Chloro Methanes
14. Diacetone Alcohol

15. Diethylene Glycol
16. 2-Ethyl Hexanol
17. Ethylene
18. Ethylene Dichloride
19. Ethylene Glycol
20. Ethylene Oxide
21. Formaldehyde
22. Isopropanol
23. Linear Alkyl Benzene
24. Maleic Anhydride
25. Methanol
26. Methyl Ethyl Ketone
27. Methyl Isobutyl Ketone (MIBK)
28. Nitrobenzene
29. Ortho Nitro Cholro Benzene
30. Para Nitro Chloro Benzene
31. Penta Erithritol
32. Phenol
33. Polyethylenes viz. LDPE, HDPE, LLDPE
34. Polypropylene
35. Polythylene Glycol
36. Propylene
37. Soda Ash
38. Sodium Tripoly Phosphate
39. Sulphuric Acid
40. Resins (excluding natural resins), Paints, Varnishes and Plastics
41. Synthetic Rubber
42. Titanium Dioxide
43. Toluene
44. Xylenes

30. Formulations

These rules shall apply to every company engaged in the production, processing or manufacture of formulations under any system of medicine including Ayurvedic, Homeopathic, Siddha and Unani formulations excepting those companies falling under the category of "Small Scale Industrial Units".

Provided that companies which are subject to price control under the Drugs (Price Control) Order as notified from time to time under the Industries (Development and Regulation) Act, 1955 will not be exempt from the operation of these rules.

For the purpose of this rule, the expression Small Scale Industrial Undertaking means a company

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit as specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act, 1951 (65 of 1951), as on the last date of the preceding financial year.

(b) The aggregate value of the turnover made by the company from the sale or supply of all its products during the preceding financial year does not exceed Rupees ten crores.

Definitions - In these rules unless context otherwise requires-

(a) The expression "formulation" means a medicine processed out of or containing one or more bulk drugs with or without the use of any pharmaceutical aids for internal or external use for or in the diagnosis, treatment, mitigation or prevention of disease in human beings or animals and shall include

    (i) Any medicine included in any bona fide Ayurvedic (including Sidha) or Unani (Tibb) systems of medicines;

    (ii) Any medicine included in the Homeopathic system of medicine.

(b) Bulk drug" means any pharmaceutical, chemical, biological or plant product including its salts, esters, stereo-isomers and derivatives, which are used as such or as an ingredient in any formulation

31. Steel Plant

These Rules shall apply to every company engaged in the production processing or manufacture of steel and steel products, Which includes Ingot steel, Blooms, Billets, Slabs (code as well as semi finished); steel products produced by backward integration like Coal based Sponge Iron, Gas based hot briquette Iron, steel products produced by forward integration like Beams, Angles, Tees, Sees, Channels, Pilings, Rails, Crane Rails, Joint Bars, Bars (Round Squares, Hexagonal, Octagonal, Flat, Triangular, Half Round); Wire, Wire ropes, Nails, Wire fabric, Plates, Pipe & Tubes, HR Coils/ Sheets, CR Coils/ Sheets excepting those companies falling under the category of Small Scale Industrial Undertakings:

Explanation: For the purpose of this rule, the expression "Small Scale Industrial Undertaking" means a company –

(a) The aggregate value of the machinery and plant installed wherein does not exceed The limit as specified for a small scale industries (Development and regulation) Act.1951 (65 of 1951), as on the last date of the preceding financial year. And

(b) The aggregate value of the realization made by the Company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

32. Insecticides

These Rules shall apply to every company engaged in the production, processing or manufacture of the classes of Insecticides as defined under clause (e) of Section 3 of the Insecticides Act. 1968 (46 of 1968) and included in the schedule annexed to the said Act and as amended from time to time, excepting those companies falling under the category of "Small Scale Industrial Undertaking".

Explanation: - For the purposes of this rule, the expression "Small Scale Industrial Undertaking" means a Company -

(a) The aggregate value of the machinery and plant installed wherein does not exceed The limit as specified for a small scale industries (Development and regulation) Act.1951 (65 of 1951), as on the last date of the preceding financial year and

(b) The aggregate value of the realization made by the Company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

33. Fertilizers

These Rules shall apply to every company engaged in the production, processing or manufacture of fertilizers whether nitrogenous, phosphates and/or complex (organic, inorganic and / or mixed) and includes all types of fertilizers as defined in clause (h) of Section 2 of the fertilizer (control) order, 1985, made under Section3 of the Essential Commodities Act, 1955 (10 of 1955) and as amended from time to time, excepting those companies falling under the category of "Small Scale Industrial Undertakings."

Explanation: For the purpose of this rule, the expression "Small Scale Industrial Undertaking" means a company –

(a) The aggregate value of the machinery and plant installed wherein does not exceed The limit as specified for a small scale industries (Development and regulation) Act.1951 (65 of 1951), as on the last date of the preceding financial year. And

(b) The aggregate value of the realization made by the Company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

34. Soaps & Detergents

These rules shall apply to every company engaged in the production, processing or manufacture of cleansing material used for cleaning, laundry/washing, bathing/toilet purposes and includes soaps and detergents (whether in the form of cake, powder or liquid), excepting those companies falling under the category of Small Scale Industrial Undertakings.

Explanation: - For the purpose of this rule, the expression Small Scale Industrial Undertaking means a company -

(a) The aggregate value of the machinery and plant installed wherein does not exceed the limit the specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act, 1951 (65 if 1951), as on the last dated of the preceding Financial Year), and

(b) The aggregate value of the realization made by the Company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees..

35. Cosmetics & Toiletries

These rules shall apply to every company engaged in the production / processing or manufacture of any article intended to be rubbed, poured, sprinkled or sprayed on, or introduced into or otherwise applied to the human body or any part thereof or otherwise for cleaning, beautifying, promoting attractiveness or altering the appearance and includes the classes of preparations as specified in the Appendix and those added thereto from time to time by notification the official Gazette, excepting those companies falling under the category of small scales industrial undertakings.

Explanation : For the purpose of this rule, the expression "Small Scale Industrial Undertaking" means a company:

(a) Aggregate value of the machinery and plant installed wherein does not exceed the limit specified for a small scale industrial under taking under the industries (Development and Regulation) Act 1951 (65 of 1951), as on the last date of the Preceding Financial Year and

(b) The aggregate value of the realization made by the company from the sale of supply of all its products during the preceding financial year does not exceed ten crore rupees.

36. Footwear

(1) These Rules shall apply to every company engaged in the production, processing or manufacture of the Foot wear including shoes, boots, sandals, chappals, slippers play shoes and moccasins.

(2) The provision of sub-rule (1) shall not apply to a company.

(a) The aggregate value of the machinery and plant installed wherein company does not exceed the limit as specified for a small scale Industrial undertaking under the Industries (Development and Regulation Act 1951(65 of 1951), as on the last date of the preceding financial year

(b) The aggregate value of the turnover made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

37. Shaving Systems

These Rules shall apply to every company engaged in the production, processing or manufacture of the classes of shaving systems used for shaving purposes by human beings, whether electronic or electric or mechanical or manual, as specified in the appendix (annexed) to these rules: Expecting those companies falling under the category of small scales Industries under taking:

Explanation: For the purpose of this rule, the expression "Small Scale Industries undertaking." means a company.

(a) Aggregate value of machinery and plant installed where in does not exceeds the limit specified for a small scale Industrial undertaking under the Industries (Development and Regulation) Act 1951 (65 of 1951), as on last date of preceding financial year]*and

(b) The aggregate value of the turnover made by the company from the sale of supply of all its products during the preceding financial year does not exceed ten crore rupees."

38. Industrial Gases

These rules shall apply to every company engaged in the production, or manufacture of the classes of the Industrial Gases specified in the appendix annexed to these rules :

Provided that these rules shall not apply to a company—

(a) Aggregate value of machinery and plant installed wherein does not exceed the limit specified for a small scale industrial undertaking under the Industries (Development and Regulation) Act 1951 (65 of 1951), as on the last date of the preceding financial year; and

(b) The aggregate value of the realisation made by the Company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

APPENDIX

Classes of Industrial Gases

(i) Oxygen Gas;

(ii) Nitrogen Gas;

(iii) Acetylene Gas;

(iv) Hydrogen Gas;

(v) Nitrous Oxide Gas;

(vi) Argon Gas;

(vii) Helium Gas; and

(viii) Carbon dioxide Gas

39. Mining and Metallurgy

These rules shall apply to every company engaged in the mining, production, processing or manufacturing activities of any of the products (metals and non-metals, their minerals, ores and alloys) as specified in the **Appendix** to these rules : Provided that these rules shall not apply to a company,-

(a) The aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed the limits as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) The aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

APPENDIX

List of products (metals and non-metals, their minerals, ores and alloys) for which the rule shall apply:

1. Uranium
2. Thorium

3. Zirconium
4. Titanium
5. Copper
6. Lead
7. Zinc
8. Nickel
9. Cobalt
10. Chromium
11. Gallium
12. Germanium
13. Platinum
14. Molybdenum

40. Electronic Products

These rules shall apply to every company engaged in the production, processing or manufacture of Electronic products and components thereof as specified in the Appendix to these rules: Provided that these rules shall not apply to a company-

(a) The aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed the limits as specified for a small scale industries undertaking under the provisions of the Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) The aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

APPENDIX

List of Electronic products and components for which the rule shall apply :

(1) All Consumer electronics such as television both black & white and colour, video cassette recorder, video cassette player, audio compact disc player, video compact disc player, digital video compact disc player, radio receiver, tape recorder & combination, electronic watch and electronic clock, etc.

(2) Industrial electronics including all control instrumentation and automation equipment.

(3) Computer including personal computer, laptop, note book, server, workstations, supercomputers, data processing equipment and peripherals like monitors, keyboards, disk drivers, printers, digitizers, SMPs, modems, networking products and add-on cards.

(4) Communication and broadcasting equipment including cable television equipment.

(5) Strategic electronics and systems such as navigation and surveillance systems, radars, sonars, infra-red detection and ranging system, disaster management system, internal security system, etc.

(6) Other electronic component and equipment such as picture tube, printed circuit board, etc.

41. Electricity

These rules shall apply to every company engaged in any of the following activities, namely :

(1) Generation of electricity from:

(a) thermal power

(b) gas turbine

(c) hydro-electric power

(d) atomic power

(e) solar power

(f) wind power

(g) any other source of energy;

(2) Transmission and bulk supply of electricity;

(3) Distribution and retail supply of electricity :

Provided that these rules shall not apply to a company,-

(a) The aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed the limits as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) The aggregate value of the turnover made by the company from sale or supply of all its products or activities during the preceding financial year does not exceed ten crores of rupees.

42. Plantation Product

These rules shall apply to every company engaged in production, processing or manufacture of product(s) as specified in the Appendix to these rules: Provided that these rules shall not apply to a company, -

(a) The aggregate value of machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed limit as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) The aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crores of rupees.

Appendix

List of plantation products for which the rules shall apply.

1. Tea and tea products
2. Coffee and coffee products
3. Other commercial plantation products including seeds thereof.

43. Petroleum Industry

They shall apply to every company engaged in production, processing and manufacturing of crude oil, gases (including Compressed Natural Gas or Liquified Natural Gas and regasification thereof) or any other petroleum products: Provided that these rules shall not apply to a company -

(a) The aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed the limits as specified for a small scale industrial undertakings under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) The aggregate value of the turnover made by the company from the sale or supply of all its products during the preceding financial year does not exceed ten crore rupees.

44. Telecommunication

These rules shall apply to every company engaged in the processing of any one or more of the telecommunication activities, namely: -

(1) Basic telephony: -

- (a) Telephone access
- (b) Local call
- (c) Subscriber trunk dialing (STD)
- (d) International subscriber dialing (ISD)

(2) Cellular mobile;

(3) Telex;

(4) Telegraphy;

(5) Voice mail /Audiotex service;

(6) Internet operations including gateway service/E-mail;

(7) Packet switched public data network (PSPDN) service;

(8) Wireless in local loop (WILL) service;

(9) Public mobile radio trunk service;

(10) Very Small Aperture Terminal service;

(11) Global mobile personnel communication services;

(12) Leased circuits;

(13) Internet ports ;

(14) National Long Distance Operator;

(15) Internet Telephony;

(16) Radio Paging;

(17) Any other telecommunication service for commercial use.

Provided that these rules shall not apply to a company, -

(a) The aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed the limits as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) The aggregate value of the turnover made by the company from sale or supply of all its products or activities during the preceding financial year does not exceed ten crore rupees.

3.2.4 Maintenance of Records

Every company to which the rules apply shall, in respect of each of its financial year commencing on or after the date of notification keep proper books of accounts relating to the utilisation of materials, labour and other items of cost in so far as they are applicable to any of the products or activities under reference.

It may be clarified that:

(a) The Cost Accounting Records Rules merely refers to the maintenance of cost records. It does not mean that there has to be cost audit also.

(b) Cost Audit Order is separately issued generally after the initial notification of cost accounting records rules. These cost audit orders are issued on selected companies only and some of the companies may never get an cost audit order despite being covered under the respective cost accounting records rules.

(c) Even though the rules come into effect on the date notified in the official Gazette, it may not be possible to maintain cost accounting records for an incomplete year. Moreover, companies need time to design and implement a cost accounting system to meet the requirements of the law. It sometimes require the change in their existing accounting system as well especially where Computerized Accounting System or SAP etc is installed. Therefore, the cost accounting records rules specify that they shall come into force on a company manufacturing a product only from the financial year commencing on or after the notification of the said rules. Thus in respect of a rule notified, say on 26.6.2008, it shall be applicable to a company whose financial year commences on or after 26.6.2008 or say 2009-2010 (financial year commencing on 1.04.2009 and obligation to maintain cost accounting records would arise only from 01.04.2009.

(d) The rules also specify that the books of accounts have to be maintained on a "regular basis" so as to make it possible to calculate the cost of production and cost of sales of each type of product every quarter and also for the financial year as a whole. The word regular basis means that the direct cost will have to be recorded concurrently with the production of each type of product while approtionable costs have to be recorded on the basis of predetermined costs. However, it may not be necessary to have interlocking or integrated books of accounts of both financial and cost accounts. It would be sufficient if cost accounts are maintained on a "proforma basis".

(e) If any company is engaged in manufacturing of any other product(s)or is engaged in other activities also in addition to the products or activities under reference, the particulars relating to utilisation of materials, labour and other items of cost in so far as they are applicable to such other products or activities shall not be included in the cost of the product or activities under reference.

(f) The rules also specify that the books of accounts and the proformae specified in the rules shall have to be completed within 90 days of the close of the financial year to which they relate. This period of ninety days was earlier incorporated in Cost Audit Report Rules also. But now that has been extended to 135 days under Cost Audit Report Rules, 2001 to allow companies to fill the various proformae prescribed under the Report Rules and get them authenticated.

3.2.5 Statistical and Other Records

3.2.5.1 The Cost Accounting Records Rules require that the Statistical and other records shall be maintained in accordance with the provisions of the Schedule to the respective rules in such a manner as to enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in cost. These records shall also provide the necessary data required by the Cost Auditor to suitably report on all the points referred to in Cost Audit Report Rules, 2001 as amended from time to time.

3.2.5.2 Statistical records represent records like production data, capacity utilization, machine utilization, labour hour etc. The data maintained for the purpose of cost accounting records shall be reconciled with the report submitted to excise and/or custom department from time to time. Similarly under the Essential Commodities Act and other legislations on the subject, several reports have to be submitted to Government authorities in respect of industries like sugar, textiles, etc. The rules prescribe that the data in the cost accounting records should be reconciled with the returns submitted to Excise and Government authorities and any discrepancies would need explanation.

3.2.6 Penalty

3.2.6.1 If the records are not maintained, the company and every officer of the company who is in default including the persons responsible for compliance of the record rules, shall be punishable as provided under sub-Section (2) of Section 642 read with sub-Sections (5) and (7) of Section 209 of Companies Act, 1956 (1 of 1956).

3.2.6.2 Sub-Section (2) of Section 642 of the Companies Act provides with a fine which may extend to Rs. 5000 and where the contravention is a continuing one, a further fine may be imposed which may extend to Rs. 500 for every day during which such contravention continues.

3.2.6.3 Sub-Section (5) of Section 209 of Companies Act, 1956 provides that if persons responsible under the Act fails to take all reasonable steps to secure compliance or has caused any default by his own willful act, he shall be punishable with imprisonment for a term which may extend to six months or with fine which may extend to ten thousand rupees or with both. This Section further provides that a person shall be sentenced to imprisonment for any such offence only if it was committed willfully. Sub-Section (7) of the Companies Act, 1956 provides for similar penalties to a person in case of any default, if such person has been charged with the duty of seeing that the requirements of Cost Accounting Records Rules are complied with.

3.2.7 Schedule I – Detailed Provisions

Detailed provisions relating to materials, labour, overheads depreciation and other statistical information that are required to be maintained are given in Schedule. The entire Schedule is in a descriptive form and the companies have a discretion to maintain the data in whatever manner of form convenient to them with the only provision that all the required information specified in Schedule should be available. This has been made clear in the rules that the records will have to be maintained in a form either as specified in Schedule (earlier schedule I or II) or as "near thereto as practicable".

Information prescribed under Schedule shall consist of :

(i) Materials :

(a) Records shall be maintained separately for the receipts, issues and balances both in quantities and cost of each item of direct materials (including primary materials and consumable stores) required and used in production.

(b) The cost of materials shall include all direct charges up to works.

(c) In the case of consumable stores and small tools the cost of which are insignificant, the company may, if it so desires, maintain such records for the group of such consumable stores and tools.

(d) The cost of indirect materials, consumable stores, and spares etc. shall be properly identified and charged to the relevant departments, cost centres or activities, on equitable and reasonable basis and applied consistently.

(e) Where joint products or more than one product of equal economic importance arises from a process, the cost up to the point of separation of products shall be apportioned to such joint products on reasonable and equitable basis and shall be applied consistently.

(f) The basis of the apportionment of common selling and distribution expenses to the product in the case of multi-product unit shall be equitable and applied consistently

(g) The proper records shall be maintained indicating the quantity as well as value of by-products recovered in the different processes having significant value of the cost of input of materials.

(h) In the case of certain by-products recovered, which cannot be reused in the process and are sold or disposed off without further processing, the realisation from such sales shall be recorded and adjusted against the process concerned on a reasonable basis.

(i) In case further processing is necessary to make the by-products usable or saleable, as the case may be, adequate records of the cost involved for such further processing shall be maintained. If such processing is done by any outside agency, proper records to show the quantity sent for processing, quantity received back after processing and the cost incurred thereon shall be maintained in detail. The net realisation, if any shall be adjusted against the major process relatable to such by-product. The cost of by-products shall be determined on equitable and reasonable basis and applied consistently.

(j) Separate data relating to consumption of direct materials shall be maintained for imported and indigenous items.

(k) In respect of imported items, details of FOB, insurance, customs duty/landing charges etc. shall be maintained.

(l) Detailed records of quantities and cost of consumption shall be maintained in respect of each item of direct material consumed.

(m) The rules do not specify that issues shall be priced adopting a particular method viz. FIFO, LIFO, Weighted Average, etc. It is left to the company to adopt any method of pricing of issues according to their convenience so long as the method is consistently adopted.

(n) In the case of companies adopting standard costing system for the pricing of materials the manner in which the variances are adjusted shall be indicated to arrive at the actual cost of production.

(o) In respect of wastages, spoilages, and rejection of raw materials including process materials or consumable stores, the method followed by the adjusting the losses or income from their disposal shall be indicated separately. Any abnormal wastage or spoilage or rejection shall be indicated distinctly and separately along with reasons thereof.

(p) If the Central Value Added Tax (CENVAT) or any benefits under the Central Government is available, in respect of any input direct materials, the cost of such material and or consumable stores or spares should be shown after adjusting such credit or benefits.

(ii) Salaries and Wages:

(a) The company should maintain records of earnings of all employees. All direct wages and salaries should be charged to the respective cost centres namely, production or service cost centre. The cost for each cost centre should indicate the piece rate wages earned, incentive wages, production bonus, overtime and other earnings of casual labourers etc. separately.

(b) The cost idle time shall be recorded separately under classified headings indicating the reasons thereof and the method followed for accounting of the idle time payment shall be stated. Wages and salaries relating to capital works, shall be excluded from the cost of production.

(c) In the case of companies adopting standard costing system the method adopted for determining and adjusting the variances shall be indicated for arriving at the actual cost.

(d) The records shall be maintained in such a manner as to enable the company to furnish necessary particulars under this head in the relevant Proformae of Schedule annexed to the rules. Where the employees work in such a manner that it is not possible to identify them with any specific cost or work centre or department, the labour charges shall be apportioned to the cost or work centers or departments on equitable basis and applied consistently.

(e) Any wages and salaries allocable to capital works, such as, additions to plant and machinery, buildings or other fixed assets of any activity etc. shall be accounted for under the relevant heads. Similarly, payments in the nature of deferred revenue expenditure shall be separately recorded under separate classified headings indicating the reasons therefore. The method followed for accounting of such payments in determining the cost of the product or activity shall be on equitable and reasonable basis and applied consistently. The said method shall be disclosed in the cost records also.

(iii) Service department expenses:

The service department's costs like laboratory, transport, dispensary, township, fire fighting security etc., shall be collected separately. These expenses wherever significant and material shall be apportioned to relevant product or activities on equitable and reasonable basis and applied consistently. Where these services are utilized for other products or activities of the company also, the basis of apportionment of such expenses to the products or activities under reference and others shall be equitable and clearly indicated in the records and applied consistently.

(iv) Utilities:

Records relating to cost of utilities like water, power, compressed air etc. shall be maintained both in respect of quantity and value. The Cost Accounting Records Rules of various industries prescribe proformae in which the cost of production of the utilities is to be maintained. The cost format given provide for furnishing on the cost of direct inputs, labour, depreciation and other items of allocable and apportionable costs in totals as well as in units. The details of quantities of utilities sold and consumed department-wise is also required to be maintained so that the cost of producion as well as the charge to the various departments can be determined in a reasonable manner.

Where any utility is produced or generated and supplied by any other unit of the company to the plant producing, processing or manufacturing the products or activities under reference, adequate records shall be maintained to indicate the quantity and cost of utility so supplied. The cost of utility allocated to products or activities under reference shall be on equitable and reasonable basis and applied consistently.

(v) Workshop, repairs and maintenance :

In respect of work done in workshops and tool rooms, the records shall indicate the basis of charging the workshop or tool room or repairs and maintenance expenses to different cost centers or departments or plant wise. Where maintenance work is done by direct workers of any production cost center or department, the wages and salaries of such workers shall be treated as direct expenses of the respective cost centre or department. If the services are utilised for other products or activities also, the manner of charging a share to such products or activities shall be on equitable and reasonable basis and applied consistently.

The expenditure on major repair works from which benefit is likely to accrue for more than one financial year shall be deferred over the period expected to benefit on a reasonable and equitable basis and applied consistently. Such cost shall be shown separately and the method of accounting along with the basis of allocation of such costs shall also be clearly indicated in cost records.

(vi) Depreciation :

Records shall be maintained separately showing the specific block and apportioned block in respect of each item of asset relating to the product for which cost accounting records are to be maintained. If a company is manufacturing more than one product like bulk drugs, formulations and cosmetics for which common services are available the records should show separately, the assets relating to the product say bulk drugs and also the share of service department assets relating to the product. The basis on which depreciation is calculated and allocated or apportioned to various cost centers or departments and absorbed on all products shall be clearly indicated in the cost records.

The basis of apportionment of common assets to the products or activities under reference shall be indicated. In case of revaluation of assets, the same shall be indicated separately and shall not be included in the cost statement. The basis of allocation of depreciation on indirect assets to the products or activities under reference shall be on equitable and reasonable basis and applied consistently.

The company can follow any method of depreciation namely, straight line or written down value method. But the depreciation shall not be less than the depreciation chargeable in accordance with the provision of sub-Section (2) of Section 205 of the Companies Act, 1956. However, the cost of small items of plant and machinery shall be allowed to be completely written off in the year of acquisition up to limit specified in the Income-tax Act. In case the amount of depreciation charged in the Cost Accounts is in excess of the depreciation chargeable under Schedule XIV to the Companies Act, the amount so charged in excess shall be indicated in the cost records, separately. However, the cumulative depreciation charged in the cost records, against any individual item of asset shall not, however, exceed the original cost of the respective asset.

(vii) Other overheads:

The records shall indicate the various items of overhead expenses chargeable to the cost centres. The expenses shall be analysed, classified and grouped under various functions viz. works, administration, selling and distribution.

Where the company is manufacturing products other than the products or activities under reference, the records shall clearly indicate the basis followed for apportionment of the common overheads including head office expenses of the company to such products and to products or activities under reference including capital works as applicable. Where certain expenses forming part of overhead can be identified with a particular activity or a product, such expenses shall be segregated and charged to the relevant activity or product in the first instance and thereafter the residual expenses under the above categories of overheads shall be apportioned on a reasonable and equitable basis in line with accepted standards and practices and applied consistently. The overheads chargeable to capital works shall be indicated separately in the cost records. The basis of apportionment or absorption of overheads to the cost or work centers or departments and products shall be indicated in the cost records.

(viii) Royalty or technical know-how fee or leasing charges:

The adequate records shall be maintained showing the royalty and/or technical know-how fee including other recurring or non-recurring payments of similar nature if any, made for the products or activities under reference to collaborators or technology suppliers in terms of agreements entered into with them. Such records shall be kept separately in respect of each such collaborator or supplier. The basis of charging such amount, including lump sum payment and its treatment shall be indicated in the cost records.

In the case of leasing arrangements, proper records shall be maintained showing details of terms and conditions, leasing charges paid or payable as well as received or receivable.

(ix) Research and development expenses:

Records shall be maintained indicating the details of R&D expenses incurred by the company separately according to the nature of development of products i.e. existing or new product or processes, development of process of manufacture, existing and new, design and development of new plant facilities and market research for the existing and new products etc. The records shall also indicate the payments made to outside parties for the research and development work.

The method of charging these expenses to the cost of products or activities under reference and all other products shall be indicated in the cost records. Where the utility of such research and development work extends over more than one financial year, such expenses shall be treated as deferred revenue expenses and charged to the cost of production of the product or activities under reference and all other products if any, on a reasonable basis and applied consistently in line with the accepted standards and practices. The detailed criteria on which it is decided to extend the utility period of these expenses to more than one financial year shall be disclosed in the cost records. The following criteria, which are only indicative and not exhaustive, may be adopted in such cases:

(i) The output or process is clearly defined and the costs attributable to the output or process can be separately identified;

(ii) The technical feasibility of the output or process has been demonstrated;

(iii) The management of the enterprise has indicated its intention to produce and market or use the output or process;

(iv) There is a reasonable indication that current and future research and development costs to be incurred on the project together with expected production, administrative and selling costs are likely to be more than covered by related future revenues or benefits; and

(v) Adequate resources exist or are reasonably expected to be available to complete the project and market the output or process.

The expenses incurred by the Research and Development Department for providing technical know-how to outsiders shall be recorded separately and excluded from the cost of products or activities under reference. The amount recovered for providing technical know-how to outsiders shall also be indicated separately and excluded from the income arising from the sale of output under reference.

(x) Quality control

The adequate records shall be maintained to indicate the expenses incurred in respect of quality control department or cost centre for products or activities under reference. Where these services are also utilised for other products of the company, the basis of apportionment to products or activities under reference and to other products shall be equitable and clearly indicated in the records and applied consistently.

(xi) Interest and other borrowing costs

The proper records shall be maintained for money borrowed for each project and/or working capital and interest charge thereon. The amount of interest and other borrowing costs shall be allocated or apportioned to the products or activities under reference and other products or activities on a reasonable and equitable basis, and applied consistently. The basis of further charging of the share of the interest and other borrowing costs to the various types of such products shall also be reasonable and equitable and the same shall be followed consistently. The basis of such allocation or apportionment shall be spelt out clearly in the cost records and statements. Net interest and other borrowing costs incurred for Project under execution shall be capitalised for the period up to the date the project is ready to commence commercial activities. However, capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

(xii) Work in progress and finished stock

The method followed for determining the cost of work in progress and finished stock of the outputs shall be indicated in the cost records so as to reveal the cost element that have been taken into account in such computation. The appropriate share of conversion cost up to the stage of completion shall be taken into account while computing the cost of work in progress. The method adopted for determining the cost of work in progress and finished goods shall be followed consistently.

(xiii) Captive consumption

If the products under reference are used for captive consumption, proper records shall be maintained showing the quantity and cost of each item of output transferred to other department or work centers of the company for self-consumption and sold to outside parties separately. The rates at which the transfers are affected shall be at cost only.

In the case of intermediates produced for captive consumption, details of cost of production shall be maintained and this should be transferred at cost.

(xiv) Packing (primary and secondary)

In case of packing of products under reference for retail sales or retail marketing, the proper records shall be maintained showing the quantity and cost of various packing materials and other expenses incurred on packing for marketing of product under reference. Where such expenses are incurred in common for other products also the basis of apportioning the expenses between the relevant products shall be clearly indicated in the cost records and applied consistently.

(xv) Expenses or incentives on exports

The proper records showing the expenses incurred on the export sales, if any, of the product under reference shall be separately maintained so that the cost of export sales can be determined correctly. Separate cost statement shall be prepared for product exported giving details of export expenses incurred and incentive earned. In case, duty free imports of input materials are made, the cost statements should reflect this fact.

(xvi) Pollution control

Expenditure incurred by the company on various measures to protect the environment like effluent treatment, control of pollution of air, water, etc., should be properly recorded.

(xvii) Human resources development

Expenditure incurred by the company on the human resources development activity shall be recorded separately.

(xviii) Related party transactions

In respect of related party transactions or supplies made or services rendered by a company to a company termed "related party relationship" as defined below and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of -

(a) purchase and sale of raw materials, finished products, process materials and rejected goods including scraps, etc;

(b) utilisation of plant facilities and technical know-how;

(c) supply of utilities and any other services;

(d) administrative, technical, managerial or any other consultancy services;

(e) purchase and sale of capital goods including plant and machinery; and

(f) any other payment related to production, processing or manufacturing of products under reference.

These records shall also indicate the basis followed for arriving at the rates charged or paid for such products or services so as to enable determination of the reasonableness of such rates in so far as they are in any way related to product under reference.

The transactions by the following "related party relationships" shall be covered under sub-rule (1) :

(a) Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries;

(b) Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

(c) Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;

(d) Key management personnel and relatives of such personnel; and

(e) Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

However, the following shall not be deemed as "related party relationships":

(a) Two companies simply because they have a Director in common, notwithstanding paragraph (d) or (e) above (unless the Director is able to affect the policies of both companies in their mutual dealings;

(b) A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process -

    (i) providers of finance;

    (ii) trade unions;

    (iii) public utilities;

    (iv) government departments and government agencies including government sponsored bodies.

Explanation: -For the purpose of these rules, -

(a) "related party relationships" means parties who are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions;

(b) "related party transaction" means a transfer of resources or obligations between related parties, whether or not a price is charged;

(c) "control" means

(i) ownership, directly or indirectly, of more than one-half of the voting power of an enterprise; or

(ii) control of the composition of the Board of Directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise; or

(iii) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise;

(d) "significant influence" means participation in the financial or operating policy decisions of an enterprise, but not control of those policies;

(e) "an Associate" means an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party;

(f) "a joint venture" means a contractual arrangement whereby two or more parties undertake an economic product, which is subject to joint control;

(g) "joint control" means the contractually agreed sharing of power to govern the financial and operating policies of an economic product so as to obtain benefits from it;

(h) "key management personnel" means those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise;

(i) "relative" in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may connected by blood relationship;

(j) "holding company" means a holding company within the meaning of Section 4 of the Companies Act, 1956(1 of 1956);

(k) "subsidiary" means a subsidiary company within the meaning of Section 4 of the Companies Act, 1956(1 of 1956);

(l) "fellow subsidiary" means a company is said to be a fellow subsidiary of another company if both are subsidiaries of the same holding company;

(m) "state-controlled enterprise" means an enterprise which is under the control of the Central Government or a State Government.

(xix) Cost statements :

The cost statements shall be prepared in the formats prescribed in Schedule of the rules. In the case of some products like Textiles, where the number of sorts is numerous, the rules provide for the maintenance of cost sheets on a consolidated basis, for those varieties of cloth which do not account for a sizable percentage of total production. Where the product is manufactured in more than one factory, the cost statements shall be prepared separately for each factory. Separate cost sheet shall be prepared in respect of products exported.

The output emerging from a process, which forms input for a subsequent process shall be valued at the cost of production up to the previous stage.

(xx) Production and sales records

Quantitative records of all finished goods whether packed or unpacked, showing production, issues for sales and balances of different type of the product packs under reference, shall be maintained. The quantitative details of production shall be maintained separately for self manufactured, third party on job work, loan license basis etc. Separate details of sales shall be maintained for domestic sales at control price, domestic sales at market price, export sales under advance license, export sales under other obligations, export sales at market price, and sales to related party/inter unit transfer.

(xxi) Reconciliation of cost and financial books :

The Cost statements shall be reconciled with the financial statements for the financial year specifically indicating the expenses or incomes not considered in the cost records or statements so as to ensure accuracy and to adjudge the profit of the products or activities under reference with the overall profit of the company. The variations, if any, shall be clearly indicated and explained.

A statement showing the total expenses incurred and income received by the company under different heads of accounts and the share applicable to the other activities or products shall be prepared and reconciled with the financial statement.

(xxii) Adjustment of cost variances :

Where the company maintains cost records on any basis other than actual such as standard costing, the records shall indicate the procedure followed by the company in working out the cost of the activities and services under such system. The cost variances shall be shown against the separate heads and analysed into material, labour, and overheads and further segregated into quantity, price and efficiency variances. The method followed for adjusting the cost variances in determining the actual cost of the product shall be indicated clearly in the cost records. The reasons for the variances shall be duly explained in the cost records and statements.

(xxiii) Records of physical verification :

The records of physical verification in respect of all items held in stock be maintained indicating the method adopted for adjustment of shortages and surplus.

(xxiv) Statistical records :

Records shall be maintained in respect of :

(a) available machine hours, direct labour hours in each production department and actual utilization.

(b) Records for consumption of idle time of machines.

(c) Statement showing the reasons for loss of production due to idle time of machines.

(d) Capital employed separately indicating the fixed assets and working capital for each item of product.

The adequate records shall be maintained to enable the company to identify the capital employed, net fixed assets and working capital separately for different products, activities and other products and other activities to the extent such elements are separately identifiable. Non-identifiable items shall be allocated on a suitable and reasonable basis to different products, activities and other products and other activities. Fresh investments on fixed assets that have not contributed to the production or processing of products or activities under reference during the relevant period shall be indicated in the cost records. The records shall, in addition, show assets added as replacement and those added for increasing existing capacity.

In the case of new major projects for product or activity under reference, proper records shall be maintained indicating the funds raised from different sources, their utilization, stage-wise cost incurred and progress of the project as per the project report. Cost and time over run shall also be analysed with reference to the cost of services or activity and profitability of the company.

Whenever WTO provisions are attracted, proper records shall be maintained to identify the competitiveness of the product in the domestic as well as global market. Adequate statistical records shall also be maintained to identify the market share of the product manufactured and the likely impact thereon on account of competitive goods imported into the country.

3.2.8 Flexibility Under the Records Rules

The nature of Cost Accounting Records Rules specified and required to be maintained is given in Schedules to the Rules. There are no cost accounting methods, which can be applied uniformly to all the units in the Industry. Therefore, based on the unique characteristics of respective company, Cost Accounting Records Rules allow a lot of flexibility to the companies. For example, in the case of materials, the rules do not specify the manner in which the stock ledgers has to be maintained. The exact method of pricing of stores has not been stipulated. The method of payment of wages, is left to the discretion of the company. They can adopt piece rate method, time rate, or a combination of the two. Also production bonus and other incentives can also be fixed by the company. The cost centres namely production and service departments can be determined by the company taking into account the technical aspects of production relating to each factory. In respect of jobs carried out in the workshops, so long as proper method is available for absorption of the cost, the rules do not specify any other stipulation. The company is also free to adopt either straight-line method or written down value method of depreciation except that the depreciation charged should not be excess of what is specified under schedule XIV of the Companies Act. In the matter of allocation, apportionment and absorption of overheads, the company is free to adopt any method. In the matter of treatment of the 'by products' and 'joint products', the company has all the flexibility in adopting a rational method so long as it confirms to sound costing principles and is applied consistently. It may be seen that greater freedom and flexibility is given to a company to maintain the records in whatever form they require so long as the method adopted is reasonable, equitable and consistent.

3.2.9 List of Annexures and Proformae Under Different Cost Accounting Record Rules

Apart from the descript write up to the nature of Cost Accounting Records to be maintained Schedule II of the cost accounting records rules contain detailed cost proformae in which the cost of the main product and intermediate (in few cases) are to be maintained.

The list of Annexure and Proformae on the different Cost Accounting Records Rules is given hereinafter for ready reference.

1. Cement

Proforma A - Cost statement of lime stone raised

Proforma B - Cost statement of limestone crushing

Proforma C - Cost statement of clinker

Proforma D - Cost statement of cement produced

Proforma E - Cost statement of cement sold

2. Cycles

Proforma - Cost of Cycles / Components of Cycle produced or manufactured

3. Tyres and Tubes

Proforma A - Cost of rubber compound produced / manufactured

Proforma B - Cost of Rubberized fabric produced / manufactured

Proforma C - Cost of sales, sales realization and margin of tyres/tubes

4. Air-conditioners

Proforma - Cost of sales, sales realization and margin in respect of air-conditioners / components produced or manufactured

5. Refrigerators

Proforma - Cost of sales, sales realization and margin in respect of refrigerators / components produced or manufactured

6. Batteries other than Dry Cell Batteries

Proforma - Cost of sales, sales realization and margin in respect of Batteries / components produced or manufactured

7. Electric Lamps

Proforma - Cost of sales, sales realization and margin in respect of Electric Lamp/ components produced or manufactured

8. Electric Fan

Proforma - Cost of sales, sales realization and margin in respect of Electric Fans/ components produced or manufactured

9. Electric Motors

Proforma - Cost of sales, sales realization and margin in respect of Electric Motors/ components produced or manufactured

10. Motor Vehicles

Proforma A - Conversion cost for various operation cost centers for Motor Vehicles and their apportionment.

Proforma B - Cost of Production of Motor Vehicles

Proforma C - Cost of Sales of Motor Vehicles.

Proforma D - Conversion cost for sales, sales realisation and margin for all Motor Vehicles manufactured and sold.

11. Aluminium

Proforma A - Cost of Utilities like Power, Steam, Water, etc., produced and consumed

Proforma B - Cost of bauxite raised and transported to the Alumna plant

Proforma C - Cost of Alumna produced and sold

Proforma D - Cost of Carbon Anodes produced

Proforma E - Cost of Aluminium (Primary Metal) produced

Proforma F - Cost of production, cost of sales, sales realization and margin in respect of each of the Aluminium product such as Ingots, Billets, Rolled products, extruded products, vis. Rods and Foils, etc. produced

Proforma G - Total production and allocation of total actual expenses and income of the company among various aluminium products and other activities.

12. Vanaspati

Proforma A - Cost of Utility like Power, Steam, Water, Effluent treatment etc., produced and consumed

Proforma B - Cost of ________oil extracted (for each oil)

Proforma C - Cost of sales, sales realization and margin in respect of each item of product under reference produced/manufactured and sold.

Proforma D - Total production and allocation of total actual expenses and income of the company between the product under reference and other activities.

13. Bulk Drugs

Proforma A - Cost of Utility like Power, Steam, Water, Effluent treatment etc., produced and consumed

Proforma B - Cost of production in respect of __________ (each ingredient/ intermediates produced/ processed/ manufactured

Proforma C - Cost of sales, sales realization and margin in respect of each type of ingredient/ intermediates / Bulk Drugs produced/ processed/ manufactured and sold.

Proforma D - Total production and allocation of total actual expenses and income of the company between the bulk drugs and other activities.

14. Sugar

Proforma A - Cost of Treated Water/Effluent Treatment

Proforma B - Cost of Steam raised/ consumed

Proforma C - Cost of Power generated, purchased / consumed

Proforma D - Cost of Sugarcane used for the Production of sugar

Proforma E - Cost of Sugar produced

Proforma F - Cost of Sugar sold

15. Industrial Alcohol

Proforma A1 - Cost of Treated/Cooling Water/Effluent Treatment

Proforma A2 - Cost of Steam raised/ consumed

Proforma A3 - Cost of Power generated, purchased and consumed

Proforma B - Conversion cost of various operation cost centers for Industrial Alcohol and their apportionment.

Proforma C - Cost of production of Industrial Alcohol

Proforma C1 - Cost of Molasses procured and consumed for use in the manufacture of Industrial Alcohol.

Proforma D - Cost of Industrial Alcohol sold.

16. Jute Goods

Annexure I - Cost of steam raised/consumed.

Annexure II - Overall wastage and gain in weight due to process/additions of jute goods.

Annexure III - Cost of production of yarn (excluding jute cost).

Annexure IV - Cost of production of fabric (excluding jute cost).

Annexure V - Cost of production of bag (excluding fabric cost).

Annexure VI - Cost of packing.

Annexure VII - Selling expenses.

Proforma A - Losses at various stage of production of jute goods.

Proforma B - Total cost of raw jute used for production of jute goods.

Proforma C - Total cutting, thread waste and caddies recovered in the process of manufacture and used for production of jute goods.

Proforma D - Batch cost composition of raw jute.

Proforma E - Reconciliation of actual jute consumption and total jute consumption as derived from proforma D.

Proforma F - Summary of batch cost of raw jute consumed.

Proforma G - Summary of conversion cost of spinning as per Annexure III.

Proforma H - Summary of conversion cost of spinning as per Annexure IV.

Proforma I - Summary of conversion cost of bag making as per Annexure V.

Proforma J - Summary of packing cost as per Annexure VI.

Proforma K - Summary of selling expenses as per Annexure VII.

Proforma L - Cost of production of pre-packed sale yarn/fabric/bags/other production for each product.

Proforma M - Cost of sale of yarn/fabric/bags/others packed and sold for each product.

Proforma N - Particulars regarding production sale, unit cost of sale and margin etc. for each product for which consolidated cost sheets are prepared under proforma L and M.

Proforma O - Allocation of total expenses and income in respect of jute goods activity and other activities of the company.

17. Paper

Annexure I - Cost of water treated/consumed.

Annexure II - Cost of steam raised/consumed.

Annexure III - Cost of power generated/purchased and consumed.

Annexure IV - Cost of chemical recovery.

Proforma A - Cost of bamboo/wood/bagasse/grass/straw used for production of paper.

Proforma B - Cost of bamboo/wood chips issued to pulp department.

Proforma C - Cost of unbleached chemical pulp manufactured.

Proforma C1 - Cost of bleached chemical pulp manufactured.

Proforma D - Cost of mechanical pulp manufactured

Proforma E - Cost of paper manufactured – printing/writing/wrapping newsprint/paper board – for each type.

Proforma F - Cost of sales of paper packed and sold for each type.

Proforma G - Cost of sales of exercise note books and other miscellaneous paper products manufactured.

Proforma H - Allocation of total expenses and income between paper and paper products, manufacturing activity and other activities.

18. Rayon

Proforma A - Cost of Utility like Power, Steam, Air-conditioning, Water, Compressed Air, etc. produced and consumed

Proforma B - Cost of sales, sales realization and margin in respect of each type of Rayon product produced / manufactured.

Proforma C - Cost of sales, sales realization and margin in respect of each type of Yarn sold.

Proforma D - Total production and allocation of total actual expenses and income of the company between the Rayon and other activities.

19. Dyes

Annexure I - Cost of water treated/consumed.

Annexure II - Cost of steam raised/consumed.

Annexure III - Cost of power generated/purchased and consumed.

Proforma A - Cost of intermediate manufactured and used either in production of other intermediate products or dyes – for each intermediate.

Proforma B - Cost of dye-stuff manufactured for each type.

Proforma C - Cost of sales of packed dyestuff/intermediate – for each type and intermediate.

Proforma D - allocation of total expenses incurred and income received by the company between dye activity and other activities.

20. Polyester

Proforma A - Cost of Utility like Power, Steam, Water etc. produced and consumed

Proforma B - Cost of sales, sales realization and margin in respect of each type of Polyester Chips / Polymer produced / manufactured and sold.

Proforma C - Cost of sales, sales realization and margin in respect of each type of Polyester product, produced or manufactured and sold.

Proforma D - Cost of sales, sales realization and margin in respect of each type of Yarn sold

Proforma E - Total production and allocation of total actual expenses and income of the company between the Polyester products and other activities.

21. Nylon

Proforma A - Cost of Utility like Nitrogen, Power, Steam, Water etc. produced and consumed

Proforma B - Cost of sales, sales realization and margin in respect of each type of Nylon Chips, produced or manufactured and sold.

Proforma C - Cost of sales, sales realization and margin in respect of each type of Nylon fibre, Nylon filament yarn, Nylon partially oriented yarn, etc. produced or manufactured.

Proforma D - Cost of sales, sales realization and margin in respect of each type of Yarn sold

Proforma E - Total production and allocation of total actual expenses and income of the company between the Nylon products and other activities.

22. Textiles

Proforma A - Cost of Utility like Power, Steam, Water etc. produced and consumed

Proforma B - Cost of raw material (mix – wise)

Proforma C - Mix-wise input, wastage, output, waste multiplier in each processing centre

Proforma D1 - Cost of sales, sales realization and margin in respect of each type of Yarn sold

Proforma D2 - Cost of sales, sales realization and margin in respect of each type of grey cloth sold

Proforma D3 - Cost of sales, sales realization and margin in respect of each type of processed cloth sold

Proforma E - Total production and allocation of total actual expenses and income of the company between the textile products and other activities.

23. Dry Cell Batteries

Proforma A - Cost of zinc can manufacture for use in each type / size of dry cell batteries

Proforma B - Cost of other component produced / manufactured such as brass caps, printed metal jackets/paper tubes, washers, carbon rods and ingredients like electrolytic manganese dioxide, acetylene black, etc. (for each item).

Proforma C - Cost of production of different dry cell batteries for each type and size.

Proforma D - Cost of sales of different dry cell batteries (for each type and size).

Proforma E - Allocation of total expenses and income in respect of dry cell batteries and other activities

Proforma F - Cost of work-in-progress and finished stock of dry cell batteries/electrolytic manganese dioxide/acetylene black and other products.

Proforma G - Cost of production, cost of sales realization and margin obtained per dry cell battery.

24. Steel Tubes and Pipes

Annexure I - Cost of water treated (cold softening/hot softening/High/Low) and consumed.

Annexure II - Cost of steam raised/consumed.

Annexure III - Cost of power generated/purchased and consumed.

Proforma A - Conversion cost in various cost centers

Proforma B - Allocation of conversion costs to various finished products

Proforma C - Cost of steel pipes/tubes manufactured for each item.

Proforma D - Cost of production of various types/shapes, quality of steel pipes/tubes.

Proforma E - Value of work-in-progress and closing stock at the end of the year.

Proforma F - Cost of sales, sales realization and margin.

Proforma G - Total expenses and income of the company and the share applicable to the tubes/pipes and other activities.

25. Engineering

Annexure I - Cost of power generated/purchase and consumed.

Annexure II - Cost of component/sub-assemblies manufactured.

Annexure III - Cost of casting made at foundry.

Proforma A - Cost of production of each item.

Proforma B - Cost of sales of each item.

Proforma C - Value of work in progress and completed stock at the end of the year.

Proforma D - Allocation of expenses and income for the product under cost audit and other activities.

26. Electrical Cables and Conductors

Annexure I - Cost of aluminum/copper/lead and any other major imported material purchased and consumed.

Annexure II - Cost of production of PVC compound, rubber compound, XLPE compound at mixing plant.

Annexure III - Cost of power generated / purchased and consumed.

Annexure IV - Cost of wooden drums manufactured.

Proforma A - Rolling / conversion cost of aluminum/copper.

Proforma B - Cost of aluminum /copper rods manufactured/purchased

Proforma C - Cost center wise conversion cost.

Proforma D - Allocation of conversion cost to various finished products.

Proforma E - Cost of cables/conductor/wire/strip manufacture of each item.

Proforma F - Value of work in progress and finished stock at the end of the year.

Proforma G - Cost of sales, sales realization and margin per unit.

Proforma H - Summary of cost of production, cost of sales, sales realization and margin obtained per unit (CKM/KM/Tonnes) Electrical cable / Conductor / Wire / Strip.

Proforma I - Allocation of total expenses incurred and incomes received by the company between electric cable, conductors, wire & stripe and other activities.

27. Bearings

Annexure I - Cost of power generated/purchased and consumed.

Proforma A - Conversion cost of various operations.

Proforma B - Conversion of the actual units in terms of standard units and Conversion cost per actual units produced

Proforma C - Cost of production of balls/rollers, inner / outer races, carges etc.

Proforma D - Cost of assembling Ball and Rollers Bearings

Proforma E - Cost of sales realization of Ball/Roller Bearings.

Proforma F - Value of work in progress and closing stock at the end of the year.

Proforma G - Summary of cost of sales and sales realization

Proforma H - Allocation of total expenses/income of the company between bearing and other activities.

28. Milk Food

Proforma A - Cost of Utility like Power, Steam, Water, Effluent treatment etc. produced and consumed

Proforma B - Cost of wet milk/dry cocoa beans/cocoa powder, malted product/malt extract/flow malt mix/intermediate of Milk food etc produced

Proforma C - Cost of sales, sales realization and margin in respect of each type of Milk food produced / manufactured and sold

Proforma D - Total production and allocation of total actual expenses and income of the company between the Milk food and other activities.

29. Chemical

Proforma A - Cost of Utility like Power, Steam, Water, Effluent treatment etc. produced and consumed

Proforma B - Cost of production of the process material / Intermediate / Product under reference

Proforma C - Cost of sales, sales realization and margin in respect of each type of process material / intermediate / product under reference

Proforma D - Allocation or apportionment of total expenses and income of the company between the products under reference and other products or activities.

30. Formulations

Proforma A - Cost of Utility like Power, Steam, Water, Effluent treatment etc. produced and consumed

Proforma B - Cost centre wise conversion cost and packing cost

Proforma C - Product wise apportionment of conversion cost

Proforma D - Cost of production, cost of sales, sales realization and margin in respect of each type of formulation.

Proforma E - Total production and allocation of total actual expenses and income of the company between the Formulations and other products or activities.

31. Steel Plant

Annexure I - Cost of nitrogen/oxygen/effluent treatment.

Annexure II - Cost of major material purchased and consumed

Annexure III - Cost of Power generated, purchased and consumed

Proforma A - Cost of production of internally manufactured materials namely sponge iron / ferro alloy, etc. captively used in manufacture of each steel product.

Proforma B - Cost of production (specify steel product)

Proforma C - Cost of sales (specify steel product)

Proforma D - Value of semi-finished goods and finished stock.

Proforma E - Cost of sales realization and margin of specified steel product.

Proforma F - Allocation of total expenses incurred and incomes received by the company as per financial accounts between the production(s) covered under these rules and other activities.

Proforma G - Allocation/apportionment of total expenses/income between productions covered under rule 2 and other activities.

Proforma H - Statement showing the reason for loss of production during the year.

Proforma I - Statement showing the unit cost of production, cost of sales, sales realization and margin per unit of specified steel product.

32. Insecticides

Annexure I - Cost of treated/cooled de-mineralized water/effluent treatment.

Annexure II - Cost of steam raised / consumed.

Annexure III - Cost of power generated, purchased and consumed.

Proforma A - Cost of production of self manufactured ingredient / substances used in the manufacture of insecticides.

Proforma B - Cost of production of insecticides manufactured during the year.

Proforma C - Cost of sales of insecticides packed and sold/captively consumed.

Proforma D - Value of work-in-progress and finished goods at the end of the year.

Proforma E - Cost of sales, sales realization and margin in respect of insecticides product.

Proforma F - Allocation of total expenses incurred and income received as per internal account by the company between product covered under the rules and other activities.

Proforma G - Allocation / Apportionment of total expenses / income of the company between product covered under the rules and other activities.

Proforma H - Reasons for loss of production during the year.

Proforma I - Unit cost of production, cost of sales, realization and margin for the specified product.

33. Fertilizers

Annexure I - Cost of treated/cooling dematerialized water, effluent treatment.

Annexure II - Cost of steam raised / consumed during the year.

Annexure III - Cost of power generated, purchased and consumed.

Proforma A - Cost of production of process materials/chemicals/intermediates manufactured and captively used.

Proforma B - Cost of production of fertilizer.

Proforma C - Cost of sales of fertilizers.

Proforma D - Value of Work-in-progress and finished goods at the end of the year.

Proforma E - Cost of sales, sales realization and margin.

Proforma F - Allocation of total expenses incurred and income received as per financial accounts between the product covered by the rules and other activities.

Proforma G - Allocation of total expenses / income between the product covered by the rules and other activities.

Proforma H - Reasons for loss of production.

Proforma I - Unit cost of production, cost of sales, sales realization and margin obtained per unit.

34. Soaps and Detergents

Annexure I - Cost of treated/cooling, dematerialized water/ effluent treatment

Annexure II - Cost of steam raised / consumed during the year

Annexure III - Cost of power generated / purchased and consumed during the year.

Proforma A - Cost of production of self-manufactured process material, ingredient or substance captively used.

Proforma B - Cost of production of product (specify product).

Proforma B1 - Cost of production of specified grade of soap/detergent.

Proforma C - Cost of sales of specified soap/detergent

Proforma D - Value of work-in-progress and closing stock

Proforma E - Cost of sales, sales realization and margin in respect of specified grade of soap and detergent.

Proforma F - Allocation of total expenses incurred and income received as per financial accounts between products covered under the rules and other activities.

Proforma G - Allocation/apportionment of total expenses / income between products covered under rule and the other activities

Proforma H - Reasons for loss of production.

Proforma I - Unit cost of production, cost of sales, sales realization and margin in respect of specified product.

35. Cosmetics and Toiletries

Annexure I - Cost of treated/cooling water / effluent treatment

Annexure II	-	Cost of steam raised / consumed
Annexure III	-	Cost of power generated, purchased and consumed during the year.
Proforma A	-	Cost of production of self-manufactured product, process material, ingredient or substance etc. captively used.
Proforma B	-	Cost of production of specified toiletry, cosmetic product.
Proforma C	-	Cost of sales of specified cosmetic or toiletry product.
Proforma D	-	Value of work-in-progress and closing stock at the end of the year.
Proforma E	-	Cost of sales, sales realization and margin in respect of specified product.
Proforma F	-	Allocation of total expenses incurred and income received as per financial accounts between products covered under the rules and other activities.
Proforma G	-	Allocation/apportionment of total expenses / income between products covered under rules and other activities.
Proforma H	-	Reasons for loss of production.
Proforma I	-	Unit cost of production, cost of sales, sales realization and margin of product.

36. Footwear

Annexure I	-	Cost of treated water/effluent treatment during the year.
Annexure II	-	Cost of steam raised/consumed during the year.
Annexure III	-	Cost of power generated, purchased and consumed during the year.
Proforma A	-	Conversion cost for various operation cost centers for footwear for the year.
Proforma B	-	Apportionment of conversion cost to various types of footwear/tannery for the year.
Proforma C	-	Cost of production of footwear for the year.
Proforma C1	-	Cost of production of self-manufactured materials/chemical/components used in the manufacture of …… produced during the year.
Proforma C2	-	Cost of rubber/PVC compound manufactured during the period.
Proforma C3	-	Cost of finished leather manufactured during the period.
Proforma D	-	Cost of sales for the year.
Proforma E	-	Cost of sales, sales realization and margin for all types of footwear manufactured and sold during the year.
Proforma F	-	Allocation of total expenses incurred and income received by the company between footwear/tannery and other activities during the year.
Proforma G	-	Reasons of loss of production during the year.

37. Shaving Systems

Annexure I	-	Cost of treated/cooling water/effluent treatment during the year.

Annexure II - Cost of steam raised / consumed during the year.

Annexure III - Cost of power generated / purchased and consumed during the year.

Proforma A - Conversion and packing cost for various cost centers for shaving blades/ Razors/shaving systems and their apportionment for the year …….

Proforma B - Cost of production of shaving blades/razors/systems for the year ended …….
.

Proforma B1 - Statement showing the cost of production self-manufactured components/ process materials used in the manufacture of product under reference.

Proforma C - Statement showing the cost of packed products for the year.

Proforma D - Cost of sales/sales realization and margin for all the blades/razors/systems manufactures and sold during the year.

Proforma E - Allocation of total expenses incurred and income received by the company between shaving systems and other activities during the year.

Proforma F - Reasons for loss of production during the year.

38. Industrial Gases

Annexure I - Cost of refrigeration/compressed air/effluent treatment during the year.

Annexure II - Cost of steam raised/consumed during the year.

Annexure III - Cost of power generated/purchased and consumed during the year.

Proforma A - Cost of production of self manufactured process material / ingredient / substance captively used in the manufacture of …… ….

Proforma B - Cost of liquid/gas (specify the name of product with type/size/grade).

Proforma C - Cost of sales of liquid/gas (specify the name of product with type/size/ grade).

Proforma D - Value of work-in-progress/finished stock at the end of the year.

Proforma E - Cost of sales, sales realization and margin for the year ended…..

Proforma F - Allocation/apportionment of total expenses/income of the company between product(s) under reference and other activities during the year.

Proforma G - Reasons for loss of production during the year ……….

39. Mining and Metallurgy

Proforma A - Cost of Utilities like power, steam, water etc. produced and consumed during the year.

Proforma B - Cost of Mineral raised and transported to ore producing plant during the year.

Proforma C - Cost of Ore (to be specified) produced and sold during the year

Proforma D - Cost of basic metal or non-metal produced during the year.

Proforma E - Cost of production, cost of sales, sales realization and margin in respect of each final product (metals and non metals, their minerals, ores and alloys) produced during the year.

Proforma F - Total production and allocation of total actual expenses and income of the company among various products under reference and other products or activities for the year ending …….

40. Electronic Products

Proforma A - Cost of Utilities like power, steam, water etc. produced and consumed during the year.

Proforma B - Cost of components or casting produced or manufactured during the year.

Proforma C - Cost of production, cost of sales and sales realization and margin in respect of electronic products produced or manufactured during the year.

Proforma D - Total production and allocation of total actual expenses and income of the company among various Electronic products and other activities for the year ending.

41. Electricity Industry

Proforma A - Cost of utilities like (1) Water collection, (2) Water treatment, (3) Ash handling Plant, (4) Effluent treatment, etc.

Proforma B - Cost of procurement of coal, lignite, gas, naptha, fuel oil, bagasse or any other primary or secondary conventional or non-conventional fuel.

Proforma C - Cost of generation of power (Thermal/ Hydro-electric/Gas Turbine/ Atomic, etc.) during the year …..

Proforma D - Cost of Transmission/Distribution during the year …...

Proforma E - Cost of supply (consumer servicing and billing, etc.) during the year……….

Proforma F - Allocation/ apportionment of total expenses/income of the company between activities covered under rule 2 and other activities during the year / period……..

42. Plantation Product

Proforma A - Cost of utilities like (1) Water, (2) Power, (3) Steam Generation, (4) Effluent treatment, etc. produced or consumed

Proforma B - Cost of Nursery raised during the year or period.

Proforma C - Cost of Development – New plantation, replantation or rejuvenation

Proforma D - Cost of production of __________ (crop) produced during the year or period ………

Proforma E - Cost of product manufactured or sold during the year ending-------

Proforma F - Allocation/ apportionment of total expenses or income of the company between activities covered under rule and other activities during the year / period……..

43. Petroleum Industry

Proforma A - Cost of utilities like (1) Water (2) Power etc. produced or consumed

Proforma B - Details of Survey Cost during the year

Proforma C - Cost of Exploratory Drilling or Development Drilling

Proforma D - Cost of Finding Proved Reserves Established during the year ending ………

Proforma E - Cost of intermediate – activities like Lifting, Conveying, Treating and Transportation of Crude Oil and Natural Gas during the year ending-------

Proforma F - Cost of Production of Crude Oil and Natural Gas during the year ending………..

Proforma G - Cost of Refining for the year ending………..

Proforma H - Product-wise Cost of Sales

Proforma I - Allocation or apportionment of total expenses or income of the company between service or activities covered under rule and other activities during the year ending……..

44. Telecommunication

Proforma A - Activity-wise Capital Cost of Plant and Machinery or Networking Equipment relating to Telecommunication activities for the year ended …………

Proforma B - Cost of Operations for the year ended…….

Proforma C - Cost of Service / Sub-Service for the year ended………

Proforma D - Allocation or apportionment of total expenses or income between activities covered under rule and other activities during the year ending……..

3.3 COST ACCOUNTING RECORDS (TELECOMMUNICATION) RULES, 2002

MINISTRY OF FINANCE AND COMPANY AFFAIRS

(Department of Company Affairs)

NOTIFICATION

New Delhi, the 8th October, 2002

G.S.R. 689(E).– In exercise of the powers conferred by sub-Section (1) of Section 642, read with clause (d) of sub-Section (1) of Section 209 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules, namely:

1. **Short title and commencement** - (1) These rules may be called the Cost Accounting Records (Telecommunications) Rules, 2002.

   (2) They shall come into force on the date of their publication in the Official Gazette.

2. **Application** - These rules shall apply to every company engaged in the processing of any one or more of the telecommunication activities, namely: -

   (1) Basic telephony: -

      (e) Telephone access

      (f) Local call

      (g) Subscriber trunk dialing (STD)

      (h) International subscriber dialing (ISD)

   (2) Cellular mobile;

   (3) Telex;

   (4) Telegraphy;

   (5) Voice mail /Audiotex service;

   (6) Internet operations including gateway service/E-mail;

   (7) Packet switched public data network (PSPDN) service;

   (8) Wireless in local loop (WILL) service;

   (9) Public mobile radio trunk service;

   (10) Very Small Aperture Terminal service;

   (11) Global mobile personnel communication services;

   (12) Leased circuits;

   (13) Internet ports ;

   (14) National Long Distance Operator;

(15) Internet Telephony;

(16) Radio Paging;

(17) Any other telecommunication service for commercial use.

Provided that these rules shall not apply to a company, -

(a) the aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed the limits as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) the aggregate value of the turnover made by the company from sale or supply of all its products or activities during the preceding financial year does not exceed ten crore rupees.

(3) **Maintenance of records** - (1) Every company to which these rules apply shall, in respect of each of its financial year commencing on or after the commencement of these rules, keep proper books of account relating to the utilisation of materials, labour and other items of cost in so far as they are applicable to any of the activities referred to in rule 2. The books of accounts, so maintained, shall contain, inter-alia, the particulars specified in Schedule annexed to these rules and Proformae A, B,C and D mentioned in the said Schedule:

Provided that if the said company is engaged in other activities in addition to products referred to in rule 2, the particulars relating to utilisation of materials, labour and other items of cost in so far as they are applicable to such other products or activities shall not be included in the cost of the activities referred to in rule 2.

(2) The books of account referred to in sub-rule (1) shall be kept on a regular basis in such a manner as to make it possible to calculate the cost of each product or activity referred to in rule 2, for every financial year from the particulars entered therein. Every such book of account and the proformae specified in the said Schedule, shall be completed not later than ninety days from the close of the financial year of the company to which it relates.

(3) The statistical and other records shall be maintained in accordance with the provisions of the Schedule to these rules in such a manner as to enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in cost. These records shall also provide the necessary data required by the Cost Auditor to suitably report on all the points referred to in Cost Audit (Report) Rules, 2001 as amended from time to time.

(4) It shall be the duty of every person, referred to in sub-Section (6) and (7) of Section 209 of companies Act, 1956 (1 of 1956), to take all reasonable steps to secure compliance by the company with the provisions of sub rules (1), (2) and (3) of this rule in the same manner as he is liable to maintain accounts required under sub-Section (1) of Section 209 of the said Act.

4. **Penalty -** If a company contravenes the provisions of rule 3, the company and every officer thereof who is in default, including the persons referred to in sub-rule (4) of rule 3 shall be punishable as provided under sub-Section (2) of Section 642 read with sub-Sections (5) and (7) of Section 209 of the Companies Act, 1956 (1 of 1956).

SCHEDULE

[see rule 3]

1. Materials and Supplies:

(1) The proper records shall be maintained showing all receipts, issues and balances both in quantities and values of each item of materials. stores and supplies such as cables, poles, telephone instrument, roust box, dropwire, lines and wires etc, used in the maintenance and operation of different activities such as access network, local switching, local transmission, long distance switching, transmission, and international gateway access, referred to in rule 2. These records shall contain such details so as to enable the company to determine the quantity and cost of receipt (including all direct charges up to the location in respect of major materials/supplies), issues and balances in quantity as well as value of each item of all such materials. The basis on which said costs of issue and consumption, for each telecom activity referred to in rule 2, have been calculated shall be indicated in the cost records and followed consistently. In the case of imported materials/supplies proper records of quantity and value shall be maintained for each item showing FOB value, overseas freight, insurance, customs duty, clearing charges, inland freight etc. If both indigenous and imported materials are consumed, the records showing details of percentage mix of the same, have to be maintained for each item.

(2) The proper records shall be maintained showing the receipts, issues and balances both in quantity and value of each item of *consumable* stores (operation and maintenance stores), small tools and spares required for any of the activities referred to in rule 2. The value shown shall include all direct charges up to location whenever specifically incurred. In the case of consumable stores, the value of which are not significant, the company may, if so desires, maintain such records for the main group of such items. The value of consumable stores, consumed for the telecom activities shall be charged to the relevant activities/ cost centres.

(3) The proper records shall be maintained showing the quantity and value of wastage, shortages, spoilage, damage, rejections and *losses of materials*, consumable stores and spares whether in transit, storage, or at any other stage. The method followed for adjusting the above losses as well as the income derived from the disposal of such rejected and waste materials including spoilage, if any, in determining the cost of activities, shall be indicated in the cost records.

(4) The proper records shall also be maintained to indicate the value of materials which have *not moved* for more than twelve months for effective control of inventory.

(5) Where any credit under Central Value Added Tax (CENVAT) under the Central Excise Act, 1944 (1 of 1944), or any other benefits such as rebates, duty drawbacks or any other similar items of credit are received/receivable on any item of material and/or consumable stores or spares, the cost of such material and/or consumable stores/spares should be shown after adjusting such credit or benefits.

2. Salaries and Wages:

(1) The proper records shall be maintained to show the attendance and earnings of all employees activity-wise on which they are employed. The records shall also indicate the following separately for each such activity:

(a) piece rate wages (wherever applicable);

(b) incentive wages, either individually or collectively as production bonus or under any other scheme based on output;

(c) overtime wages;

(d) earnings of casual or contractual labour;

(e) bonus or gratuity, statutory as well as other;

(f) contribution to superannuation scheme; and

(g) any other earning of the nature specified in (a) to (f) above.

(2) The records shall be maintained in such a manner as to enable the company to furnish necessary particulars under this head for the different services/ and for different telecom activities in Proformae A, B, C and D of Schedule I annexed to these rules. The records may be maintained to book these expenses activity-wise. Where the employees work in such a manner that it is not possible to identify them with any specific activity, the employees' cost shall be apportioned to various activities on equitable and reasonable basis and applied consistently.

(3) The idle labour cost shall be separately recorded under classified headings indicating the reasons therefor. The method of accounting followed for accounting of idle time payments shall be disclosed in the cost records.

(4) Any wages and salaries allocable to capital works, such as, additions to plant and machinery, buildings or other fixed assets shall be accounted for under the relevant capital heads. Similarly, payments in the nature of deferred revenue expenditure shall be separately recorded under separate classified headings indicating the reasons therefor. The method followed for accounting of such payments in determining the cost of the activity or service shall be on equitable and reasonable basis and applied consistently. The said method shall be disclosed in the cost records also.

(5) The cost of termination benefits payable to the employees shall be recorded under separate head. The method followed for accounting for such costs in determining the cost of each telecommunication activity shall be on equitable and reasonable basis, applied consistently and disclosed separately. Only the termination benefits, say in respect of a voluntary retirement scheme, which are payable in addition to the normal retirement benefits and that are likely to provide benefits in terms of savings in cost in future shall be treated as deferred revenue expenditure over a period not exceeding five years. These costs shall not form part of salaries and wages and shall be shown separately. Such costs shall be excluded from valuation of inventories since these do not result in putting the inventories to their present location and condition.

3. Service Department Expenses:

(1) The proper records shall be maintained to indicate expenses incurred in respect of each service department or function like laboratory, welfare measures, transport, dispensary, school, crèche, township etc. These expenses shall be apportioned to telecom activities on

equitable and reasonable basis and applied consistently. Where these services are utilized for other products or activities or services of the company also, the basis of apportionment of such expenses to other products or activities or services shall be on equitable and reasonable basis and applied consistently.

(2) Common operation and maintenance cost incurred for a number of activities, shall be apportioned to the product/activity benefiting from these services on reasonable and equitable basis and shall be applied consistently. The basis on which such common operation and maintenance cost are apportioned to different products/activities shall be indicated in the cost records.

4. Utilities:

The proper records showing quantity and cost of purchased or self produced utilities such as power, air conditioning required for any of the activities under reference, shall be maintained by the company.

5. Repairs and Maintenance:

(1) The proper records showing the expenditure incurred by the workshop and on repairs and maintenance on various activities shall be maintained. The records shall also indicate the basis of charging the repairs and maintenance expenses to different activities. Where maintenance work is done by direct workers, the wages and salaries of such workers shall be treated as direct expenses of the respective activity. If the services are utilized for other products/activities also, the manner of charging a share to such products/activities shall be on equitable and reasonable basis and applied consistently.

(2) The records shall also indicate the quantity and amount and also the proportion of closing inventory of stores and spare parts representing items which have *not* moved for over twenty four months.

(3) The expenditure on major repair work from which benefit is likely to accrue for more than one financial year shall be allocated over the period expected to benefit on equitable and reasonable basis and applied consistently. Such costs shall be shown separately and method of accounting along with the basis of allocation of such costs shall also be clearly indicated in cost records.

6. Fixed Assets and Depreciation:

(1) The proper and adequate records shall be maintained for assets used for each of the activities under reference in respect of which depreciation has to be provided for. These records shall inter-alia, indicate the cost of acquisition of asset, date of acquisition and rate of depreciation. The records shall also indicate value of fixed assets under each activity namely local telephone exchange system into customer access network, local switching and local transmission, long distance switching, long distance transmission etc grouped under each telecom activity referred to in rule 2. Where the fixed assets are joint and inseparable, segregation shall be made on the basis of technical estimates. This information shall be maintained in accordance with Proforma A of the Rules.

(2) Also such records as will enable to identify and/or allocate gross fixed assets, accumulated depreciation upto the year and net fixed assets under the heads; land and building, plant and machinery, furniture and fixtures etc. employed for the provision of activities under reference alongwith the method and rate of depreciation shall be maintained. The basis of apportionment of common assets to the activities under reference shall also be indicated. In case of revaluation of assets, the same shall be indicated separately. The basis of allocation of indirect assets to the activities under reference shall be on equitable and reasonable basis and applied consistently.

(3) The basis on which depreciation is calculated and allocated or apportioned to various activities and absorbed shall be clearly indicated in the cost records. If depreciation charged or chargeable to the departments is in excess or lower than the depreciation calculated by applying the rates of depreciation prescribed under the provisions of sub-Section (2) of Section 205 of the Companies Act, 1956, such amount of excess or lower depreciation shall also be indicated clearly in the cost records. The cost records shall also show the effect of such excess or lower depreciation as the case may be, on the per unit cost of activity. The cumulative depreciation charged in the cost records, against any individual item of asset shall not, however, exceed the original cost of the respective asset.

7. Other Overheads:

(1) The Proper records shall be maintained for the activities under reference showing the various items of expenses comprising the other overheads. These expenses shall be analysed, classified and grouped according to functions, namely, operation, maintenance, administration, marketing and distribution for each activity.

(2) Where the company is manufacturing products or providing services, carrying out activities other than the activities under reference, the records shall clearly indicate the basis followed for apportionment of the common overheads including head office expenses of the company to such products, other activities and to telecom activities including capital works. Where certain expenses forming part of overheads can be identified with a particular activity or a product, such expenses shall be first segregated and charged to the relevant activity or product and thereafter the residual expenses under the above categories of overheads shall be apportioned on a reasonable and equitable basis and applied consistently. The overheads chargeable to capital works shall be indicated separately in the cost records. The basis of apportionment or absorption of overheads to the cost centres/activities and products shall be indicated in the cost records. The records shall be maintained in such a manner as to indicate the details of operation, maintenance, administration, marketing and distribution overheads.

8. Royalty or Technical Know-how Fee or Leasing Charges or Licensing Fee :

(1) The adequate records shall be maintained showing the royalty and/or technical know-how fee including other recurring or non-recurring payments of similar nature if any, made for the activities under reference to collaborators or technology suppliers in terms of agreements entered into with them. Such records shall be kept separately in respect of each such collaborator or supplier. The basis of charging such amount, including lump sum payment and its treatment shall be indicated in the cost records. The basis on which amortisation of

licence fee has been calculated and absorbed shall be mentioned in the records.

(2) In the case of leasing arrangements/licensing fee proper records shall be maintained showing details of terms and conditions, leasing charges or licensing fee paid or payable as well as received or receivable for each telecom activity.

(3) If licence fee is payable on revenue earning basis in addition to lump sum licence fee, proper records shall be maintained indicating the basis of calculation, amount of additional licence fee payable and its allocation to various telecommunication services.

(4) Records relating to Universal Service Organisation shall also be maintained, wherever applicable.

(5) If licence fee and royalty payable for usage of radio spectrum, proper records should be maintained indicating frequency allocation, royalty fee paid, spectrum licence fee and the number of users, where applicable.

9. Research and Development Expenses:

(1) The proper records showing the details of expenses, if any, incurred by the company on the research and development work of the products/activities covered under these rules shall be maintained.

(2) The method of charging these expenses to the cost of activities under reference and all other products or activities shall be indicated in the cost records. Where the utility of such research and development work extends over more than one financial year, such expenses shall be treated as deferred revenue expenses and charged to the cost of activities under reference and all other products if any, on equitable and reasonable basis and applied consistently. The detailed criteria on which it has been decided to extend the utility period of these expenses to more than one financial year shall be disclosed in the cost records. The following criteria, which are only indicative and not exhaustive, may be adopted in such cases :

(i) the activity or product is clearly defined and the costs attributable to the activity or product can be separately identified;

(ii) the technical feasibility of the activity or product has been demonstrated;

(iii) the management of the enterprise has indicated its intention to engage in the activity or produce and market or use the product or process;

(iv) there is a reasonable indication that current and future research and development costs to be incurred on the project together with expected volume of activity, production, administrative and selling costs are likely to be more than covered by related future revenues or benefits; and

(v) adequate resources exist or are reasonably expected to be available to complete the project and engage in the activity or market the product or process.

(3) The expenses incurred by the Research and Development Department for providing technical know-how to outsiders shall be recorded separately and excluded from the cost of activities under reference. The amount recovered for providing technical know-how to outsiders shall also be indicated separately and excluded from the income arising from the marketing of products or activities under reference.

10. Interest and Other Borrowing Costs :

The proper records shall be maintained for money borrowed for each project and/or working capital and borrowing costs thereon. The borrowing costs include amortisation of discounts or premiums relating to borrowings, finance charges in respect of assets acquired under finance leases, exchange difference arising from foreign currency borrowings etc. The amount of borrowing cost shall be allocated or apportioned to the activities covered by these rules and other activities on a reasonable and equitable basis and followed consistently. The basis of further charging of the share of the borrowing cost to the various types of such activities shall also be equitable or reasonable and followed consistently. The basis of such allocation or apportionment shall be spelt out clearly in the cost records. Net borrowing cost incurred on borrowed money or outlays for projects under execution, shall be capitalized for the period upto the date of commencement of commercial activities.

11. Expenses on Interconnection:

The proper records showing the expenses incurred and revenue received on the interconnection of telecom services provided and received shall be separately maintained indicating the units in terms of time, pulse rate etc. so that the cost of interconnection of services and revenue earned can be determined correctly. Similar cost statement shall also be prepared for international traffic for use of international gateway access for services provided and received and revenue earned thereof.

12. Cost Statements:

(1) The Cost statement showing details of installed capacity of each service (activity wise) and all elements of cost of the current financial year and previous year shall be prepared for each revenue earning unit in relation to the activities under reference in Proformae A, B, C and D. The revenue earning unit means a part or Section or geographical location identified by the company for which books of accounts and other records are maintained independently for accounting and administrative convenience and it may be based on grouping or classification of services as referred to in rule 2 above or on the basis of consolidation of streams of revenue and expenditure and/ or assets and liabilities for the presentation of accounts by the company.

(2) The service rendered by one activity which forms input for a subsequent activity shall be valued at cost upto the service.

13. Activity Records:

The quantitative records of the activities/ services provided in appropriate units of measurement along with proper classification, sub-classification etc. shall be maintained by the company. The records shall be maintained in such a manner that will enable a company to cost and correlate revenues from such classified or sub-classified activities/ services under the main activities as stipulated in rule 2.

14. Reconciliation of Cost and Financial Accounts:

(1) The Cost statements shall be reconciled with the financial statements for the financial year specifically indicating the expenses or incomes not considered in the cost records or statements and reasons therefor so as to ensure accuracy and to adjudge the profit of the activity under

reference with the overall profit of the company. Variations, if any, shall be clearly indicated and explained.

(2) A costing profit and loss statement showing the total expenses incurred and income received by the company under different heads of accounts and the share applicable to the activities or services shall be prepared and reconciled with the financial statement.

15. Adjustment of Cost Variances:

Where the company maintains cost records on any basis other than actual such as standard costing, the records shall indicate the procedure followed by the company in working out the cost of the activities and services under such system. The cost variances shall be shown against the separate heads and analysed into material, labour, overheads and further segregated into quantity, price and efficiency variances. The method followed for adjusting the cost variances in determining the actual cost of the activities or services shall be indicated clearly in the cost records. The reasons for the variances shall be duly explained in the cost records/statements.

16. **Statistical Records:**

(1) The proper records shall be maintained in respect of locations from where activities are carried out or services are rendered. The records shall show the rated capacity, the practical capacity and capacity actually utilised in terms of appropriate unit of accounting for various resources that are employed like infrastructure, installation of equipments, manpower and its utilisation etc. The records shall also be maintained showing efficiency achieved in terms of attending the customer complaints and keeping the resources under operating conditions.

(2) The adequate records shall be maintained to enable the company to identify the capital employed, net fixed assets and working capital separately for different activities under reference and other products and activities. Fresh investments on fixed assets that have not contributed to the activities under reference during the year shall be indicated in the cost records. The records shall, in addition, show assets added as replacement and those added for increasing existing capacity.

(3) In the case of new projects for activity under rule 2, proper records shall be maintained indicating the funds raised from different sources, their utilization, stage-wise cost incurred and progress of the project as per the project report. Cost and time over run shall also be analysed with reference to the cost of services/activity and profitability of the company.

17. Captive Use:

The proper records shall be maintained showing the quantity and cost of telecom services used by the company for self-use and free services provided to employees and others.

18. Human Resources Development:

Expenditure incurred by the company on the training and development activity of human resources shall be recorded separately.

19. Related-party Transactions:

(1) In respect of related party transactions or supplies made or services rendered by a company to its holding company or subsidiary or a company termed "related party relationship" as

defined below and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of:

(a) purchase and sale of materials, finished products and rejected goods including scraps, etc;

(b) utilisation of plant facilities and technical know-how;

(c) supply of utilities and any other services;

(d) administrative, technical, managerial or any other consultancy services;

(e) purchase and sale of capital goods including plant and machinery;

(f) any other payments related to activities or services under reference.

These records shall also indicate the basis followed for arriving at the rates charged or paid for such activities or services so as to enable determination of the reasonableness of such rates in so far as they are in any way related to activity under reference.

(2) The transactions by the following “related party relationships” shall be covered under sub-rule(1) :

(a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);

(b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

(c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;

(d) key management personnel and relatives of such personnel; and

(e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

However, the following shall not be deemed as “related party relationships”:

(a) two companies simply because they have a Director in common, notwithstanding paragraph (d) or (e) above (unless the Director is able to affect the policies of both companies in their mutual dealings);

(b) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process);

(i) providers of finance;

(ii) trade unions;

(iii) public utilities;

(iv) government departments and government agencies including government sponsored bodies.

Explanation : for the purpose of these Rules -

(a) **"related party relationships"** means parties who are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions;

(b) "related party transaction" means a transfer of resources or obligations between related parties, whether or not a price is charged;

(c) **"control"** means -

(i) ownership, directly or indirectly, of more than one-half of the voting power of an enterprise; or

(ii) control of the composition of the Board of Directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise; or

(iii) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

(d) **"significant influence"** means participation in the financial or operating policy decisions of an enterprise, but not control of those policies;

(e) **"associate"** means an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party;

(f) **"joint venture"** means a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control;

(g) **"joint control"** means the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it;

(h) **"key management personnel"** means those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise;

(i) **"relative"** – in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be connected by blood relationship;

(j) **"holding company"** means a holding company within the meaning of Section 4 of the Companies Act, 1956(1 of 1956);

(k) **"subsidiary"** means a subsidiary company within the meaning of Section 4 of the Companies Act, 1956(1 of 1956);

(l) **"fellow subsidiary"** means a company is said to be a fellow subsidiary of another company if both are subsidiaries of the same holding company;

(m) **"state-controlled enterprise"** means an enterprise which is under the control of the Central Government or a State Government.

Proforma 'A'

Name of the company :

Name and address of the Area of Operation or Circle or Secondary Switching Area or District Headquarters :

Statement showing Activity-wise **Capital Cost of Plant and Machinery or Networking Equipment** relating to Telecommunication activities for the year ended ....

Sr. No.	Particulars	Gross Block				Depreciation				Net Block	
		Cost as at begining of the year	Additions /transfers during the year	Deduct-ions / transfer during the year	Total cost at the end of the year	As at begining of the year	For the year	On deducti -ons during the year	Total at the end of the year	As at begining of the year	As at the end of the year
A	Basic Telephony										
1.	(specify)										
2.											
etc.											
B	Cellular Mobile Telephone Services										
1.	(specify)										
2.											
etc.											
D.	Network Element jointly used in more than one service (specify)										
1.											
2.											
etc.											
E	Grand Total (A + B + C + D)										

Notes 1. Separate proforma shall be prepared in respect of each Area of Operation or Circle or Secondary Switching Area or District Headquarters .

2. The proforma may be modified suitably to incorporate unit specific special features, if any, indicating reasons thereof.

3. Within each area of operation separate proforma may be used for each service and only those network elements are to be taken which are exclusively used for that particular service. All those equipment which are jointly used in more than one service, the requisite details be given against Sr. No. D of this proforma specifying these services.

4 Details of apportionment of depreciation to respective activity be specified separately in case of Network equipments which are jointly used in more than one service.

Proforma 'B'

Name of the company :

Name and address of the Area of Operation or Circle or Secondary Switching Area or District Headquarters :

Statement showing the Cost of Operations for the year ended ....

Serial No.	Particulars	Quantity	Rate	Amount	Cost per unit	
			(Rupees)	(Rupees)	Current Year (Rupees)	Previous Year (Rupees)
A	Operation Cost					
	1) Materials (major items to be specified)					
	2) Employees Cost : (i) Salaries and wages (ii) Others (specify) (iii) Sub total					
	3) Utilities (Specify)					
	4) Stores, Spares and Consumables					
	5) Repairs and Maintenance					
	6) Other direct expenses (Specify)					
	7) Rent, Rates and Taxes					
	8) Depreciation					
	9) Amortisation on the fixed component of license fees					
	10) License Fee paid as Revenue share					
	11) Lease Rent, if any					
	12) Insurance					
	13) Royalty or technical know-how fee					
	14) Other overheads					
	15) Total (1 to 14)					
B	Other Charges or Levies					
	1) Interconnection charges - Port Charges - Leased Line Charges - Other interconnection charges 2) Spectrum Royalty 3) Spectrum License Fee 4) DOT charges, if any 5) Other expenses (specify) 6) Total (1 to 5)					
C	Administrative Overheads (Specify major heads) (a) (b) etc. Sub total					
D	Cost of Operation (A+B+C)					

E	Apportionment of Cost to various segment / services				
	Segment / Service	Basic of apportinment	Actual Quantity	Equivalent Quantity	Value (Rupees)
	1) Basic - Local Swithching and Transmission 2) National Long Distance 3) International Long Distance 4) Cellular 5) 6) etc. Total				

Notes 1. Separate proforma shall be prepared in respect of each Area of Operation or Circle or Secondary Switching Area or District Headquarters

2. The proforma may be modified suitably to incorporate unit specific special features, if any, indicating reasons thereof.

Proforma 'C'

Name of the company:

Name and address of the Area of Operation or Circle or Secondary Switching Area or District Headquarters :

Statement showing the Cost of Service/ Sub-service for the year ended ....

Quantitative Information

Serial Number	Particulars	Unit	Current Year	Previous year
1.	Equipped Capacity - Subscriber			
2.	Traffic Handling Capacity (in Erlang)			
3.	-Working Lines/subscribers -Working Circuits/Channels/Ports			
4.	Capacity utilisation (%) -In terms of Subscriber. -In terms of traffic handling			
5.	Number of Points of Interconnection: Other Basic Operator Cellular Operator National long distance operator International long distance Operator Specify any other (Internet service providser, Radio paging, etc)			

6.	Number of E1 links: 1) Other Basic Operator Cellular Operator National long distance operator International long distance operator Specify any other (Internet service provider, Radio paging, etc)			
7.	Number of Village Public Telephones			
8.	Number of Public call offices -Local -STD or ISD			
9.	Number of metered calls or hours of usage -Charged -free			
10.	Total duration of metered calls or hours of usage.			
11.	Average duration per call (minutes) (For Basic and Cellular)			
12	Average call per direct exchange line or cellular subscriber (For asic and Cellular)			
13.	Telephone Traffic (in minutes) (A) Incoming Traffic from - (i) Public switch telephone network (ii) Wireless in local loop (iii) Mobile (iv) National long distance operator (Intra Circle) (v) National long distance operator (Inter Circle) (vi) International long distance operator (B) Outgoing Traffic to - (i) Public switch telephone network (ii) Wireless in local loop (iii) Mobile (iv) National long distance operator (Intra Circle) (v) National long distance operator (Inter Circle) (vi) International long distance operator			

Cost Information

Sr. No.	Particulars	Quantity	Rate (Rupees)	Amount (Rupees)	Cost per unit Current Year (Rupees)	Cost per unit Previous Year (Rupees)
A	**Apportioned Cost for the Activity or Service transferred from "Proforma B"**					
B	**Direct Cost**					
	1) Materials (major items to be specified)					
	2) Employees Cost: (i) Salaries and wages (ii) Others (specify) (iii) Sub total					
	3) Utilities (specify)					
	4) Stores, Spares and Consumables					
	5) Repairs and Maintenance					
	6) Other direct expenses, if any					
	7) Rent, Rates and Taxes					
	8) Depreciation					
	9) Amortisation on the fixed component of license fees					
	10) License Fee paid as revenue share					
	11) Lease Rent, if any					
	12) Insurance					
	13) Royalty or technical know-how fee					
	14) Other overheads					
	15) Total (1 to 14)					
C	**Other Charges / Levies:** 1) Interconnection charges a) Port Charges b) Leased Line Charges c) Other Interconnection Charges 2) Spectrum Royalty 3) Spectrum License Fee 4) Other (please specify) 5) Total (1+2+3+4)					

D	**Administrative** Overheads (Specify major heads) (a) (b) etc. Sub total					
E	Other Direct Cost (Specify)					
F	Cost of Operation (A + B + C+ D + E)					
	Marketing expenses 1. Salaries and Wages 2. Commission and Discounts etc. 3. Others (specify) 4. Total					
H	Interest and other borrowing cost					
I	Other Cost, if any (Specify)					
J	Total Cost (F+G+H+I)					
	Revenue Information					
K	1. Installation Charges					
	2. Activation Charges					
	3. Rental Charges					
	4. Call Charges					
	5. Interconnection Charges a) From related Parties b) From Others					
L	Other Charges (specify)					
M	Revenue Earned (excluding statutory levies, if any)					
N	Margin Per Call (M -J)					
O	Margin Per Minute of Usage					
P	Margin Per Direct exchange line / Channel / Port / Circuit					

Notes:

1. Separate cost statement shall be prepared for each of the activities or services including value added service indicating the complete details (wherever applicable).
2. The proforma may be modified suitably to incorporate unit specific features, if any, indicating reasons thereof.
3. Interconnection related cost or revenue is to be further segregated and shown under separate heading as Fixed Interconnection Charges or Revenues and Variable Interconnection Charges or Revenue. They are also to be subdivided under charges paid to related companies and others.

PROFORMA 'D'

Name of the company :

Statement showing the **allocation or apportionment** of total expenses or income between activities covered under rule 2 and other activities during the year ending :

Sr. No.	Particulars	Total actual expenses	Share applicable to activities covered under rule 2			Share applicable to other activities	Basis of allocation
			Basic telephony	Value added service (specify)	Value added service (specify)		
1.	Materials						
2.	Employee cost						
3.	Utilities						
4.	Stores, Spares and Consumables						
5.	Repairs and maintenance						
6.	Rent, rates and taxes						
7.	Depreciation						
8.	Amortisation on the fixed component of license fees						
9.	Lease charges						
10.	Insurance						
11.	Royalty or technical know-how fee						
12.	Research and development						
13.	Other overheads						
14.	Administrative overhead						
15.	Total (1 to 14)						
16.	Stock adjustment, if any						
17.	Less : Credits, if any						
18.	Borrowing costs						
19.	Marketing expenses						
20.	Add : any other expenses not included in cost						
21	Less : any other income not considered in cost						
22.	Total cost (excluding statutory levies like service tax, etc.)						

23.	Total revenue earned (excluding statutory levies like service tax, etc.)						
24.	Margin						
25	Add : Export benefits and incentives, if any						
26.	Total margin						

Notes:

1. All items of income and expenditure in this Proforma shall be reconciled with the financial accounts for the relevant period/year.
2. The proforma may be modified suitably to incorporate unit specific special features, if any, indicating reasons thereof.

[F.No.52/14/CAB-2001]

RAJIV MEHRISHI, Jt. Secy.

3.4 Specimen Questions With Answers

Question No. 1 :

In a caustic soda plant, hydrogen is a by-product and it is disposed of as follows:

(a) 40% of hydrogen generated is used as fuel for generating steam used in caustic soda production (steam is also produced by using furnace oil);

(b) 30% is used in manufacturing hydrochloric acid;

(c) 20% is filled in cylinders and sold to customers (cylinders are supplied by customers);

(d) 10% is let out in the atmosphere.

Suggest a method for valuing the hydrogen to be credited to the main process cost sheet.

Answer :

Suggested basis of valuation of hydrogen :

(a) Hydrogen, when used as fuel for boiler, is a substitute for furnace oil. The correct method of valuation of hydrogen in that case is to compute the equivalent calorific value of Hydrogen in terms of fuel oil and credit the cost of equivalent fuel oil to the cost sheet of caustic soda in Proforma A (Cost Accounting Records [Chemicals] Rules, 1987)

(b) Two alternative bases may be considered for valuing hydrogen used in manufacture of hydrochloric acid, depending upon the market price of hydrochloric acid (HCI). If the market price of hydrochloric acid (HCI) can absorb, hydrogen may be valued at its market price, i.e. the price payable if hydrogen is purchased from the market for manufacture of hydrochloric acid (HCI). On the other hand, if the price realized for hydrochloric acid (HCI) is low, the difference between the sale price of HCI and its cost of manufacture excluding the cost of hydrogen, may be taken as the value of hydrogen to be credited to the process cost of caustic soda.

(c) In the case of hydrogen sold to outside customers, the sales realization may be credited straight away to the process cost of caustic soda.

(d) The value of hydrogen let out into the air NIL.

Question No. 2 :

An establishment footwear/tannery unit has for a long time let out its chemical effluents into a canal resulting in contamination of ground water in the neighbourhood. The company was ordered to put up an effluent treatment plant and also make arrangements for supply of potable (drinking) water in tankers free of cost to the 500 residents affected on a regular basis till ground water becomes potable again. As a cost auditor of the company, how will you treat the cost of such an operation? Explain with reasons, taking into account the social responsibility of the company in regard to environmental pollution.

Answer :

The Cost Accounting Rules for the Footwear industry stipulate maintenance of adequate records for the cost of effluent treatment, and have also prescribed a proforma in Annexure A for this purpose. Therefore, the cost of effluent treatment is automatically absorbed in the cost of production of the finished product in the normal course.

However, apart from the legal necessity to provide potable water to community in which the factory is located, the Company has a clear social responsibility to compensate for the damage done to the environment. This obligation has arisen due to the inherent nature of the manufacturing process of finished leather, which required toxic chemicals. Hence the cost of supplying drinking water to the community should be borne entirely by the leather manufacturing operation. The company will have to shut down its entire operations, if this obligation is not met.

In the circumstances, the cost of supplying water to the neighbourhood should be absorbed in the product our of finished leather. For this purpose, this expense may be included in "other expenses" in the proforma prescribed for cost of finished leather manufactured (Proforma C-3), under the Cost Accounting Records Rules for footwear.

Question No. 3

How will you treat the following items in the Cost Accounting Records?

(a) Interest received on security deposit with the Electricity Board?

(b) Commission paid to the Managing Director as a percentage of profit, included in the financial accounts under the head "Salaries and Wages".

(c) Voluntary Retirement Compensation paid to workers, included under "Wages".

(d) CENVAT availed as credit on purchased raw materials.

(e) Profit on sale of fertilizers to cane growers by a Sugar company.

Answer :

a. **Interest received on security deposit with Electricity Board :** This cannot be considered as an investment outside the business. Deposit with Electricity Board is made for obtaining power connection and is based on estimated monthly bill for power consumption. It is part of the working capital (current assets), interest on such deposits can therefore be set off against interest paid, or alternatively taken as a credit against overheads. However, the amount involved may not be very significant.

b. **Commission paid to the Managing Director as a percentage of profits :** This is clearly an item to be excluded from cost. This should be shown as an item in the reconciliation statement between costing and financial Profit and Loss accounts.

c. **Voluntary Retirement compensation :** This is a one time non-recurring expenditure. Even if it is included under Salaries & Wages in Financial Accounts, it should be excluded for Cost Accounts purposes. This item also is an item of reconciliation.

d. **CENVAT credit availed on purchased raw materials :** This is to be deducted from the cost of raw materials, and only the net value should be taken in the priced stores ledger, which forms the basis for pricing material issues to cost centres.

e. **Profit on sale of fertilizers to cane growers by a sugar company :** Some sugar factories supply fertilizers to cane growers to ensure quality of supplies, and as an incentive for regular supply. Although it helps sugar production, this activity is not directly related to sugar production, and is purely a trading activity. The profit from such activity should be shown as an item of reconciliation between financial and cost accounts.

Question No. 4

The profit as per financial accounts of XY Cement Ltd. for the year 2008-09 was Rs.1,34,27,561. The profit as per Cost Accounting Records for the same period was more. You are required to prepare a reconciliation statement and arrive at the profit as per Cost Accounts. The following details are collected from the financial accounting schedules and cost accounting records :

	Financial Accounts	*Cost Accounts*
Value of stock : *Opening : WIP*	*29,52,315*	*23,45,720*
Finished goods	*2,48,37,410*	*2,72,16,930*
Closing : WIP	*41,72.635*	*36,35,345*
Finished goods	*3,67,51,400*	*4,15,24,148*
Interest income from inter-corporate Deposits	*6,14,250*	--
Donations given	*4,75,250*	--
Loss on sale of Fixed assets	*1,04,148*	--
Value of cement taken for own consumption	*3,75,920*	*3,45,200*
Cost of power drawn from own Wind Mill :		
— At EB tariff		*48,58,415*
— At cost	*34,10,420*	

Answer

Reconciliation of financial profit and costing profit (Figure in Rs.)

Profit as per financial accounts	1,34,27,561

Add :	Difference in stock valuation	24,92,523	
	Loss on sale of fixed assets	1,04,148	
	Donations not considered in cost accounts	4,75,250	30,71,921
			1,64,99,482
Less :	Interest income from inter-corporate deposits	6,14,250	
	Diff. In value of cement taken for own consumption	30,720	
	Difference in valuation of windmill power	14,47,995	20,92,965
	Profit as per cost accounts		1,44,06,517

Note : Computation of difference in valuation of stock

	Financial A/c	Cost A/c
Opening (WIP + FG)	2,77,89,725	2,95,62,650
Closing (WIP + FG)	4,09,24,045	4,51,89,493
Increase	1,31,34,320	1,56,26,843

The increase is higher in Cost Accounts, and hence the cost accounts profit would be more than the financial accounts profit by (Rs. 1,56,26,843 – 1,31,34,320) i.e. Rs. 24,92,523.

Question No. 5

The following are the processwise input and output in a Spinning Mill –

Blowroom :	*Cotton processed*	*4672563 kgs.*
	Laps produced	*4258274 kgs.*
Carding :	*Laps produced*	*4274362 kgs.*
	Silvers produced	*3976420 kgs.*
Draw frames :	*Silvers processed*	*3948241 kgs.*
	Silvers drawn	*3901810 kgs.*
Roving (Simplex) :	*Drawn silvers processed*	*3874125 kgs.*
	Transferred to Ring frame	*3831510 kgs.*
Ring frame :	*Silvers used*	*3911645 kgs.*
	Finished Yarn produced	*3647141 kgs.*
Reeling and Winding :	*Yarn wound*	*3635420 kgs.*

Salable Yarn produced *3580889 kgs.*

Calculate the processwise Waste Multiplier factors.

Answer :

Calculation of Waste Multiplier

Process	Input (kgs)	Output (kgs)	% Loss	Output (%)	Waste Multiplier
Total consumption				100.00	1.3161
Blowroom	46,72,563	42,58,274	8.87	91.13	1.2140
Carding	42,74,362	39,76,420	6.97	84.78	1.1158
Drawing	39,48,241	39,01,810	1.18	83.78	1.1026
Roving (Simplex)	38,74,125	38,31,510	1.10	82.86	1.0905
Ring Frame	39,11,645	36,41,741	6.90	77.14	1.0153
Reeling & Winding	36,35,420	35,80,899	1.50	75.98	1.0000

3.5 Self-examination Questions

1 As a cost Auditor, hoe would you deal with the following :

(a) A company has produced all cost accounting records within the stipulated time for your audit. It however is unable to produce audited financial accounts, as financial audit is not yet complete.

(b) As a cost auditor of a cement company for the year 1995-96, you want to refer to their cost records for the year 1982-83. The company regrets its inability to produce such records as it does not preserve such records for more than 10 years.

(c) A company which produces Sulphuric Acid has not given any credit for waste heat on the plea that it is not possible to arrive at any value for such waste head.

2 Discuss the requirements relating to the following in the Cost Accounting Records Rules.

(a) MODVAT

(b) Technical know-how fees

(c) Interest

(d) Cost variance analysis

(e) Capital expenditure

(f) Research and development

(g) Wastage, spoilage, rejection, scrap etc.

3 Examine whether the following organizations are covered by the cost accounting records prescribed under the Companies Act, 1956 :

(a) A private limited company engaged in manufacture of Electric Motors

(b) A foreign company manufacturing Bulk Drugs in India.

(c) A public Limited Company engaged in production of Synthetic Resin.

(d) A Govt. company engaged in production of cement.

(e) A company manufacturing Cycles but treated as a small scale unit under relevant notifications satisfying the ceiling of investment in plant and machinery.

4 Discuss the checks that would be exercised in the case of the following items in cost accounts :

(a) Depreciation; (b) Wages and salaries;

(c) Production; (d) Power

5 What types of manufacturing organizations are exempt from the maintenance of cost accounting records though they are engaged in the industries in respect of which Section 209 (1) (d) Rules have been prescribed?

☆☆☆

STUDY NOTE - 4

Cost Accounting Standards

This Study Note includes:

- Cost Accounting Standards - Background and History.
- CAS 1 - Classification of Cost
- CAS 2 - Capacity Determination
- CAS 3 - Overheads
- CAS 4 - Cost of Production for Captive consumption
- CAS 5 - Determination of Average (Equalized) Cost of Transportation

4.1 Cost Accounting Standards – Background and History

4.1.1 Introduction

4.1.1.1 Cost Accounting Standards (CAS) are a set of standards that are designed 'to achieve uniformity and consistency in cost accounting practices." A point is often raised that cost accounting is meant for internal use of companies for their cost control, cost reduction and promoting efficiency. Thus, there should be no rules or regulations from the government regarding nature of cost records to be maintained etc. However, it is also true that there are no uniformly applicable mandatory cost accounting principles or methodologies especially. Therefore, corporates have the flexibility to use any method of costing, which suits them. This so called flexibility sometimes distorts the total financial reporting trapping the innocent investors. These distributions may sometimes help in forming of cartels also. The recent hikes in the prices of infrastructure building inputs like cement and steel etc. have always been vaguely justified on the ground of increasing costs. However, in absence of uniform costing methodologies or disclosure requirements, no meaningful inter-firm comparison can be made as to the reasonability of the claims made by the units in the industry.

4.1.1.2 Government has embarked upon major reforms during last almost two decades. Private Sector has been introduced in social, infrastructural and health & welfare sector also, with built in flexibility to recover their costs with reasonable profits. Private sector has already come out in a very big way in 'education sector'. It is therefore, very pertinent that appropriate laws must be framed to avoid malpractices and to ensure that this flexibility is not mis-used and public at large is not made to pay exorbitant prices for availing or using these facilities. Similarly, Government gives annual grants to various educational organisations and other social and welfare organisations, which are required to furnish the 'funds utilization certificate' at the year end. The absence of Cost Accounting Standards provides a scope for various malpractices, reducing the impact of overall welfare objective of government.

4.1.1.3 Central Government, State Governments and other public sector organizations are the biggest procurement agencies in the country. Defense procurements by the Central Government itself amount to almost forty to fifty thousand crores rupees every year. A significant portion of these procurements are made on single tender basis i.e., non-competitive bidding where there is mostly one vendor only on the pretext of secrecy, non-availability or international sanctions etc. Government is the single customer for these products. Therefore, 'cost' is the very important factor during the price negotiations to ensure the reasonability of prices. However, Companies can always manipulate their costs to a higher figure by allocating or apportioning maximum possible amount to the government procurements in absence of any mandatory rules or regulations especially with respect to 'allowability of expenses'. The public perception or the media perception is also that the government procurements are very costly. This necessitates the need for mandatory Cost Accounting Standards in India. These mandatory Cost Accounting Standards are already in place in other developed countries.

4.1.1.4 The liberalization in the country needs simple, transparent and flexible rules to enable the Government Organisations/Departments, early procurements/services at competitive costs without going into cumbersome procurement process . Therefore, many developed countries have issued uniform costing guidelines for small value projects. For example, the Uniform Public Construction Cost Accounting Act (Act), enacted in 1983 by the State of California (USA) under Public Contract Code Section 22000 et seq., allows local agencies to perform public project work of up to $30,000 with their own workforces if the agencies elect to follow the cost accounting procedures set forth in the Cost Accounting Policies and Procedures Manual of the California Construction Cost Accounting Commission. Any local agency can voluntarily elect to become a participating agency of the Act. Local agencies include cities, counties, redevelopment agencies, special districts, school districts, and community college districts. Participating agencies benefit from the raised force account limit and the informal bidding procedures. Thus Cost Accounting Standards also ensure that more projects are completed in a timely manner as a result of the streamlined awards process and the reduction in paperwork related to advertising and report filing.

4.1.2 Background and History of Cost Accounting Standards in USA

4.1.2.1 The Cost Accounting Standards in USA were issued as a result of concern for the pricing and accounting practices of defense contractors. There was no consistency within and between contractors' cost accounting practices, making it difficult to conduct standard audits. Congress asked the General Accounting Office (GAO) in 1968, to study the feasibility of establishing and applying uniform Cost Accounting Standards to provide greater uniformity in cost accounting as a basis for negotiating and administering procurement contracts. The GAO concluded that it was indeed feasible and recommended Government-wide coverage on both fixed-price and cost-type contracts. Congress subsequently established the Cost Accounting Standards Board (CASB), which in turn instituted the Cost Accounting Standards. Congress was influenced into taking this decision for the following main factors:

(a) Almost 86% of defense procurements were based on non-competitive bidding i.e., single tender negotiations or limited tender negotiations;

(b) Testimony that the different cost accounting procedures and practices being followed by different defense contractors would impair comparability among various bidders. It may be added here that cost estimates furnished by the vendors form the very basis of negotiations especially negotiations during non-competitive bidding; and

(c) The House Report had noted that the uniform cost principles were necessary due to substantially increased costs of procurement and to help prevent excessive profits by the single vendors for defense contracts. The House Committee also heard the testimony that the main function of cost accounting is to ensure allocation of direct and overhead costs to individual orders. Moreover, cost accounting procedures and principles followed have a very significant bearing on the final determination of contractor's costs. For example, various items of expenditure like Head Office Expenses, Depreciation, Selling Expenses or Research & Development Expenses can be allocated in many different ways and each method will come out with its own result and these may vary significantly amongst each other.

4.1.2.2 After the standards were implemented in 1980, Congress decided the Board had fulfilled its mission and dissolved it. Although the Board ceased operations, the 19 Cost Accounting Standards promulgated by the Board remained in force. Board interpretations were also used in applying those Standards.

4.1.2.3 Cost Accounting Standards were designed to achieve uniformity and consistency in the measurement, assignment, and allocation of costs to Government contracts. The standards were based on examinations of common cost accounting practices throughout the industry. Advice and comments were sought from Government agencies, industry, and professional accounting associations. Numerous publications on the subject were also reviewed. Cost Accounting Standards are therefore, not an onerous set of Government rules, regulations, and requirements. Cost Accounting Standards do not provide rigid, inflexible procedures. In fact, most standards provide numerous options in accounting techniques. The GAO recognized the impossibility of implementing precise methods or techniques in its recommendation to Congress. CAS does establish limits and constraints on what is considered appropriate, allowing the CAS to meet the goal of providing consistency and uniformity in cost accounting.

4.1.2.4 Congress re-instituted the CASB in 1988 as a permanent and independent board and assigned it to the Office of Federal Procurement Policy (OFPP) in the Office of Management and Budget (OMB). The CASB was given exclusive authority to make, promulgate, amend, and rescind cost accounting standards and regulations. The five-member board is chaired by the OFPP Administrator with one representative from the Department of Defense and one from the General Services Administration. The remaining two members are from the private sector. One is from industry and the other is a cost accounting expert. A quorum consists of three members, one of which must be from the private sector. Each board member, with the exception of the Chairman, serves a 4-year term. The OFPP Administrator (Chairman) must ensure that no agency regulation is inconsistent with CAS. Costs subject to CAS cannot be subject to other agency regulations that differ in the measurement, assignment, and allocation of costs.

4.1.3 Cost Allowability

4.1.3.1 As already stated above, the Cost Accounting Standards Board has the exclusive power and authority for establishing standards governing the measurement, assignment and allocation of costs. However, CASB does not define the specific expenses or category of expenses allowed or not allowed. Allowability of an expenses is a procurement issue affecting the final price paid or payable. Therefore, in most of the cases, details of allowable or non-allowable expenses are contained in the contractual provisions between the purchaser and the seller. The procurement agency may include a provision in its contract terms or procurement regulations disallowing those costs incurred by the vendors, which are unreasonable in amount or contrary to public policy. For example, the contractual provisions may provide that any amount paid to public servants shall not be allowed or that share of head-office expenses shall not exceed 2% of the total costs. In other words, while the total costs of a contract include all costs properly allocable to the contract, the costs which the Government will pay are limited to those costs which are allowable pursuant to FAR Part 31 and applicable agency supplements. The following factors affect in determining the cost allowability:

- Reasonableness;
- Allocability (requires a cost to be properly measured, assigned, and allocated);

- Applicable accounting practices and standards;
- Applicable cost principles; and
- Terms of the contract.

4.1.3.2 Before actually allowing any cost, it is very important that a cost must be properly measured, assigned, and allocated. A cost is first measured (how much is the cost), then assigned (to which cost accounting period should the cost be booked), and then allocated (how much of the cost should be assigned to each of the contracts being performed in the accounting period in which the cost is booked). Measurement, assignment, and allocation are determined using (1) the Cost Accounting Standards (CAS) (for contracts subject to the CAS), (2) FAR Part 31 (when the contract is not subject to CAS or where the FAR addresses an area of the cost where CAS is silent), and (3) Generally Accepted Accounting Principles (when the CAS and FAR are either silent and/or do not apply).

4.1.4 Summary of Cost Accounting Standards

4.1.4.1 For contracts covered by the cost accounting standards in USA, costs are subject to the measurement, assignment, and allocability provisions contained in the following nineteen standards:

Cost Accounting Standards	
Concepts and Principles	
CAS 401	Consistency in Estimating, Accumulating, and Reporting Costs
CAS 402	Consistency in Allocating Costs Incurred for the Same Purpose
CAS 403	Allocation of Home Office Expenses
CAS 404	Capitalization of Tangible Assets
CAS 405	Accounting for Unallowables
CAS 406	Cost Accounting Period
CAS 407	Use of Standard Cost Systems
CAS 408	Accounting for Paid Absence
CAS 409	Depreciation of Tangible Assets
CAS 410	Allocation of Business Unit General and Administrative Expenses
CAS 411	Accounting for Acquisition Costs of Materials
CAS 412	Composition and Measurement of Pension Costs
CAS 413	Adjustment and Allocation of Pension Costs
CAS 414	Cost of Money as an Element of Facilities Capital
CAS 415	Accounting for Deferred Compensation
CAS 416	Accounting for Insurance Costs
CAS 417	Cost of Money of Capital Assets under Construction
CAS 418	Allocation of Direct and Indirect Costs
CAS 419	Reserved
CAS 420	Independent Research and Development and Bid and Proposal Costs

4.1.5 Types of Cas Coverage

4.1.5.1 All contracts awarded using sealed bidding are exempt from CAS coverage. When awarding a contract using negotiation procedures, CAS applies unless the contract or offeror is specifically exempt from CAS requirements. Broadly, there are two types of coverage for noncommercial contracts and subcontracts detailed as under:

	CAS Coverage	
Coverage Type	**Application**	**Coverage requires that the business unit:**
Full	Applies to contractor business units that -- Receive a single CAS-covered contract award of $50 million or more; or Received $50 million or more in net CAS-covered awards during its preceding cost accounting period.	Comply with all Standards that are in effect on the date of contract award and with any Standards that become applicable because of later award of a CAS-covered contract.
Modified	If the offeror certifies that it is eligible for and elects to use modified coverage, it may be applied to a CAS-covered contract of: Less than $50 million awarded to a business unit that received less than $50 million in net CAS-covered awards in the immediately preceding cost accounting period.	Comply with CAS 401, 402, 405, and 406. Note: A contract awarded with modified CAS coverage shall remain subject to modified coverage throughout its life regardless of changes in the business unit's CAS status during subsequent cost accounting periods.

4.1.5.2 These standards are endorsed by the Financial Accounting Standards Board (FASB) and their use is required by the Securities and Exchange Commission (SEC) for corporations under its jurisdiction. They are also commonly used by business entities not under SEC jurisdiction. When the CAS and FAR are silent on how a cost should be measured and/or assigned, GAAP applies. If a contract requires the prime contractor to follow CAS, the CAS requirement must be passed down to its subcontractors, unless they meet one of the listed exemptions. Vice versa, if a prime contractor need not follow CAS, neither do its subcontractors. Similarly, in case of contract modifications, if CAS applies to the initial contract, it also applies to contract modifications. Vice versa, if the initial award is not covered, neither are contract modifications.

4.1.6 Disclosure Statement

A Disclosure Statement is a written description of a contractor's cost accounting practices and procedures. Disclosure is made using a Disclosure Statement Form (CASB DS – 1) and requires the contractor to provide general information on its accounting system and specific information on how the firm accounts for specific types of costs. The rules further provide that a Disclosure Statement is required for:

- Any business unit that receives a contract in excess of $50 million.
- Any company which, together with its segments, received net CAS-covered contract awards exceeding $50 million in the contractor's previous accounting period.

4.1.7 Cost Accounting Standards Versus Cost Principles in USA

4.1.7.1 CAS and cost principles are not one and the same. As previously mentioned, CAS addresses cost accounting--the measurement, assignment, and allocation of costs to Government contracts. The cost principles address cost allowability. Cost allowability is a procurement matter and is a function of law, regulation, or individual contracts. Costs may be allocable but unallowable.

4.1.7.2 In other words, a practice or costing methodology, which is in-consistent with the Cost Accounting Standards, is subject to disallowance under the cost principles as well as finding of non-compliance with the standards. The ASBCA concluded in the case of 'The Boeing Co.' that Cost Accounting Standards shall prevail if there is any conflict in the allocability criteria between Cost Accounting Standards and the Cost Principles.

4.1.8 Reporting Non-compliance by the Auditor

4.1.8.1 In assigning responsibilities to the CFAO and the contract auditor, the regulations require the auditor to conduct audits of Disclosure Statements for adequacy and compliance and report practices that do not comply with CASB rules, regulations, and standards. The CFAO is to determine whether the reported practices actually do not comply with the CASB promulgations or FAR Part 31. Noncompliance reports should include only CAS violations that the auditor considers significant. The auditor should report:

(1) Violations of major requirements of CAS regardless of their effect on contract costs.

(2) Non-compliances having a significant cost effect on CAS-covered contracts.

(3) Non-compliances that currently have no significant effect on contract costs but could eventually result in a significant adjustment because of changed circumstances. However, a noncompliance report will not be issued when the auditor determines the non compliance will never result in a significant adjustment.

(4) Non-compliances that are an inherent part of the contractor's cost accounting system and that are of such a nature that the cost effect on CAS-covered contracts would be difficult or impossible to determine. (In ASBCA Case No. 20998, the Board upheld the Government's right to determine a contractor to be in noncompliance even though the Government was unable to determine that increased costs resulted from the noncompliance.

4.1.8.2 Compliance Audits: Compliance with FAR Part 31 and CAS is an inherent part of every contract audit. Auditors are expected to be knowledgeable of compliance requirements and consider them as applicable in examination of contract proposals and incurred cost. In addition a comprehensive audit of a contractor's compliance with each applicable cost accounting standard, except for CAS 401, 402, 405, and 406, shall be conducted once every three years, unless circumstances at the contractor warrant conducting the audit sooner. The comprehensive compliance audits will cover the incurred cost in the last completed contractor fiscal year and serve to provide added assurance to the overall consideration of all applicable CAS requirements in audit work performed during the intervening years.

4.1.8.3 During annual audit planning, identify those standards for which tests of CAS compliance are necessary. Establish separate audit assignments for each standard to be tested. The auditor's assessment of risk for each standard should identify those provisions of a standard which are significant to the particular contractor. The materiality criteria provided in 48 CFR 9903.305 must be considered in developing the nature and extent of CAS compliance tests.

4.1.9 Cost Accounting Standards for Educational Institutions

4.1.9.1 Contracts and subcontracts with educational institutions are subject to special CAS coverage. Contracts and subcontracts performed by federally funded research and development centers operated by educational institutions are subject to CAS coverage for commercial companies. The four CAS and disclosure statement requirements as they apply to educational institutions were incorporated in OMB Circular A-21, Cost Principles for Educational Institutions, on May 8, 1996. The four CAS policies are:

- 501 - Consistency in Estimating, Accumulating and Reporting Costs.
- 502 - Consistency in Allocating Cost Incurred for the Same Purpose.
- 505 - Accounting for Unallowable Costs.
- 506 - Cost Accounting Period.

4.2 Federal Financial Accounting Standards

4.2.1 As already stated above, Government has embarked upon major thrust on privatization and outsourcing. However, the Government is still the main supplier of public utilities, social services and the infrastructure developments. It is a common knowledge that Government organizations generally mean lot of inefficiency, delays and cost over-run. Therefore, the cost of Government services is always a concern to the public as well as to the Government itself, whether it is water treatment for drinking water or water supply to individual houses, electricity generation or distribution, it is perceived that there are lot of inefficiencies or wastages. Moreover, there is no "bottom line" or profit index to help measure public sector performance. However, Government service efforts and accomplishments can be evaluated using certain financial and non-financial measures and "cost" is an important financial measure for Government programs. Therefore reliable information on costs of Government programs and activities is very crucial for effective management of Government operations. However, presently there is no costing policy and each organization is free to use its own costing procedures and methodology.

4.2.2 It is often stated that cumbersome procurement procedures in the government leads to cost overrun and delays. It is, therefore imperative that procurement rules are not only simple, transparent and flexible but also reasonable and promoting efficiency. The Cost Accounting Standards can always fill this gap and can make the government procurements competitive and much faster.

4.2.3 Parliament and the respective administrative ministers are the primary users of cost information. Ministries are responsible for carrying out programme objectives with resources entrusted to them. Reliable, accurate and timely cost information can help them ensure that resources are spent to achieve expected results and outputs, and alert them to waste or inefficiency. Similarly, Ministry of Finance, Planning Commission and all other Government departments make policy decisions on program priorities and allocate scarce resources among programs. They need authentic cost information to compare alternative courses of action and to make program authorization decisions by assessing costs and benefits. They also need cost information to evaluate program performance. However, there is no authentic source as on date to provide full cost of a program or activity. The expenses accumulated by the different government departments mostly contain the procurement cost or other direct costs only. Therefore, all projects costs or programme costs are understated by totally excluding the manpower costs, overheads cost of utilities and reasonable amount of profits etc. These costs do not reflect the opportunity cost of the manpower which could have been earned at the time of making decisions.

4.2.4 The managerial cost accounting concepts and standards as issued in USA are aimed at achieving following three general objectives:

(a) Provide program managers with relevant and reliable information relating costs to outputs and activities. This information will assist them in improving operational economy and efficiency;

(b) Provide relevant and reliable cost information to assist the Government in allocating federal resources, authorizing and modifying programs and evaluating program performance; and

(c) Ensure consistency between costs reported in general purpose financial reports and costs reported to program managers. This includes standardizing terminology for managerial cost accounting to improve communications and users of cost information.

4.2.5 Para 165 of SFFAS 4 clarifies that Cost Accounting Standards were needed as the users of financial information, especially tax payers and members of congress, began putting more emphasis on the cost of Government programs, products and activities. The efforts to reduce Government spending, control the deficit, and improve Government functions necessitated information about the true costs of Government. Furthermore NPR issued a recommendation that the Board move rapidly to recommend cost accounting standards. Therefore "Federal Accounting Standards Advisory Board" was constituted in USA. It was felt that accounting and financial reporting standards are essential for public accountability and for an efficient and effective functioning of our democratic system of Government.

4.2.6 The mission of the "Federal Accounting Standards Advisory Board" (FASAB) is to promulgate federal accounting standards in USA after considering the financial and budgetary information needs of the citizens, congressional oversight groups, executive agencies and the needs of other users of federal financial information. Thus federal accounting standards and financial reporting play a major role in fulfilling the Government's duty to be publicly accountable and can be used to assess:

(a) The Government's accountability and its efficiency and effectiveness; and

(b) The economic, political and social consequences of the allocation and various uses of federal resources.

4.2.7 The Federal Accounting Standards Advisory Board convened an advisory group in 1994 to help develop standards for managerial cost concepts and five standards for the federal Government. The standards provide that managerial cost accounting information, to be useful, should rely on consistent and uniform terminology for concepts, practices and techniques. The five standards address the following topics:

(a) Requirement for cost accounting;

(b) Responsibility segments;

(c) Full costs;

(d) Inter-entity costs; and

(e) Costing methodology

4.2.8 The federal standard provides that there are many different purposes for which cost information may be used by the federal Government. The focus of this statement is on cost information needed to improve federal financial management and managerial decision making. It further provides that in managing federal Government programs, cost information is essential in the following five areas:

(a) Budgetary and cost control;

(b) Performance measurement;

(c) Determining reimbursements and setting fees and process;

(d) Program evaluations; and

(e) Making economic choice decisions.

4.2.9 Statement of Federal Financial Accounting Standard (SFFAS) 4 regarding Managerial Cost Accounting concept's and standards for the federal Government was issued on 31 July 1995 and finally effective in fiscal year 1998 (after 30 September 1997) provided five standards setting forth the fundamental elements of managerial cost accounting:

(a) Accumulating and reporting cost of activities on a regular basis for management information purposes;

(b) Establishing responsibility segments to match costs with outputs;

(c) Determining full costs of Government goods and services;

(d) Recognizing the costs of goods and services provided among federal entities; and

(e) Using appropriate costing methodologies to accumulate and assign costs to outputs.

4.2.10 The aforesaid standards required that the reporting entities should report the full costs of outputs in general purpose financial reports. The full cost of an output produced by a responsibility segment is the sum of:

(1) The costs of resources consumed by the segment that directly or indirectly or indirectly contributes to the output; and

(2) The costs of identifiable supporting services provided by other responsibility segments within the reporting entity, and by other reporting entities.

4.2.11 This further provides regarding inter-entity's full cost should incorporate the full cost of goods and services that it receives form other entities. The entity providing the goods or services has the responsibility to provide the receiving entity with information the full cost of such goods or services either through billing or other advice.

4.2.12 SFFAS 4 initially recognizing the difficulties in implementing provided for gradual implementation of inter-entity requirement. However SFFAS 30, which was issued on 15 August 2005, now requires full implementation of the inter-entity cost provision in SFFAS 4 in Financial Year 2009.

The standard is effective for reporting periods beginning after 30 September 2008 with earlier implementation encouraged.

4.2.13 Para 110 and Para 111 of the Statement of Federal Financial Accounting concepts No. 1, “Objections of Federal Financial Reporting” provide that “Managerial cost accounting is especially important for fulfilling the objective of assessing operating performance. It is further stated in SFFAC No. 1 that “The topic of costs and performance measurement are related because it is by associating cost with activities or cost objectives that accounting can make much of its contributions to reporting on performance. “Cost” is the monetary value of resources used or sacrificed or liabilities incurred to achieve an objective.

4.3 Government Accounting Standards Advisory Board in India

4.3.1 The Government Accounting System in India was mainly based on cash accounting system. However, Government has now initiated the steps to transform Government Accounting also on accrual system of accounting. Still the Accounting Systems in India stops short of Accrual Accounting and enveloped in several Accounts Codes which are general and specific to certain departments. In order to standardize these various Codal provisions and transit from an era of Rules to Standards common to all departments and professionals within the Government, the Government Accounting Standards Advisory Board was set up. The Board seeks to promote the basic characteristics of understandability, reliability, relevance, timeliness, consistency and comparability of Government accounts across departments, authorities and organizations in the Federal and Provincial Governments.

4.3.2 The Board is a high powered advisory body and has representatives from:

(a) Ministry of Finance, Government of India,

(b) Departments of Finance of four State Governments by rotation,

(c) The Reserve Bank of India which is the banker to all Governments,

(d) The Chartered Accountants of India, President or his nominee, and

(e) National Council of Applied Economic Research, Director General

4.3.3 In addition, the Board includes stewards of four major Accounting Departments of the Government of India namely,

(a) Indian Audit and Accounts Department

(b) Indian Civil Accounts Department responsible for maintenance of Accounts of Government of India

(c) Indian Defense Accounts Department , and

(d) Indian Railway Accounts Department

(e) The Deputy Comptroller and Auditor General of India who is from the Indian Audit and Accounts Department is the Chairperson of the Board.

4.3.4 However, no Cost accounting concepts or Cost Accounting Standards have so far been issued by the GASAB in India.

4.4 Cost Accounting Standard Board in India:

4.4.1 A need was being felt for Cost Accounting Standards in India also especially when the Government had constituted National Accounting Standards Board. Moreover, in absence of any Cost Accounting Standards, the efficacy of Cost Audit Reports was also felt to be affected. So, the Central Council of the Institute of Cost and Works Accountants of India (ICWAI) has set up Cost Accounting Standard Board (CASB), which has taken up the mandate of prescribing Cost Accounting Standards in India. This Cost Accounting Standard Board has now reps of Institute of Company Secretaries of India (ICSI) and ASSOCHAM also.

4.4.2 The standards issued by CASB will be initially recommendatory in nature and every member of the institute is expected to honour the same. Therefore, as far as maintenance of cost accounting record rules under section 209(1)(d) is concerned, Cost Accounting Standards should be followed, wherever applicable, will be followed. However, it may be clarified here that if any of the provisions of Cost Audit Report Rules, 2001 or respective Cost Accounting Records Rules are found to be in conflict with the Cost Accounting Standards, the former will prevail till these Standards are adopted by the National Accounting Standards Board.

4.4.3 As already stated above, the Cost Accounting Standards issued by the CASB are initially recommendatory in nature and do not possess any legal enforceability at present due to absence of any legal backing either from National Accounting Standard Board or under the provisions of Companies Act, 1956, The Cost Accounting Standard Board has already issued five standards and two more are under issue as per detail in following paragraphs.

4.5 Cost Accounting Standards

4.5.1 Cost Accounting Standards have been defined as "Federally mandated accounting standards intended to ensure uniformity in budgeting and spending funds". The purpose of these standards is to provide uniformity and consistency in estimating accumulating and reporting costs in connection with the pricing and administration of negotiated procurement. These are set of standards that are designed to achieve uniformity and consistency in the cost accounting practices. In other words, these standards aim at :

(a) Consistency in treatment of costs as either direct or indirect, and

(b) Consistency in budgeting and accounting for costs.

The following Cost Accounting Standards have so far been issued in India :

Cost Accounting Standards			
CAS No	Title	Objective	Useful for
CAS1	Classification of Cost	For preparation of Cost Statement	Assessment of excise duty and other taxes, anti-dumping measures, transfer pricing etc.
CAS2	Capacity Determination	For determination of capacity	Proper allocation, apportionment and absorption of cost.

Cost Accounting Standards			
CAS No	Title	Objective	Useful for
CAS3	Overheads	For Collection, Allocation, Apportionment and Absorption of overhead	Determining Cost of products, services or activities.
CAS4	Cost of Production for Captive Consumption	To determine the assessable value of excisable goods used for captive consumption.	Determining Cost of products, services or activities.
CAS5	Average (equalized) Cost of Transportation	To determine averaged/ equalized transportation cost	Calculating the amount of deduction from assessable value of excisable goods, freight subsidy, Insurance claim valuation, etc.
CAS6 (Draft)	Arm's Length Price	For computation of Arm's Length Price	Determining Arms Length Price, for transactions between related parties.
CAS7 (Draft)	Costing of Joint Products & By-Products	For Appointment of Joint costs to Individual products	Inventory valuation, Cost of Goods Sold computations, Cost reimbursements under Cost Plus contracts, Transfer Pricing and Insurance settlement computations for Joint products and by products.

It is clear from above that first three Cost Accounts Standards (CAS 1 to CAS 3) are primarily on basic principles of Cost accounting, whereas CAS 4 and CAS 5 were mainly aimed at principles for assessment of cost.

4.5.2 The Central Board of Excise & Customs has issued a Circular No 692/8/2003-Cx dated 13th February 2003 clarifying that cost of production of captively consumed goods will henceforth be done strictly in accordance with CAS-4. The validity of this standard has been accepted by Supreme Court also in the case of Commissioner of Central Excise, Pune vs. Cadbury India Limited [2006 (200) ELT 353]. The Hon'ble Supreme Court held that the cost of production of captively consumed goods is to be determined strictly in accordance with CAS-4 laid down by the Institute of Cost and Works Accountants of India (ICWAI). This meant that " cost of production shall consist of Material Consumed, Direct wages and salaries, Direct Expenses, Works overheads, Quality Control Cost, R &D cost, packing Cost, Administrative Overheads relating to production". These principles were also recognized by the Central Board of Excise & Customs vide Circular No 692/8/2003-Cx dated 13th February 2003. Even though the circular issued by the Central Excise refers to CAS 4 only, CAS 4 is incomplete without CAS 1 (Classification of Cost), CAS 2 (Capacity Determination) and CAS 3 (Collection, Allocation, Apportionment and Absorption of overheads). Therefore, practically it can be concluded that cost of production of captively consumed goods is required to be determined taking into account CAS 1, CAS 2, CAS 3 and CAS 4 issued by ICWAI.

4.5.3 The validity of Cost Accounting Standards have been accepted in Cost Accounting Records (Chemical Industry) Rules also, where para 3 (3) provides that the statistical and other records shall be maintained in line with the Cost Accounting Standards issued by the Institute of Cost and Works Accountants of India, in so far as possible. The said para 3 (3) is reproduced as under:

> "(3) The statistical and other records shall be maintained in accordance with the provisions of the Schedule annexed to these rules and in line with Cost Accounting Standards issued by the Institute of Cost and Works Accountants of India, in so far as they are applicable, in such a manner as to enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in utilization of resources. These records shall also provide the necessary data which may be required to be furnished under Cost Audit Report Rules, 2001 as prescribed under section 233B of the Companies Act, 1956 and amended from time to time."

4.5.4 It may be noted here that the aforesaid para will go a long way in making Cost Accounting Standards effective and useful. Therefore, it is very necessary that the aforesaid paragraph be included in all other Cost Accounting Records Rules also. In any case, these cost accounting standards may have to be ultimately adopted by the Government to bring the country at par with other developed countries in the world.

4.6 Cost Accounting Standards vs Cost Accounting Record Rules

4.6.1 Presently, separate Cost Accounting Records Rules have been prescribed w.r.t. each class of industry or product covered under section 209(1)(d). Total 44 products have so far been covered under the respective cost accounting record rules. Even though the rules broadly the similar, there are definitely differences amongst various rules, especially formats and treatment of certain items of expenditure. Therefore each rule has its own complexities. In any case, their coverage is limited to the selected companies only falling in 44 industries. However, Cost Accounting Standards on the other hand, shall be uniformly applicable to all the units including companies and are easier to understand besides being flexible and uniform. Therefore these will have much wider coverage. Today, when most of the companies are multi-product organisations manufacturing or producing number of products, only one or two products only are generally covered under Cost Accounting Records Rules. Both of them are covered under different rules and it becomes difficult for the companies to comply with the requirements. On the other hand Cost Accounting Standards shall be equally applicable to the companies and all products manufacturers. Therefore, many experts are of the view that prescription of Cost Accounting through Cost Accounting Standards with appropriate compliance audit or disclosure norms may be much more effective and useful than through complicated Cost Accounting Records Rule. Moreover, this will bring more numbers of companies under the ambit and will help the Government to achieve its objectives.

4.7 Compliance of Cost Accounting Standards

Presently, the Cost Accounting Standards are not strictly enforceable in nature. Therefore, their application may be restricted to those companies only, which are under cost audit as the cost auditor shall disclose the non-compliance in the Cost Audit Reports. However, it may be very difficult for the cost auditor to enforce these standards on all the companies under cost audit. Therefore, it is necessary that these standards be subject to some sort of compliance audit with disclosure norms.

4.8 Preface to Cost Accounting Standards Board :

4.8.1 The preface to Cost Accounting Standards Board as issued by ICWAI itself provides the details about the Constitution of the Board, its objectives, scope and applicability and operating procedure and policies of CASB. The said 'Preface to Cost Accounting Standard Board' is reproduced as under:

PREFACE TO COST ACCOUNTING STANDARD BOARD

1. **Introduction**

Due to open competition for globalization, the Cost Management has gained special importance in the business activities. Cost Accounting Standard Board (hereinafter called CASB) set up by the Council of the Institute of Cost and Works Accountants of India (ICWAI) and following statements are issued to define the objectives, operating procedures, scope and applicability and authority of CASB.

2. **Constitution**

2.1 The CASB will have a Chairman as appointed and nominated by the Council of the Institute and other members will also be appointed and nominated by the Council.

2.2 The terms and period of appointment will also be decided by the council of the Institute.

2.3 The Director (Technical) will be the Secretary of the CASB.

2.4 The CASB will prepare a report of its work each year and send it to the Council.

3. **Objective**

The work of CASB is to develop Cost Accounting Standard on important issues/topics relating to Cost and Management Accounting with the following objectives :

3.1 To equip the profession with better guidelines on standard cost accounting practices

3.2 To assist the Cost Accountants in preparation of uniform cost statements

3.3 To provide guidelines to Cost Accountants to make standard approach towards maintenance of Cost Accounting Record Rules and Undertaking Cost Audit under section 209 (1) (d) and section 233B of Companies Law respective and various other Acts like Income Tax Act, Central Excise Act, Customs Act, Sales Tax Act, etc.

3.4 To assist the management to follow the standard cost accounting practices in the matter of compliance of statutory obligations.

3.5 To help Indian industry and the Government towards better cost management

4. **Operating Procedure and Policies of CASB**

4.1 Organizing and initiating discussion and deliberation at national level to identify the areas/topics in respect of which needs for standards are felt

4.2 Generating information on all alternative cost accounting practices in respect of selected practices

4.3 Preparation of draft on the standard cost accounting practices in respect of chosen areas/topic in cost accounting and circulate it to the members of the Institute, national accounting institute and other end user bodies like industry association, Chambers of Commerce and Industry, Government bodies etc

4.4 Allowing sufficient time for consideration and comments on the exposure draft

4.5 Pronouncement of the exposure draft as 'standard' after giving due consideration to the suggestions and modification generated on the circulated exposure drafts from such individuals and agencies as mentioned in 4.3 above.

4.6 To fix a date for the standard to be effective

4.7 To propagate and generate acceptance and commitment to follow the 'standards' prescribed by CASB

4.8 To revise the 'standards' once issued, if dictated by environment, government, legal authority and other situation.

5. **Scope and Applicability**

5.1 The 'standards' issued by CASB will be recommendatory in nature and every member of the institute is expected to honour the same.

5.2 A standards will always make sure that it complies with the legal regulations in respect of the matter covered by it. However, a standard by its vary nature will have to be more definite and specific than its legal requirements.

5.3 Any limitation in application of a 'standard' in specific circumstances must be spelt out in the 'standard' itself.

5.4 Every standard will broadly have two parts – (a) explanatory part and (b) the operative part. The explanatory section will set out topic covered, the premises, the need for standardization and methodology and rationale for practice recommended. The second part, the operative portion will be the definite direction on the matter.

5.5 Every standard will indicate the date from which it will be operative.

5.6 The standards will be applicable to preparation of cost statements and other documents where the concepts embedded in the standard will be applicable.

5.7 As far as maintenance of cost accounting record rules under section 209 (1) (d) is concerned, relevant matter covered under the standards , wherever applicable, will be followed.

5.8 Cost Auditors will adopt and encourage the adoption of the standards, wherever applicable, in maintenance of Cost Accounting Record Rules under section 209(1)(d) and report the deviations, if any, in the Cost Audit Reports under section 233B.

5.9 The Institute will take up the standards with National Accounting Standard Board to enforce them and to include in Companies Act, 1956.

6. **Authority Attaching to the Standard**

6.1 So long the standards are not enforced by National Accounting Standard Board or by Companies Act, the CASB does not possess the legal authority to impose its views as statutory regulations but it is by only persuasion the standard can be followed as normal practice by the members of the profession.

6.2 ICWAI will be duty bound to protect its members who respect and adhere to the standard prescribed.

6.3 Disciplinary restriction may be imposed by the Council of the Institute at appropriate stages as may be felt necessary for not complying with or not honouring the standard.

Comments: *Para 5.1 above clarifies that the "Standards" issued by CASB will be recommendatory in nature and every member of the institute is expected to honour the same. Para 5.8 casts the responsibility on Cost Auditors to adopt and encourage the adoption of the cost accounting standards, wherever applicable, in the maintenance of Cost Accounting Records Rules under section 209(1)(d) and report the deviations, if any, in the Cost Audit Report of the respective companies. Para 6.2 seeks to protect the practicing members by re-iterating that the Institute shall be duty bound to protect its members who respect and adhere to the prescribed standards.*

CAS – 1
COST ACCOUNTING STANDARD ON "CLASSIFICATION OF COST"

4.9 Cost Accounting Standard 1 : "Classification of Cost"

COMMENTS (CAS 1) :

4.9.1 One of the main criticism of Cost Audit and Cost Accounting in India has been the non-comparability of inter-unit cost details due to different cost classifications and different costing principles adopted by respective units. A need was, therefore felt to provide uniform terminology for various classifications of costs and uniform definition of each such classification. Hence, COST ACOUNTING STANDARD 1 (CAS1) regarding 'classification of cost' is the first cost accounting standard issued by ICWAI. The object of CAS 1 is stated to be:

(a) to prescribe the classification of costs for ascertainment of cost of a product or service and preparation of cost statements on a consistent and uniform basis with a view to effect the comparability of the same of an enterprise with that of previous periods and of other enterprises;

(b) the classification and its disclosure are aimed at providing better transparency in the cost statement; and

(c) the standard is also for better adoption of Uniform Costing and Inter-firm Comparison.

4.9.2 The standard provides the uniform terminology for various classifications of costs and seeks to define each such classification. The following basis of classifications have been defined under the standard:

i) Nature of expense i.e., Material, Labour or Expense.

ii) Relation to cost centre or cost object – traceability. Example material cost into 'direct material cost and indirect material cost', labour cost into 'direct labour cost and indirect labour cost' and expenses into 'direct expenses and indirect expenses'. Indirect cost is also known as overhead.

iii) Functions /activities i.e., production cost, administration cost, selling cost, distribution cost or research & development expenditure cost.

iv) Behaviour i.e., fixed cost, semi-variable cost or variable cost.

v) Management decision making i.e., marginal cost, differential cost, opportunity cost, replacement cost, relevant cost, imputed cost, sunk cost, normal cost abnormal cost, avoidable cost etc.

vi) Production Process i.e., batch cost, process cost, operation cost, operating cost, contract cost or joint cost.

vii) Time period i.e., historical cost, pre-determined cost, standard cost or estimated cost.

4.9.3 The standard further provides that the classification of cost item should be chosen with pre-determined objective and that should be followed consistently. The standard also provides in para 7.3 that a change in classification should be made only if it required by law or for compliance with a Cost Accounting Standard. However, same para 7.3 then it goes on to say that change can be made if such change would reset in a more *appropriate preparation or presentation of cost statements of an enterprise. However para 7.4 requires that any change in classification of cost, which has a material effect on the cost of the product should be disclosed in the cost statements.*

4.9.4 *It may be summarized here that the CAS 1 mainly refers to the various alternatives available for 'accumulation and reporting' of costs on regular basis. The intention of the Cost Accounting Standard seems to re-iterate that any method of 'cost accumulation' may be chosen and then followed consistently. The impact of any mid-way change in such basis should be reflected in cost statements, if the impact is material.*

4.9.5 *This standard therefore, provides the ample flexibility to the corporates to chose their own costing system as long as it is consistently applied. This is necessary as most of the companies prefer to link cost – accumulation to responsibility segment also. This standard, therefore, will go a long way in moving towards uniform Cost Accounting Concepts & Principles and help in providing meaningful management information, cost comparison and cost analysis. This is in line with the similar flexibility available to these units under Cost Accounting Records Rules or Cost Audit Report Rules. The CAS 1 as issued by ICWAI is re-produced as under:*

CAS - 1

COST ACCOUNTING STANDARD ON "CLASSIFICATION OF COST"

The following is the text of the COST ACCOUNTING STANDARD 1 (CAS 1) issued by the Council of the Institute of Cost and Works Accountants of India on "Classification of Cost". The standard deals with the principle of classifying costs in the cost statements. In this Standard, the standard portions have been set in bold italic type. These should be read in the context of the background material which has been set in normal type.

1. Introduction

The standard on classification of costs deals with the basis of classification of costs and the practice to be adopted for classification of cost elements in regard to its nature and management objective. The statement aims at providing better understanding on classification of cost for preparation of various cost statements required for statutory obligations or cost control measures.

2. Objective

2.1 The objective of this Standard is to prescribe the classification of costs for ascertainment of cost of a product or service and preparation of cost statements on a consistent and uniform basis with a view to effect the comparability of the same of an enterprise with that of previous periods and of other enterprises.

2.2 The classification and its disclosure are aimed at providing better transparency in the cost statement.

2.3 The standard is also for better adoption of Uniform Costing and Inter-firm Comparison.

3. Scope

3.1 The standard on classification of cost should be applied in assessment of cost of a product or service, application of costing technique and in case of management decision making by the manufacturing industries in India.

3.2 The standard is to be followed by an enterprise, whether covered under section 209(1)(d) of the Companies Act,1956 or not, to classify cost in order to prepare cost statement on uniform basis to make it relevant and understandable for effective cost management.

3.3 The standard has also to be followed for the purpose of assessment of cost of production or valuation of product or the valuation of stock to be certified for calculation of duties and taxes, tariffs and other purposes as the case may be. The cost statement prepared based on standard will be used for assessment of excise duty and other taxes, anti-dumping measures, transfer pricing etc.

4. Definitions

4.1 Cost : Cost is a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services.

4.2 Manufacturing of goods or rendering services involves consumption of resources. Cost is measured by the sacrifice made in terms of resources or price paid to acquire goods and services. The type of cost is often referred in the costing system depends on the purpose for which cost is incurred. For example material cost is the price of materials acquired for manufacturing a product.

4.3 Cost Centre : Any unit of Cost Accounting selected with a view to accumulating all cost under that unit. The unit may be a product, a service, division, department, section, a group of plant and machinery, a group of employees or a combination of several units. This may also be a budget centre.

4.4 Cost Centre or Cost Object is the logical sub-unit for collection of cost. Cost Centre may be of two types – personal and impersonal cost centers. Personal cost centre consists of a person or a group of persons. Cost centres which are not personal cost centres are impersonal cost centers. Again Cost centers may be divided into broad types i.e. Production Cost Centres and Service Cost Centres. Production Cost Centres are those which are engaged in production like Machine shop, Welding shop, Assembly shop etc. Service Cost centers are for rendering service to production cost centre like Power house, Maintenance, Stores, Purchase office etc.

4.5 Cost unit is a form of measurement of volume of production or service. This unit is generally adopted on the basis of convenience and practice in the industry concerned.

4.6 Examples of Cost Units :

Power	-	MW
Cement	-	MT
Automobile	-	Number etc

5. Basic Rules For Classification Of Costs

5.1 Classification of cost is the arrangement of items of costs in logical groups having regard to their nature (subjective classification) or purpose (objective classification).

5.2 Items should be classified by one characteristic for a specific purpose without ambiguity.

5.3 Scheme of classification should be such that every item of cost can be classified.

5.4 Basis of classification :

- **i) Nature of expense**
- **ii) Relation to object – traceability**
- **iii) Functions / activities**
- **iv) Behaviour fixed, semi-variable or variable**
- **v) Management decision making**
- **vi) Production Process**
- **vii) Time period**

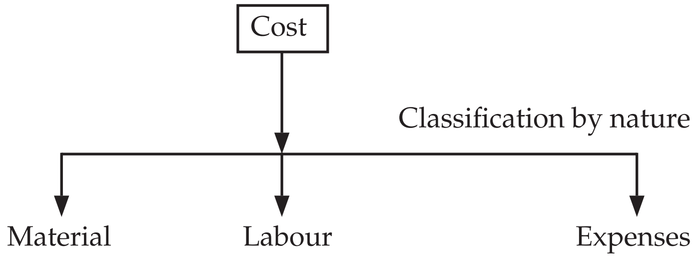
5.5 Classification of cost is the process of grouping the components of cost under a common designation on the basis of similarities of nature, attributes or relations. It is the process of identification of each item and the systematic placement of like items together according to their common features. Items grouped together under common heads may be further classified according to their fundamental differences. The same costs may appear in several different classifications depending on the purpose of classification.

5.6 Cost is classified normally in terms of a managerial objective. Its presentation normally requires sub-classification. Such sub-classification may be according to nature of the cost elements, functional lines, areas of responsibility, or some other useful break-up. The appropriate sub-classification depends upon the uses to be made of the cost report.

6. Classification Of Costs

6.1 By Nature of expense:

6.1.1 ***Costs should be gathered together in their natural groupings such as material, labour and other expenses. Items of costs differ on the basis of their nature. The elements of cost can be classified in the following three categories : i) Material ii) Labour iii) Expenses***



6.1.2 ***Material Cost is the cost of material of any nature used for the purpose of production of a product or a service.***

6.1.3 Material cost includes cost of procurement, freight inwards, taxes & duties, insurance etc. directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks, refunds on account of modvat, cenvat, sales tax and other similar items are deducted in determining the costs of material.

6.1.4. ***Labour Cost means the payment made to the employees, permanent or temporary, for their services.***

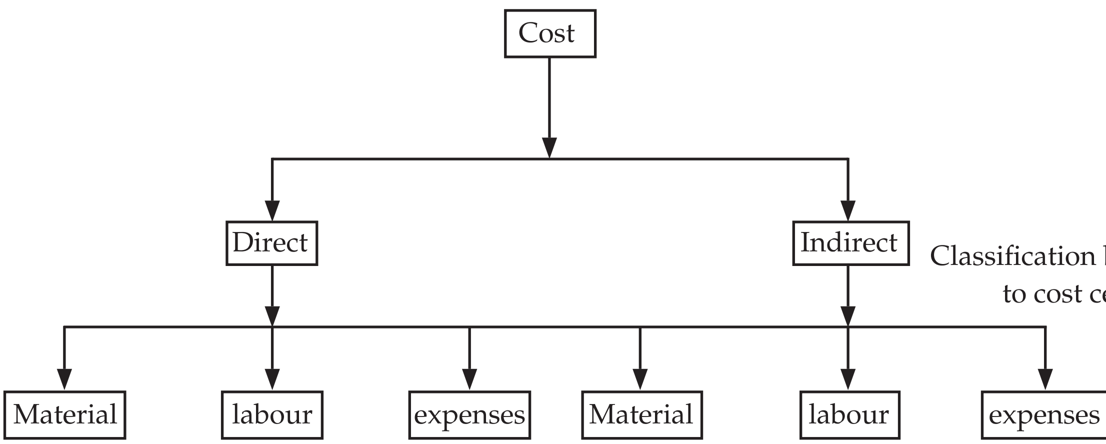
6.1.5 Labour cost include salaries and wages paid to permanent employees, temporary employees and also to employees of the contractor. Here, salaries & wages include all fringe benefits like Provident Fund contribution, gratuity, ESI, overtime, incentives, bonus , ex-gratia, leave encashment, wages for holidays and idle time etc.

6.1.6 Expenses are other than material cost or labour cost which are involved in an activity.

6.1.7 Expenditure on account of utilities, payment for bought out services, job processing charges etc. can be termed as expenses.

6.2 By Relation to Cost Centre

6.2.1 Classification should be on the basis of method of allocation of cost to a cost unit. If expenditure can be allocated to a cost centre or cost object in an economically feasible way then it is called direct otherwise the cost component will be termed as indirect. According to this criteria for classification, material cost is divided into direct material cost and indirect material cost, labour cost into direct labour cost and indirect labour cost and expenses into direct expenses and indirect expenses. Indirect cost is also known as overhead.



Classification by relation to cost centre

6.2.2 Direct cost has three components – direct material cost, direct labour cost and direct expenses and indirect cost has three components- indirect material, indirect labour cost and indirect expenses. Sum of all direct costs is called prime cost.

6.2.3 Direct material Cost is the cost of material which can be directly allocated to a cost centre or a cost object in a economically feasible way.

6.2.4 Raw materials consumed for production for a product or service which are identifiable in the product or service form the direct material cost. Direct Material cost includes cost of procurement, freight inwards, taxes & duties, insurance etc directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks, refunds on account of modvat, cenvat, salex tax and other similar items are deducted in determining the costs of direct material.

6.2.5 ***Direct Labour Cost is the cost of wages of those workers who are readily identified or linked with a cost centre or cost object.***

6.2.6 Here, the wages of the workers include the fringe benefits include all fringe benefits like Provident Fund contribution, gratuity, ESI, overtime, incentives, bonus , ex-gratia, leave encashment, wages for holidays and idle time etc. for the purpose of calculation of direct labour cost.

6.2.7 ***Direct Expenses are the expenses other than direct material or direct labour which can be identified or linked with the cost centre or cost object.***

6.2.8 Examples of direct expenses are :

- expenses for special moulds required in a particular cost centre
- hiring charges for tools and equipments for a cost centre
- royalties in connection to a product
- Job processing charges etc.

6.2.9 ***Indirect Material is the cost of material which can not be directly allocable to a particular cost centre or cost object.***

6.2.10 Materials which are of small value and can not be identified in or allocated to a product/service are classified as indirect materials. Examples :

- Consumable spares and parts
- Lubricants etc.

6.2.11 ***Indirect labour cost is the wages of the employees which are not directly allocable to a particular cost centre.***

6.2.12 Examples of indirect labour :

- Salaries of staff in the administration and accounts department
- Salaries of security staff etc

6.2.13 Indirect expenses are the expenses other than of the nature of material or labour and can not be directly allocable to a particular cost centres.

6.2.14 Indirect expenses are not be allocable to a particular cost centre. Examples – insurance, taxes and duties.

6.3 By functions/activities:

6.3.1 ***Costs should be classified according to the major functions for which the elements are used into the following four major functions :***

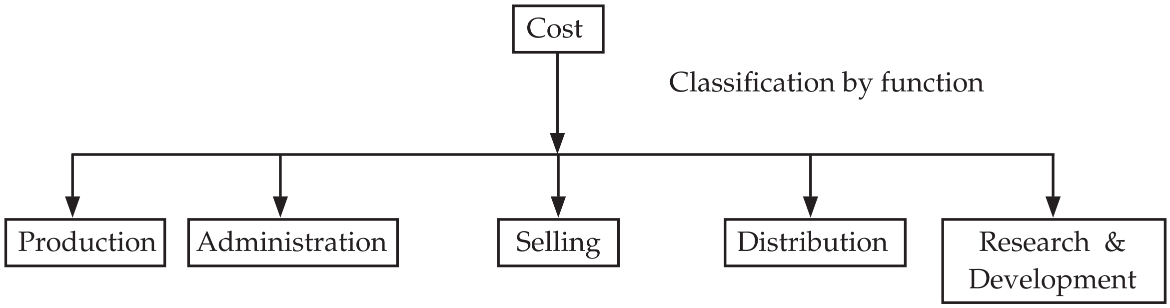
Production;

Administration;

Selling;

Distribution; and

Research & Development Expenditure.



6.3.2 ***Production Cost is the cost of all items involved in the production of a product or service. It includes all direct costs and all indirect costs related to the production.(Exhibit 1)***

6.3.3 ***Production overhead is the indirect costs involved in the production process.***

6.3.4 Production overhead is also termed as factory overhead or manufacturing overhead. Examples of Production overhead:

- Salaries for staff for production planning, technical supervision, factory administration etc
- Normal idle time cost
- Expenses for stores management
- Security expenses in the factory
- Labour welfare expenses
- Dispensary and canteen expenses
- Depreciation of plant and machineries
- Repair and maintenance of factory building and plant & machineries
- Insurance
- Quality control etc.

6.3.5 ***Administration costs are expenses incurred for general management of an organization. These are in the nature of indirect costs and are also termed as administrative overhead.***

6.3.6 Examples of items to be included in Administrative overhead :

- Salaries of administrative and accounts staff
- General office expenses like rent, lighting, rates and taxes, telephone, stationery, postage etc
- Bank charges
- Audit fees
- Legal expenses
- Depreciation & repair and maintenance of office building etc.

6.3.7 ***Selling costs are indirect costs related to selling of products or services and include all indirect cost in sales management for the organization.***

6.3.8 Selling Costs include all costs relating to regular sales and sales promotion activities. Examples of expenses which are included in selling cost are :

- Salaries, commission and traveling expenses for sales personnel
- advertisement cost
- Legal expenses for debt realization
- market research cost
- royalty on sale
- after sales service cost etc.

6.3.9 Distribution Costs are the cost incurred in handling a product from the time it is completed in the works until it reaches the ultimate consumer.

6.3.10 Distribution costs are the costs incurred for distribution of product to customers. Examples of distribution costs :

- Transportation cost
- cost of warehousing salable products
- cost of delivering the products to customers. etc.

Note :

1. Primary packaging cost is included in production cost whereas secondary packaging cost is distribution cost.
2. In exceptional cases, for example in case of heavy industries equipment supply, installation cost at delivery site for heavy equipments which involves assembling of parts, testing etc is included in production cost but not distribution cost. For example, installation cost of a gas turbine at plant site is included in the cost of production of gas turbine.

6.3.11 Research & Development Costs are the cost for undertaking research to improve quality of a present product or improve process of manufacture, develop a new product, market research etc and commercialization thereof.

6.3.12 Research Cost comprises the cost of development of new product and manufacturing process; improvement of existing products, process and equipment; finding new uses for known products; solving technical problem arising in manufacture and application of products etc. Development cost includes the cost incurred for commercialization / implementation of research findings.

Exhibit 1

		(1)	Direct Material Cost (a)
		(2)	Direct Labour Cost
		(3)	Direct Expenses
(1)+(2)+(3)	=	(4)	Prime Cost
		(5)	Production Overhead
		(6)	Administrative Overhead
		(7)	Research & Development Cost (apportioned)
(4)+(5)+(6)+(7)	=	(8)	Cost of Production (b)
		(9)	Selling Cost
		(10)	Distribution Cost
(8)+(9)+(10)	=	(11)	Cost of Sales

Note :

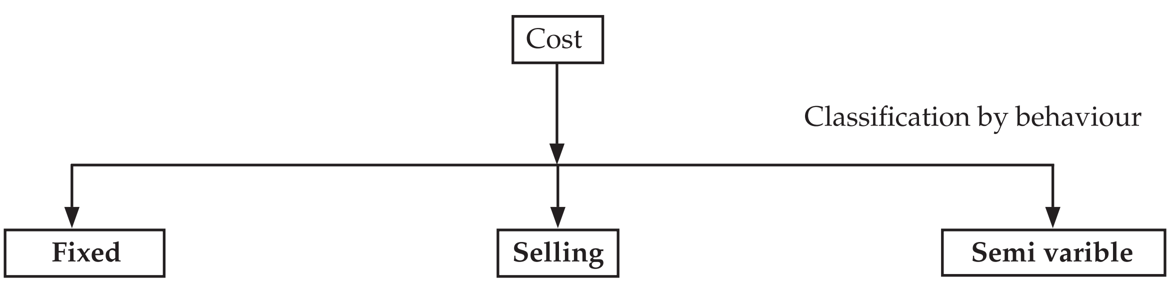
To arrive at value at different points as indicated above adjustment with opening and closing stock is necessary at following different points :

(a) opening and closing stock of raw materials

(b) opening and closing stock of work-in-progress & finished goods

6.4 By Behaviour

6.4.1 ***Costs are classified based on behaviour as fixed cost, variable cost and semi-variable cost depending upon response to the changes in the activity levels.***



6.4.2 Fixed Cost is the cost which does not vary with the change in the volume of activity in the short run. These costs are not affected by temporary fluctuation in activity of an enterprise. These are also known as period costs.

6.4.3 Examples for fixed cost : salaries, rent, audit fees, depreciation etc.

6.4.4 Variable Cost is the cost of elements which tends to directly vary with the volume of activity. Variable cost has two parts – (a) Variable direct cost; and (b) Variable indirect costs. Variable indirect costs are termed as variable overhead.

6.4.5 Examples of variable cost are materials consumed, direct labour, sales commission, utilities, freight, packing, etc.

6.4.6 Semi Variable Costs contain both fixed and variable elements. They are partly affected by fluctuation in the level of activity.

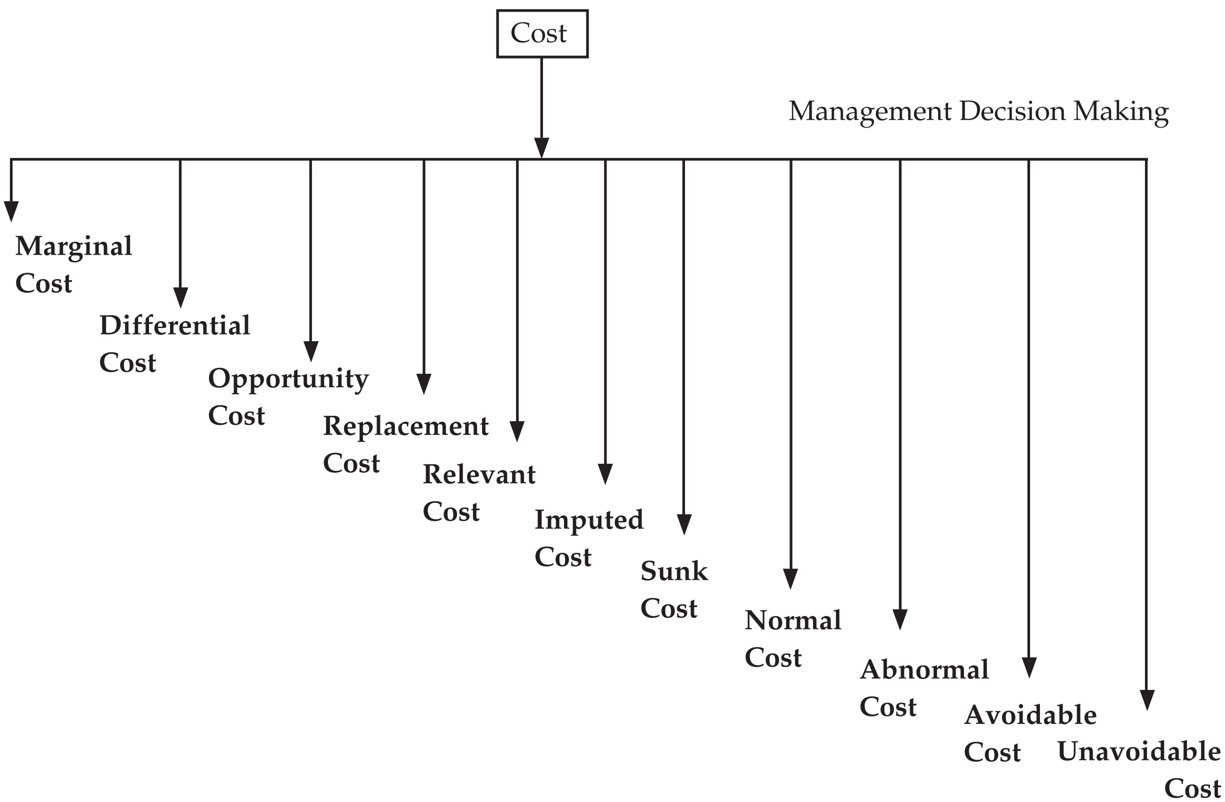
6.4.7 Examples of semi-variable cost: Factory supervision, maintenance, power etc.

Note :

1. The characteristics of fixed costs are (1) fixed amount within an output range (2) fixed cost per unit decreases with increased output
2. The characteristics of variable Cost: (1) The variable cost varies directly with volume of activities or production (2) variable cost remains constant per unit within a range of activity.

6.5 For Management Decision Making

6.5.1 Costs are classified for the purpose of management decision making under different circumstances as under :



6.5.2 Marginal cost is the aggregate of variable costs, i.e. prime cost plus variable overhead. Marginal cost per unit is the change in the amount at any given volume of output by which the aggregate cost changes if the volume of output is increased or decreased by one unit.

6.5.3 Marginal cost is used in Marginal Costing system. For determining marginal cost, semi-variable costs, if any, are segregated into fixed and variable cost. Then, variable costs plus the variable part of semi-variable costs is the total marginal cost for the volume of production in consideration.

Example :

A.	Production		45,000 units
		Fixed Cost	Variable Cost
B.	Cost	Rs lakhs	Rs lakhs
1.	Material cost		4.5
2.	Labour Cost		2.4
3.	Fixed Cost	4.80	-
4.	Variable Production & Selling overhead		2.30
5.	Semi-variable Cost (after segregation fixed and variable part)	3.20	2.00
C.	Total Marginal Cost		11.25
D.	Marginal cost per unit		Rs 25.00

6.5.4. ***Differential Cost is the change in cost due to change in activity from one level to another.***

6.5.5 Differential Cost is found by using the principle which highlights the points of differences in costs by adoption of different alternatives. This technique is used in export pricing, new products and pricing goods sought to be promoted in new markets, either within the country or outside.

6.5.6 The algebraic difference between the relevant cost at two levels of activities is the differential cost. When the level of activity is increased, the differential cost is known as incremental cost and when the level of activity is decreased, the decrease in cost is known as decremental cost.

Output Unit in (Rs)	Differential Unit in lakhs	Total Cost (Rs lakhs)	Differential cost (Rs lakhs)	Differential cost per unit (Rs.)
(a) 1.00	-	30.00	-	-
(b) 1.20	0.20 (b) – (a)	35.00	5.00	25.00
(c) 0.80	0.20 (a) – (c)	26.00	- 4.00	- 20.00

(+) Incremental cost
(-) Decremental cost

6.5.7 Opportunity Cost is the value of the alternatives foregone by adopting a particular strategy or employing resources in specific manner.

6.5.8 It is the return expected from an investment other than the present one. The opportunity cost is considered for selection of a project or justification of investment, studying viability of an investment option. Example: A machine is currently being used to produce product P. It can also be used to produce product Q which can fetch Rs 60,000 profit. Then the opportunity cost of using the machine is Rs 60000.

6.5.9 Replacement Cost is the cost of an asset in the current market for the purpose of replacement.

6.5.10 Replacement cost is generally used for determining the optimum time of replacement of an equipment or machine in consideration of maintenance cost of the existing one and its productive capacity.

6.5.11 Relevant Costs are costs relevant for a specific purpose or situation.

6.5.12 In the context of decision making relating to a specific issue, only those costs which are relevant are considered. A particular cost item may be relevant in a decision making and may be irrelevant in some other decision making situation. For example, present depreciated cost of machine is relevant in case of decision of its sale but it is irrelevant in case of decision of its replacement.

6.5.13 Imputed Costs are hypothetical or notional costs, not involving cash outlay, computed only for the purpose of decision making.

6.5.14 In economics, 'imputed' indicates an ascribed or estimated value when there is no criteria of absolute monetary value for such purpose. In national income estimation wages of housewives are imputed. Similarly, in farming operations, the wages or salaries of owner are imputed. Imputed costs are similar to opportunity costs. Interest on internally generated fund, which is not actually paid is an example of imputed cost.

6.5.15 Sunk Costs are historical costs which are incurred i.e. 'sunk' in the past and are not relevant to the particular decision making problem being considered.

6.5.16 Sunk costs are those that have been incurred for a project and which will not be recovered if the project is terminated. While considering the replacement of a plant, the depreciated book value of the old asset is irrelevant as the amount is a sunk cost which is to be written off at the time of replacement.

6.5.17 Normal Cost is a cost that is normally incurred at a given level of output in the conditions in which that level of output is achieved.

6.5.18 Normal cost includes those items of cost which occur in the normal situation of production process or in the normal environment of the business. The normal idle time is to be included in the ascertainment of normal cost.

6.5.19 Abnormal Cost is an unusual or a typical cost whose occurrence is usually irregular and unexpected and due to some abnormal situation of the production.

6.5.20 Abnormal cost arises due to idle time for some heavy break down or abnormal process loss. They are not considered in the cost of production for decision making and charged to profit & loss account.

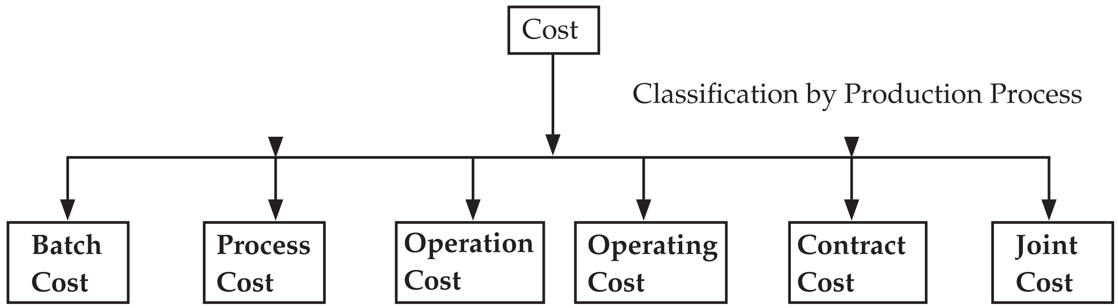
6.5.21 Avoidable Costs are those costs which under given conditions of performance efficiency should not have been incurred.

6.5.22. Avoidable costs are logically associated with some activity or situation and are ascertained by the difference of actual cost with the happening of the situation and the normal cost. When spoilage occurs in manufacture in excess of normal limit, the resulting cost of spoilage is avoidable cost. Cost variances which are controllable may be termed as avoidable cost.

6.5.23 Unavoidable Costs are inescapable costs which are essentially to be incurred, within the limits or norms provided for. It is the cost that must be incurred under a programme of business restriction. It is fixed in nature and inescapable.

6.6 By nature of production process

6.6.1 Costs are also classified on the basis of nature of production or manufacturing process.



6.6.2 Batch Cost is the aggregate cost related to a cost unit which consist of a group of similar articles which maintain its identity throughout one or more stages of production.

6.6.3 Process cost: When the production process is such that goods are produced from a sequence of continuous or repetitive operations or processes, the cost incurred during a period is considered as process cost. The process cost per unit is derived by dividing the process cost by number of units produced in the process during the period.

6.6.4. Accounts are maintained for cost of a process for a period. The average cost per unit produced during the period is process cost per unit.

6.6.5 Operation Cost is the cost a specific operation involved in a production process or business activity.

6.6.6. When there are distinctly separate operations involved in a process, cost for each operation is found out for effective control mechanism.

6.6.7 Operating Cost is the cost incurred in conducting a business activity. Operating costs refer to the cost of undertakings which do not manufacture any product but which provide services.

6.6.8 Contract cost is the cost of a contract with some terms and condition of adjustment agreed upon between the contractee and the contractor.

6.6.9. Contract cost usually implied to major long term contracts as distinct from short term job costs. Escalation clause is sometimes provided in the contract in order to take care of anticipated change in material price, labour cost etc.

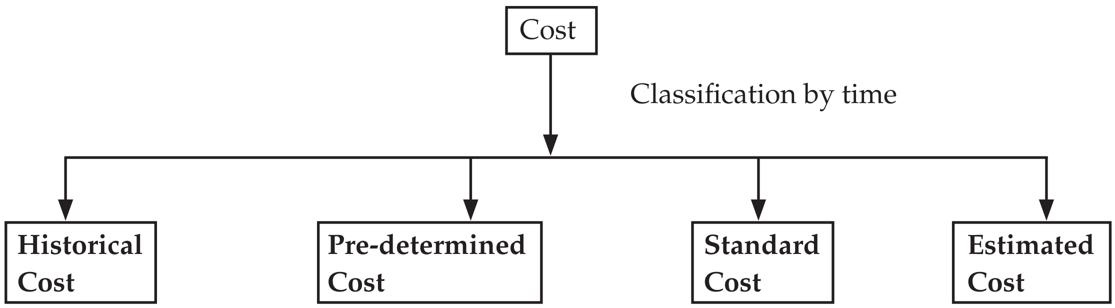
6.6.10 Joint Costs are the common cost of facilities or services employed in the output of two or more simultaneously produced or otherwise closely related operations, commodities or services.

6.6.11 When a production process is such that from a set of same input, two or more distinguishably different products are produced together, products of greater importance are termed as joint products and products of minor importance are termed as by-products and the costs incurred prior to the point of separation of the products are termed as Joint Costs. For example, in a petroleum refinery industry, petrol, diesel oil, kerosene oil, naptha, tar etc are produced jointly in the refinery process.

6.6.12 By-Product Cost is the cost assigned to the by-products.

6.7 Classification By Time

6.7.1 A cost item is related to a specific period of time and cost can be classified according to the system of assessment and specific purpose as indicated in the following ways:



6.7.2 Historical Costs are the actual costs of acquiring assets or producing goods or services.

6.7.3 They are 'postmortem' costs ascertained after they have been incurred and they represent the cost of actual operational performance. Historical costing system follows a system of accounting to which all values (in revenue and capital accounts) are based on costs actually incurred or as relevant from time to time.

6.7.4 Pre-determined Costs for a product are computed in advance of production, on the basis of a specification of all the factors affecting cost and cost data. Pre-determined costs may be either standard or estimated.

6.7.5 Standard Costs : A predetermined norm applied as a scale of reference for assessing actual cost, whether these are more or less. The standard cost serves as a basis of cost control and as a measure of productive efficiency when ultimately posed with an actual cost. It provides management with a medium by which the effectiveness of current results is measured and responsibility of deviation placed.

6.7.6. Standard costs are used to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them.

6.7.7 Estimated Costs of a product are prepared in advance prior to the performance of operations or even before the acceptance of sale orders.

6.7.8 Estimated cost is found with specific reference to product in question, and activity level of the plant. It has no link with actual and hence it is assumed to be less accurate than the standard cost.

7. Presentation And Disclosure

7.1 The classification of cost item should be done on 'basis of classification' chosen with pre-determined objective.

7.2 ***The classification of cost item should be followed consistently from period to period and preparation of cost statements should be made with reference to a period of time.***

7.3 ***A change in classification should be made only if it is required by law or for compliance with a Cost Accounting Standard or the change would reset in a more appropriate preparation or presentation of cost statements of an enterprise.***

7.4 ***Any change in classification of cost which has a material effect on the cost of the product should be disclosed in the cost statements. Where the effect of such change is not ascertainable wholly or partly, the fact should be indicated in the cost statement.***

CAS – 2
COST ACCOUNTING STANDARD ON "CAPACITY DETERMINATION"

4.10 Cost Accounting Standard 2 : "Capacity Determination"

COMMENTS (CAS 2) :

4.10.1 All managements need a variety of information to meet different decision needs. One of the long-standing difficulties in cost accounting has been the effective allocation or apportionment of "indirect costs" to various products, departments or cost centers. One of the more popular methods for apportionment of these "indirect costs" is on the basis on "Normal Capacity". Abnormal idle capacity cost is usually changed to Profit & Loss A/c. Therefore, realistic capacity determination is very important for cost determination especially Government procurement and payments of subsidies/incentives. For example, the Costing Policy followed by Department of Energy (USA) and other standards provide that all costs that can be identified to the maintenance of an excess capacity at the production facility should be excluded from the product cost. Capacity determination is also important to ensure that costs attributable to Abnormal idle capacity are not charged to closing inventory.

4.10.2 COST ACCOUNTING STANDARD 2 (CAS 2) regarding 'CAPACITY DETERMINATION' is the second cost accounting standard issued by ICWAI. The object of CAS 2 as stated in para 2 is to prescribe the method of determination of capacity to be applied uniformly and consistently. The standard will also help the management to identify the bottlenecks, imbalances and idle capacity for effective use of various resources. This determination of capacity is to help in proper allocation, apportionment and absorption of cost. The determination of capacity is also very critical for any unit especially where subsidies or incentives are paid by the Government. Any increase in capacity determination may bring down the costs as per unit impact of fixed overheads will come down. Similarly any decrease in capacity determination shall increase the 'per unit cost' as 'per unit' impact of 'fixed overhead's shall increase.

4.10.3 The standard has been recommended to be followed for capacity determination required to be carried out for any purpose or under provisions of any Act, Rules or Regulations except where capacity determination has been prescribed otherwise. The standard is applicable for an undertaking, whether existing or new, where there is expansion of more than 5% of the existing capacity due to introduction of new machines or productive resources. Similarly, the standard is also applicable where there is more than 5% reduction of the existing capacity due to disposal or withdrawal or impairment of old machines or productive resources. In other words, whenever more than 5% variation in capacity (whether positive or negative) takes place in any of the units covered under Cost Audit or Cost Accounting Records Rules, the Cost Auditor is required to undertake the capacity determination under these rules as per this standard. This standard mainly seeks to define the following eight types of capacities:

(a) Licenced Capacity' i.e., the production capacity of the plant for which licence has been issued by an appropriate authority.

(b) Installed Capacity' i.e., the maximum productive capacity according to the manufacturers' specification of machines / equipment. However, installed capacity of the unit/plant is determined after taking into account imbalances in different machines/ equipment in the various departments / production cost centres in the unit / plant and number of working shifts.

(c) 'Practical or Achievable Capacity' i.e., the maximum productive capacity of a plant reduced by the predictable and unavoidable factors of interruption pertaining to internal causes. Thus, practical capacity is the installed capacity minus the inevitable interruptions due to time lost for preventive maintenance, repairs, set ups, normal delays, weekly off-days and holidays etc.

(d) 'Normal Capacity' is the production achieved or achievable on an average over a period or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance. Normal capacity is practical capacity minus the loss of productive capacity due to external factors.

(e) Actual Capacity Utilization' is the volume of production achieved in relation to installed capacity.

(f) Idle Capacity' is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is less than installed capacity.

(g) 'Excess Capacity Utilization' is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is more than installed capacity.

(h) 'Abnormal idle capacity' is the difference between practical capacity and normal capacity or actual capacity utilization whichever is higher.

4.10.4 The Cost Accounting Standard explains the detailed methodology to determine 'installed capacity' in para 5, 'practical / achievable capacity' in para 6 and 'normal capacity' in para 7 of the standard. Licensed Capacity is determined by the 'appropriate' or 'regulatory' authority' and. Actual capacity utilisation is the actual volume of production. Hence both of them need no determination. Other three types of capacities are the derived figures i.e., Idle capacity and Excess capacity utilisation are 'installed capacity' minus 'actual capacity utilisation. Abnormal idle capacity is the difference between practical capacity and normal capacity or actual capacity utilization, whichever is higher.

4.10.5 The term installed capacity has been defined by CAS as maximum productive capacity according to the manufacturers specification after taking into account imbalances in different machines/ equipment. It may be added here that Capacity imbalances in different production cost centres or "bottleneck" departments can be reduced to some extent by taking the following remedial actions:

(a) Overtime

(b) Enhancement is work-force or additional workers

(c) Additional shifts

(d) Taking machines/equipments on lease or hiring of facilities by outsourcing.

(e) Installing balancing equipments.

Similarly, those production cost centers or "bottleneck" departments having excess capacity may hire out the spare capacity or spare machine hours.

4.10.6 As already clarified in para 2 above, the capacity determination is very critical for determination of cost of production. The variable production overheads are generally be adsorbed in production cost based on actual capacity utilisation. However, the fixed production overheads and other similar item of fixed costs like quality control cost, research and development cost and administrative overheads etc. relating to manufacturing are generally absorbed in the production cost on the basis of the normal capacity or actual capacity utilization of the plant, whichever is higher. The abnormal cost shall not form the part of cost of production.

4.10.7 Explanation 1 to para 7 provides that if the same products with different specifications and of different ranges in terms of size, type, variety etc are manufactured, then there is a need to determine equivalence among them in order to determine the capacity. This is especially true in those cases where multiple products are made from same machine or say steel sheets of different gauges or steel rods of different sizes are made. This is necessary to ensure meaningful comparison. Similarly intermediate products / components etc., if any produced shall also be taken into consideration for determining equivalent capacity.

4.10.8 Explanation 3 to para 7 further provides that if some machines are leased out/let out or some machines are taken on lease, resulting decrease / increase in capacity should also be considered. It may be clarified here that the scope of Cost Accounting Standard is to prescribe the method of determination of capacity to be applied uniformly and consistently. It does not suggest any particular method for valuation of inventory.

4.10.9 AS 2 requires the use of "Normal Capacity" to allocate fixed production overheads to determine the product cost for inventory valuation. The term "Normal Capacity" has been defined as the production expected to be achieved on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance. The actual level of the production may be used if it approximates normal capacity. Cost Accounting Standard on the other hand, defines Normal Capacity production achieved or achievable on an average over a period of time or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance. Normal capacity is practical capacity minus the loss of productive capacity due to external factors. It may therefore, be seen that even though, the definitions of "Normal Capacity" in Cost Accounts Standards is similar to the definition as contained in AS 2, guidelines may be required to define "External factors", which has not been defined in the CAS 2. Similarly, even though AS 2 allows the actual level production may be taken if it approximates Normal Capacity. However, this is not permissible under Cost Accounting Standard.

4.10.10 It may be seen that the Cost Accounting Standard defines "Normal Capacity" in terms of "Practical Capacity" minus the loss of Productive Capacity due to external factors, Para 4.3 of the Cost Accounting Standard defines the "Practical Capacity" or "Achievable Capacity" as the maximum productive capacity of a plant reduced by predicable and unavoidable factors of interruption pertaining to internal causes. Therefore, if any plant decides to run for three shifts in a year as against one or two shifts earlier, the normal capacity will increase proportionately under the Cost Accounting Standards. Whereas it is fixed (average) under AS 2. Therefore, there may be differences. In any case, the productive capacity of any plant may have not much meaning in this era of outsourcing and leasing. The CAS 2 as issued by the ICWAI is reproduced as under:

CAS - 2
COST ACCOUNTING STANDARD ON CAPACITY DETERMINATION

The following is the COST ACCOUNTING STANDARD 2 (CAS 2) issued by the Council of the Institute of Cost and Works Accountants of India on "CAPACITY DETERMINATION". The standard deals with determination of capacity of a unit. In this Standard, the standard portions have been set in bold italic type. These are to be read in the context of the background material which has been set in normal type.

1. Introduction

Better utilization of capacity means better utilization of resources. It is an important consideration for cost determination and cost reduction. Thus, it is essential to establish the capacity of the plant. Cost Accounting Records Rules under section 209(1)(d) of Companies Act, 1956 and Cost Audit Report Rules, 2001 under section 233B of the said Act specify that comparative statement of installed capacity and actual capacity utilization is to be recorded and furnished in order to assess the operating level.

2. Objective

2.1 The objective of the standard is to prescribe the method of determination of capacity to be applied uniformly and consistently.

2.2 The standard is to help the management to identify the bottlenecks, imbalances and idle capacity for effective use of various resources.

2.3 The standard is to help in proper allocation, apportionment and absorption of cost.

3. Scope

3.1 The standard should be followed for capacity determination required to be carried out for any purpose or under provisions of any Act, Rules or Regulations except where capacity determination has been prescribed otherwise.

3.2 The standard shall also be followed for maintaining cost records under the Cost Accounting Records Rules or for furnishing information on Capacity Utilization under the Cost Audit Report Rules issued pursuant to Section 209(1)(d) and section 233B of Companies Act,1956 respectively.

3.3 The standard is applicable for an undertaking, whether existing or new, where there is expansion of more than 5% of the existing capacity due to introduction of new machines or productive resources. Similarly, the standard is also applicable where there is more than 5% reduction of the existing capacity due to disposal or withdrawal or impairment of old machines or productive resources.

4. Definitions

4.1 'Licenced Capacity' is the production capacity of the plant for which licence has been issued by an appropriate authority.

4.2 'Installed Capacity' is the maximum productive capacity according to the manufacturers' specification of machines / equipment. Installed capacity of the unit/plant is determined after

taking into account imbalances in different machines/ equipment in the various departments / production cost centres in the unit / plant and number of working shifts.

4.3 'Practical or Achievable Capacity' is the maximum productive capacity of a plant reduced by the predictable and unavoidable factors of interruption pertaining to internal causes.

Thus, practical capacity is the installed capacity minus the inevitable interruptions due to time lost for preventive maintenance, repairs, set ups, normal delays, weekly off-days and holidays etc. Practical capacity does not consider the external factors causing reduction in production e.g. lack of orders.

4.4 'Normal Capacity' is the production achieved or achievable on an average over a period or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance.

Normal capacity is practical capacity minus the loss of productive capacity due to external factors.

4.5 'Actual Capacity Utilization' is the volume of production achieved in relation to installed capacity.

4.6 'Idle Capacity' is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is less than installed capacity.

4.7 'Excess Capacity Utilization' is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is more than installed capacity.

4.8 'Abnormal idle capacity' is the difference between practical capacity and normal capacity or actual capacity utilization whichever is higher.

5. Determination Of Installed Capacity

5.1 Installed capacity is determined based on :

i) Manufacturers' Technical specifications

ii) Capacities of individual or interrelated production centres.

iii) Operational constraints / capacity of critical machines

iv) Number of shifts

v) Any other factor

5.2 In case of manufacturers' technical specifications are not available, the estimates by technical experts on capacity under ideal conditions may be considered for determination of installed capacity.

5.3 In case a product passes through different production processes and each process is having different capacity then the process which brings effective or ultimate production shall be considered for deciding installed capacity.

6. Determination Of Practical / Achievable Capacity

6.1 Practical capacity or achievable capacity should be determined after adjustment of the following with the installed capacity.

(i) Available production hours taking into consideration holidays, normal shut down days and normal idle time.

(ii) Normal time loss in batch change over, break downs of machines, repairs etc

(iii) Loss in efficiency due to ageing of the machines/ equipment

(iv) Number of shifts

(v) Any other factor

7. Determination Of Normal Capacity

7.1 Normal capacity is determined based on the productive capacity achieved over a period of time, say average of three normal years out of preceding five years or expected to be achieved over a period of time, say next three to five years .

7.2 This capacity is determined after adjustment of external factors with practical capacity.

7.3 Normal capacity of production process involved in the production of a product or the productive capacity of the plant as a whole should be taken into account to arrive at normal capacity for a product or plant, as the case may be.

7.4 The periods influenced by abnormalities should be excluded for this purpose.

Explanation :

1. In case the same products with different specifications and of different ranges in terms of size, type, variety etc. are manufactured, then there is a need to determine equivalence among them in order to determine the capacity.

2. In case some intermediate products / components etc are also produced, they should be taken into consideration for determining equivalent capacity.

3. In case some machines are leased out/let out or some machines are taken on lease, resulting decrease / increase in capacity should also be considered.

8. Disclosure

8.1 The details of basis for arriving at the capacity, variables used and assumptions made should be disclosed.

8.2 Any change in the installed capacity due to modifications in the machines/ equipment or addition of balancing equipment or disposal or impairment of some machines/ equipment should be disclosed.

8.3 The licenced capacity and installed capacity should be disclosed in absolute term of production whereas practical capacity, normal capacity and actual capacity utilization should be disclosed in absolute term as well as in percentage of installed capacity.

8.4 In case the same products with different specifications and of different ranges in terms of size, type, variety etc are manufactured, then there is a need to determine equivalence among them and capacity should be established in terms of equivalent units.

8.5 In case some machines are taken on lease or some machines are leased out, their impact in terms of increase/ decrease in capacity should be disclosed separately.

8.6 ***In case of low capacity utilization as compared to the installed capacity, reasons for the same should be disclosed. Comments on the shortfall in production should also specify the factors which are controllable and uncontrollable in short term or in long term.***

8.7 ***In case of excess capacity utilization, the same should be disclosed separately in absolute terms and in terms of percentage with reasons.***

Exhibit 1

Illustration

Manufacturers' Specifications - capacity per hour	=	500 units
No of shifts (each shift 8 hours)	=	3 shifts
Holidays in a year :		
Sundays	=	52 days
Other holidays	=	13 days
Annual maintenance is done within these 13 hoildays		
Preventive Weekly Maintenance for the machine on Sunday.		
Normal idle capacity for batch change over, Lunch, personal need etc.	=	1 hr per shift

Production based on sales expectancy in past 5 years

= 30.1, 26.9, 29.7, 24.4 and 30.2 lakh units

Actual Production for the year = 30.1

Calculation

Installed Capacity for the machine = 365 * 8 *3 * 500 = 43.8lakh units

Practical Capacity = (365 – 52 - 13) * (8 - 1) * 3 * 500 = 31.5lakh units

Out of the past five years, normal capacity is average of 3 normal years.

Normal Capacity = (30.1 + 29.7 + 30.2) / 3 = 30.0 lakh units

Actual Capacity Utilization = 30.1 lakh units = 68.7 %

Idle Capacity = (43.8 – 30.1) = 13.7 lakh unit = 31.3 %

Abnormal idle capacity = 31.5 – 30.1 = 1.4 lakh units

CAS – 3
COST ACCOUNTING STANDARD ON
"OVERHEADS"

4.11 COST ACCOUNTING STANDARD 3 : "OVERHEADS"

COMMENTS (CAS 3) :

4.11.1 COST ACCOUNTING STANDARD 3 (CAS 3) regarding 'OVERHEADS' is aimed to facilitate taking of commercial and strategic management ` decisions such as resource allocation, product mix optimization, make or buy decisions, price fixation etc. The stated objective of the standard is to prescribe the methods of collection, allocation, apportionment of overheads to different cost centers and absorption thereof to products or services on a consistent and uniform basis in the preparation of cost statements and to facilitate inter-firm and intra-firm comparison. It further clarifies that the standardization of collection, allocation, apportionment and absorption of overheads is to provide a scientific basis for determination of cost of different activities, products, services, assets, etc. The standard also aims at ensuring better disclosure requirement and transparency in the cost statement.

4.11.2 This standard is again dealing with principles of costing and is supposed to be applicable to Cost and Management Accounting practices relating to

(a) Cost of products, services or activities

(b) Valuation of stock

(c) Transfer pricing

(d) Segment Performance

(e) Excise / Custom duty, VAT, Income Tax, Service Tax and other levies, duties and abatement fixation

(f) Cost statements for any other purpose

4.11.3 The full cost of any product consists of both direct costs and indirect costs. Accurate accounting and allocation of overhead expenses are very important for computing the total cost of production and subsequent pricing of the product. The direct costs can be easily traced or identified with the relevant product or activity. As per para 6.2.2 of CAS 1, direct cost has three components – direct material cost, direct labour cost and direct expenses. Sum of all the three direct expenses is called the prime cost. Indirect cost has three components – indirect material, indirect labour cost and indirect expenses like depreciation, consumables, utilities, repairs, taxes and insurance etc. These expenses are not directly identifiable or allocable to any specific product or activity in an economically feasible way. Sum of all the three indirect expenses is called the overhead. As clarified in CAS 1, the overhead costs can be classified in a following way:

(a) On the basis of functions i.e., production overheads, administrative overheads, selling overheads or distribution overheads; or

(b) On the basis of behaviour i.e., variable overheads, semi-variable overheads and fixed overheads;

4.11.4 The procedure of distributing or sharing out the common overhead costs to respective products or activities is known as 'absorption of overheads'. An activity base is therefore chosen as a means for assigning of *overhead costs or 'absorptions of overheads' cost to the production unit. These activity bases are measures of production that can reasonably account for variations in the amount of overheads actually incurred. The Cost Accounting Standard has prescribed the following three stages for absorption of overheads:*

Stage – I: Collection, Allocation and Apportionment of Overheads (Primary Distribution): *The first stage is to identify and collect overheads for the respective production and other cost centers. For example, depreciation of a particular machine should be allocated to a particular cost centre if the machine is directly attached to the cost centre. Similarly, repairs and maintenance incurred in particular specific department, supervision, indirect labour cost, overtime, indirect materials and factory supplies etc., which can be directly identified with a respective department or cost center should also be allocated to that particular department or cost center. Other indirect expenses, which are common to different cost centers have to be apportioned to the respective cost centers on an rational and equitable basis. This is also called primary distribution of overheads. For example, the expenditure on general repairs and maintenance pertaining to a department can be allocated to that department but has to be apportioned to various cost centers. Further, if the department is involved in the production of a single product, the whole repairs and maintenance of the department can be directly allocated to the product. Para 5.2 of the standard requires that basis of apportionment must be rational and should be followed consistently and uniformly. Any change in basis of apportionment shall necessitate proper disclosure in cost records. Para 5.1 of the CAS 3 requires that this apportionment to different cost centers should be based on following two principles :*

i) *Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost. Apportionment of overheads based on this criterion ensures better rationality as it is guided by the relationship between cost object and cost.*

ii) *Benefits received – overheads are to be apportioned to the various cost centres in proportion to the benefits received by them.*

Stage – II: Apportionment of Service Department Overheads to Production Departments or Cost Centers (Secondary Distribution): *In case of multi-product environment, there are common service cost centers which are providing services to the various production cost centers and other service cost centers. The second stage is to apportion the costs of service cost centers to production cost centers on an equitable basis. This re-assignment or re-apportionment of overhead costs of service departments (accumulated through direct allocation or primary distribution) to production departments or cost centers is called the secondary distribution. The para 5.5 explains the 'Apportionment of Overheads on Non-reciprocal basis, whereas Para 5.4 of the standard recommends any one of the following three methods :*

I. *Repeated Distribution Method*

II. *Trial & Error Method*

III. *Simultaneous Equation Method*

Stage – III: Absorption of Overhead Costs of Production Cost Centers: *The last stage is to spread overheads to different products or output produced by respective production cost centers. This allotment of overheads to cost units is also termed as 'overhead absorption'. In other words, expenses pertaining to a production cost center are finally charged to or absorbed in the cost of products passing through respective production cost centers and each unit of product coming out from the respective production center includes an equitable share of the total overhead cost of that cost center. Para 5.8 of the standard recommends the following bases for absorption of Production overheads from production cost centers to products or services :*

Bases of denominator	*Applicability*
Unit of Production	*When single product is produced or various products are similar in specification.*
Direct labour cost	*When conversion process is labour intensive and wage rates are substantially uniform*
Direct labour hour	*When conversion process is labour intensive*
Machine Hour or Vessel Occupancy or Reaction Hour or Crushing Hour etc	*When production mainly depends on performance of the base*

Para 5.7 further provides that overheads shall be analyzed into variable overheads and fixed overheads. The variable overheads shall be absorbed on the basis of actual capacity utilisation. The fixed production overheads and other similar item of fixed costs such as quality control cost shall be absorbed in the production cost on the basis of the normal capacity or actual capacity utilization of the plant, whichever is higher. In case of less production than normal, under-absorption of overheads shall be adjusted with Costing Profit & Loss Account. In case of higher production than normal, the over-absorption of overheads shall also be adjusted with Costing Profit & Loss Account.

Similarly, Administrative overheads are to be further analyzed into two – one for production activities and other for sales and distribution activities. on rational basis. Administrative overheads relating to production activities are to be apportioned to different production cost centers on the basis conversion costs of production cost centers. The apportioned overheads are absorbed to products on the basis of the normal capacity or actual capacity, whichever is higher.However, in case of under-absorption or over-absorption of administrative overheads relating to production, the same shall also be adjusted with Costing Profit & Loss Account.

As regards, selling overheads and distribution overheads, the items of selling overheads and distribution overheads, which can be directly identified should be absorbed to products or services. The remaining part of selling and distribution overhead along with the with share of administration overheads relating to selling and distribution activities should be apportioned to various products or jobs or services on the basis of net actual sales value (i.e. Gross sales value less excise duty, sales tax and other government levies). The CAS 3 as issued by ICWAI is reproduced as under:

CAS - 3

COST ACCOUNTING STANDARD ON "OVERHEADS"

The following is the text of the COST ACCOUNTING STANDARD 3 (CAS- 3) issued by the Council of the Institute of Cost and Works Accountants of India on "Overheads". The standard deals with the method of collection, allocation, apportionment and absorption of overheads" In this Standard, the standard portions have been set in bold italic type. These should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 In Cost Accounting the analysis and collection of overheads, their allocation and apportionment to different cost centres and absorption to products or services plays an important role in determination of cost as well as control purposes. A system of better distribution of overheads can only ensure greater accuracy in determination of cost of products or services. It is, therefore, necessary to follow standard practices for allocation, apportionment and absorption of overheads for preparation of cost statements.

2. Objective

2.1 The standard is to prescribe the methods of collection, allocation, apportionment of overheads to different cost centres and absorption thereof to products or services on a consistent and uniform basis in the preparation of cost statements and to facilitate inter-firm and intra-firm comparison.

2.2 The standardization of collection, allocation, apportionment and absorption of overheads is to provide a scientific basis for determination of cost of different activities, products, services, assets, etc.

2.3 The standard is to facilitate in taking commercial and strategic management ` decisions such as resource allocation, product mix optimization, make or buy decisions, price fixation etc.

2.4 The standard aims at ensuring better disclosure requirement and transparency in the cost statement.

3. Scope

3.1 The standard should be followed for treatment of overheads by all enterprises including companies covered under Cost Accounting Records Rules issued in pursuant to Sec 209(1)(d) of the Companies Act, 1956 or under the provisions of any other Act, Rules and Regulations.

3.2 The standard shall be applied in Cost and Management Accounting practices relating to :

(a) Cost of products, services or activities

(b) Valuation of stock

(c) Transfer pricing

(d) Segment Performance

(e) Excise / Custom duty, VAT, Income Tax, Service Tax and other levies, duties and abatement fixation

(f) Cost statements for any other purpose

4. DEFINITIONS

4.1 Overheads – Overheads comprise of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object in an economically feasible way.

Overheads are to be classified on the basis of functions to which the overheads are related (Refer to ' Classification of cost' – CAS-1), viz

- ***Production overheads***
- ***Administrative overheads***
- ***Selling overheads***
- ***Distribution overheads***

Overheads may also be classified on the basis of behaviour such as variable overheads, semi-variable overheads and fixed overheads.

Variable overheads comprise of expenses which vary in proportion to the change of volume of production. For example, cost of utilities etc.

Fixed overheads comprise of expenses whose value do not change with the change in volume of production such as salaries, rent etc.

Semi-variable overheads are partly affected by change in the production volume. They are further segregated into variable overheads and fixed overheads

Any items of overheads arising out of abnormal situation in business activity should not be treated as overheads. They are charged to Costing Profit and Loss Account. Items not related to business activities such as donation, loss / profit on sale of assets etc. are also not to be treated as overheads.

Borrowing cost and other financial charges including foreign exchange fluctuations will not form the part of overheads.

4.2 Collection of Overheads - Collection of overheads means the pooling of indirect items of expenses from books of account and supportive/ corroborative records in logical groups having regards to their nature and purpose.

Overheads are collected on the basis of pre-planned groupings, called cost pools. Homogeneity of the cost components in respect of their behaviour and character is to be considered in developing the cost pool. Variable and fixed overheads should be collected in separate cost pools under a cost centre. A great degree of homogeneity in the cost pools are to be maintained to make the apportionment of overheads more rational and scientific. A cost pool for maintenance expenses will help in apportioning them to different cost centres which use the maintenance service.

4.3 Allocation of overheads – Allocation of overheads is assigning a whole item of cost directly to a cost centre.

An item of expense which can be directly related to a cost centre is to be allocated to the cost centre. For example, depreciation of a particular machine should be allocated to a particular cost centre if the machine is directly attached to the cost centre.

4.4 Apportionment of overhead - Apportionment of overhead is distribution of overheads to more than one cost centre on some equitable basis.

When the indirect costs are common to different cost centres, these are to be apportioned to the cost centres on an equitable basis. For example, the expenditure on general repair and maintenance pertaining to a department can be allocated to that department but has to be apportioned to various machines (Cost Centres) in the department. If the department is involved in the production of a single product, the whole repair & maintenance of the department may be allocated to the product.

4.5 Primary and Secondary Distribution of Overheads :

In case of multi-product environment, there are common service cost centres which are providing services to the various production cost centres and other service cost centres. The costs of services are required to be apportioned to the relevant cost centres. First step to be followed is to apportion

the overheads to different cost centres and then second step is to apportion the costs of service cost centres to production cost centres on an equitable basis. The first step is termed as primary distribution and the second step is termed as secondary distribution of overheads.

4.6 Absorption of overheads - Absorption of overheads is charging of overheads from cost centres to products or services by means of absorption rates for each cost center which is calculated as follows :

$$\text{Overhead absorption Rate} = \frac{\text{Total overheads of the cost centre}}{\text{Total quantum of base}}$$

The base (denominator) is selected on the basis of type of the cost centre and its contribution to the products or services, for example, machine hours, labour hours, quantity produced etc.

Overhead absorbed = Overhead absorption rate x units of base in product or service

4.7 Normal Capacity is the production achieved or achievable on an average over a period or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance. (CAS-2)

5. Apportionment And Absorption of Production Overheads

5.1 Overheads are to be apportioned to different cost centres based on following two principles :

i) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost. Apportionment of overheads based on this criterion ensures better rationality as it is guided by the relationship between cost object and cost.

ii) Benefits received – overheads are to be apportioned to the various cost centres in proportion to the benefits received by them.

5.2 Primary Distribution of overheads :

Basis of primary apportionment of items of production overheads is to be selected to distribute them among the cost centres following the above two principles as given above in 5.1.

Basis of apportionment must be rational to distribute overheads. Once the base is selected, the same is to be followed consistently and uniformly. However, change in basis for apportionment can be adopted only when it is considered necessary due to change in circumstances like change in technology, degree of mechanization, product mix, etc. In case of such changes, proper disclosure in cost records is essential.

Examples of basis of primary distribution of some items of production overheads

Item of Cost	Basis of Apportionment
Power	(H.P. rating of Machines x hours x LF*
Fuel	Consumption rate x hour
Jigs, tools & fixtures	Machine hours or Man hours
Crane hire charges	Crane hours or weight of materials handled
Supervisors’ salary & fringe benefits	Number of employees
Labour welfare cost	Number of employees
Rent & rates	Floor or Space area
Insurance	Value of fixed asset
Depreciation	Value of fixed asset

* LF = Motor Load Factor

5.3 Secondary Distribution of Overheads :

Secondary distribution of overheads may be done by following either Reciprocal basis or Non-Reciprocal Basis. While reciprocal basis considers the exchange of service among the service departments, non-reciprocal basis considers only one directional service flow from a service cost centre to other production cost centre(s).

5.4 Secondary Apportionment of Overheads on Reciprocal Basis :

The services rendered by certain service cost centres are also utilized by other service cost centres. In reciprocal secondary distribution, the cost of service cost centres are apportioned to production cost centres as well as other service cost centres. In such case, any one of the following three methods may be followed :

- *I. Repeated Distribution Method*
- *II. Trial & Error Method*
- *III. Simultaneous Equation Method*

5.4.1 Repeated Distribution Method :

Steps to be followed under this method are :

- *i) The proportion at which the costs of a service cost centres are to be distributed to production cost centres and other service cost centres are determined.*
- *ii) Costs of first service cost centres are to be apportioned to production cost centres and service cost centres in the proportion as determined in step (i).*
- *iii) Similarly, the cost of other service cost centres are to be apportioned.*
- *iv) This process as stated in (ii) and (iii) are to be continued till the figures remaining undistributed in the service cost centres are negligibly small. The negligible small amount left with service centre may be distributed to production cost centres.*

For example, refer to Exhibit 1

5.4.2 Trial and Error Method :

This method is to be followed when the question of distribution of costs of service cost centres which are interlocked among themselves arises. In the first stage, gross costs of services of service cost centres are determined and then in the second stage, costs of service centres are apportioned to production cost centres. Steps to be followed :

- *i) The proportion at which the costs of a service cost centre to be distributed to production cost centres and other service cost centres is determined.*
- *ii) Cost of first service cost centre is distributed to the other service centres in the proportion of service they received from the first as assessed in step (i).*
- *iii) In the next step, total cost of second service cost centre so arrived has to be distributed to the other service centres in the proportion of service they received from the second as assessed in step (i).*

iv) ***Similarly, the cost of other service cost centres are to be apportioned to the service cost centres.***

v) ***This process as described in (iii) and (iv) is to be continued till the figures remaining undistributed in the service cost centres are negligibly small.***

vi) ***At the last, total cost of service cost centres to be distributed to production cost centres.***

For example, refer to Exhibit 2

5.4.3 Simultaneous Equation Method:

The simultaneous equation method is to be adopted to take care of secondary distribution of cost of service cost centres to production cost centres with the help of mathematical formulation and solution. Steps to be followed:

i) ***Proportion of service benefits received by different cost centres from a cost centre are assessed on the basis of records***

ii) ***The same ratios are used as coefficients in the equations framed for apportionment of cost of service cost centres to production cost centres.***

iii) ***Solution of the equations gives the cost of service cost centres.***

iv) ***Cost of service cost centres to be distributed to production cost centres.***

For example, refer to Exhibit 3

5.5 Secondary Apportionment of Overheads on Non-Reciprocal basis

In non-reciprocal secondary distribution, the costs of service cost centres are apportioned to the production cost centres. Steps involved are :

i) ***The cost of first service cost centre is apportioned on a suitable basis to production cost centres.***

ii) ***The next step is to apportion the cost of second service centre to the production cost centres as indicated in stage (i).***

iii) ***The process is to be continued till the costs of all service cost centres are apportioned.***

For example, refer to Exhibit 4

5.6 Common bases for absorption of Production overheads from production cost centres to products or services :

Bases of denominator	*Applicability*
Unit of Production	*When single product is produced or various products are similar in specification.*
Direct labour cost	*When conversion process is labour intensive and wage rates are substantially uniform*
Direct labour hour	*When conversion process is labour intensive*
Machine Hour or Vessel Occupancy or Reaction Hour or Crushing Hour etc	*When production mainly depends on performance of the base*

5.7 Absorption of Production Overheads and production capacity :

Overheads shall be analysed into variable overheads and fixed overheads.

The variable production overheads shall be absorbed to products or services based on actual capacity utilisation.

The fixed production overheads and other similar item of fixed costs such as quality control cost shall be absorbed in the production cost on the basis of the normal capacity or actual capacity utilization of the plant, whichever is higher.

In case of less production than normal, under-absorption of overheads shall be adjusted with Costing Profit & Loss Account. In case of higher production than normal, the over-absorption of overheads shall also be adjusted with Costing Profit & Loss Account.

5.8 Absorption of Production overheads :

Production Overheads absorption rate for each cost centre is to be determined with the help of quantum base as indicated in 5.6 above and the formula as indicated below :

$$\text{Fixed overheads absorption rate} = \frac{\text{Fixed overheads}}{\text{Normal or actual quantum of base, whichever is higher}}$$

$$\text{Variable overheads absorption rate} = \frac{\text{Variable overheads}}{\text{Actual quantum of base}}$$

5.9 A pre-determined rate may be used on a provisional basis for internal management decision-making such as cost estimates for quotation, fixation of selling price etc. These rates are to be calculated for each cost centre for a particular period. Budgeted overheads for the respective cost centres for the period concerned are to be taken as numerator and budgeted normal base for the period as denominator for determining the rate.

$$\text{Budgeted normal base for the period} = \frac{\text{Budgeted Overheads for the period}}{\text{Actual quantum of base}}$$

The amount of total overheads absorbed by a product, service or activity will be the sum total of the overheads absorbed from individual cost centres on pre-determined basis. The difference between overheads absorbed on pre-determined basis and the actual overheads incurred is the under- or over-absorption of overheads.

The under- or over- absorption of overheads is mainly due to variation between the estimation and actual.

6. Apportionment And Absorption Of Administrative Overheads

6.1 Administrative overheads include the following items of cost :

Printing and stationery, other office supplies

Employees cost – salaries of administrative staff

Establishment expenses – Office rent & rates, insurance, depreciation of office building and other assets, legal expenses, audit fees, bank charges etc.

6.2 Administrative overheads are to be collected in different cost pools such as :

- General Office
- Personnel department
- Accounts department
- Legal department
- Secretarial department etc

6.3 Administrative overheads are to be further analysed into two – one for production activities and other for sales and distribution activities. Costs collected under the cost pools indicated in 6.2 above are to be distributed to administrative overheads relating to production activities and administrative overheads relating to selling and distribution activities on rational basis for each cost pool.

6.4 Administrative overheads relating to production activities are to be apportioned to different production cost centres on the basis conversion costs of production cost centres. The apportioned overheads are absorbed to products on the basis of the normal capacity or actual capacity, whichever is higher.

In case of under-absorption or over-absorption of administrative overheads relating to production, the same shall also be adjusted with Costing Profit & Loss Account.

7. Apportionment And Absorption Of Selling Overheads And Distribution Overheads

7.1 The selling overheads and distribution overheads are collected under different cost pools such as:

Selling Overheads :

(i) Sales Employees cost

(ii) Rent

(iii) Traveling expenses

(iv) Warranty claim

(v) Brokerage & Commission

(vi) Advertisement relating to sales and sales promotion

(vii) Sales incentive

(viii) Bad debt etc

Distribution Overheads :

(i) Secondary Packaging

(ii) Freight & forwarding

(iii) Warehousing & storage

(iv) Insurance etc.

7.2 *Some items of selling overheads and distribution overheads are directly identified and absorbed to products or services and remaining part of selling and distribution overhead along with the with share of administration overheads relating to selling and distribution activities are to be apportioned to various products or jobs or services on the basis of net actual sales value (i.e. Gross sales value less excise duty, sales tax and other government levies).*

8. *Presentation And Disclosure:*

8.1 *Once the basis of collection, allocation, apportionment and absorption for different production cost centres are selected, the same shall be followed consistently and uniformly*

8.2 *Change in basis for collection, allocation, apportionment and absorption can be adopted only when it is compelled by the change in circumstances like change in technology, refinement and improvement in the basis etc and the change would provide more scientific approach. In case of such changes, proper disclosure in cost records is essential..*

8.3 *Any change in basis for collection, allocation, apportionment and absorption which has a material effect on the cost of the product should be disclosed in the cost statements. Where the effect of such change is not ascertainable wholly or part*ly, the fact should be indicated in the cost statement.

Exhibit 1

Reciprocal Overheads Apportionment : Repeated Method

	Production Department			Service Department	
	Machine	Assembly	Finishing	Stores	Repair
Ratio of apportionment from Stores	50%	20%	15%		15%
Ratio apportionment from Repair	40%	35%	15%	10%	
Distribution from					
Primary Distribution	35500.00	31900.00	14800.00	5000.00	6000.00
Stores Dept.	2500.00	1000.00	750.00	-5000.00	750.00
Total	38000.00	32900.00	15550.00	0.00	6750.00
Repairs & Maintenance Dept	2700.00	2362.50	1012.50	675.00	-6750.00
Total	40700.00	35262.50	16562.50	675.00	0.00
Stores Dept.	337.50	135.00	101.25	-675.00	101.25
Total	41037.50	35397.50	16663.75	0.00	101.25
Repairs & Maintenance Dept	40.50	35.44	15.19	10.13	-101.25
Total	41078.00	35432.94	16678.94	10.13	0.00
Stores Dept.	5.06	2.03	1.52	-10.13	1.52
Total	41083.06	35434.96	16680.46	0.00	1.52
Repairs & Maintenance Dept	0.61	0.53	0.23	0.15	-1.52
Total	41083.67	35435.49	16680.68	0.15	0.00
Stores Dept.	0.10	0.03	0.02	-0.15	0.00
Total	41083.77	35435.52	16680.71	0.00	0.00

Exhibit 2

Reciprocal Overhead Apportionment : Trial & Error Method

	Production Department			Service Department	
	Machine	Assembly	Finishing	Stores	Repair
Ratio of apportionment from Stores	50%	20%	15%		15%
Ratio of apportionment from Repair	40%	35%	15%	10%	
Distribution from					
Primary Distribution	35500.00	31900.00	14800.00	5000.00	6000.00
Distribution between service centres					
Stores Dept.				0.00	750.00
Total				5000.00	6750.00
Repairs & Maintenance To stores				675.00	0
Stores Dept. to Repair & Maint				0.00	101.25
Repairs & Maintenance To stores				10.13	0.00
Stores Dept. to Repair & Maint				0.00	1.52
Repairs & Maintenance To stores				0.15	0.00
Stores Dept. to Repair & Maint				0.00	0.02
Gross cost of service cost centres				5685.28	6852.79
Stores to Production cost centres	2842.63	1137.06	852.79	-5685.28	
Repairs & Maint to Production centres	2741.14	2398.46	1027.92		-6852.79
Total	41083.77	35435.52	16680.71	0	0

Exhibit 3

Reciprocal Overhead Apportionment : Simultaneous Equation Method

	Production Departments			Service Departments	
	Machine	Assembly	Finishing	Stores	Repair
Ratio of apportionment from Stores	50%	20%	15%		15%
Ratio of apportionment from Repair	40%	35%	15%	10%	
Distribution from					
Primary Distribution	35500.00	31900.00	14800.00	5000.00	6000.00

Let x, y be Store Dept and Repair & Maintenance Dept expenses respectively.

$x - 0.10y = 5000$

$-0.15x + y = 6000$

Solving $x = 5685.28$, $y = 6852.79$

Now, distribution of expenses will be as follows :

	Production Departments			Service Departments	
	Machine	Assembly	Finishing	Stores	Repair
Ratio of apportionment from Stores	50%	20%	15%		15%
Ratio of apportionment from Repair	40%	35%	15%	10%	
Amounts from Primary Distribution	35500.00	31900.00	14800.00	5685.28	6852.79
Stores to Production cost centres	2842.63	1137.06	852.79	-5685.28	
Repairs & Maint to Production centres	2741.14	2398.46	1027.92		-6852.79
Total	41083.77	35435.52	16680.71	0	0

Exhibit 4

Non-Reciprocal Overheads Apportionment

Primary Distribution

			Production Departments			Service Departments	
Expenses	Basis of allocation / appointment	Total (Rs.)	Machine Shop	Assembly Shop	Finishing Dept	Stores	Repairs & Maint.
Consumable stores	Direct Materials	15,400	5,200	6,000	2,000	600	1,600
Supervision	Direct Wages	22,800	7,900	5,100	6,100	2,200	1,500
Rent & Rates	Area	10,000	3,000	2,000	2,500	1,000	1,500
Insurance	Asset Value	2,000	800	900	200	50	50
Depreciation	Assset Value	30,000	12,000	13,500	3,000	750	750
Power	H.PxHoursx LF.	9,000	5,400	3,600	—	—	—
Light & Heat	Area	4,000	1,200	800	1,000	400	600
Total		93,200	35,500	31,900	14,800	5,000	6,000

Secondary Distribution

			Production Departments			Service Departments	
Expenses	Basis of allocation / appoint-ment	Total (Rs.)	Machine Shop	Assembly Shop	Finishing Dept	Stores	Repairs & Maint.
Primary dist. (earlier Table)		93,200	35,500	31,900	14,800	5,000	6,000
Stores	Direct Material (9 : 6 : 5)		2,250	1,500	1,250	- 5,000	
Repairs & Maint.	Direct (2 : 3 : 1)		2,000	3,000	1,000		- 6000
		93,200	39,750	36,400	17,050	0	0

Exhibit 5 : Distribution of Administrative Overheads

Item	Total	Product 1 (Rs. lakh)	Product 2 (Rs. lakh)	Product 3 (Rs. lakh)
1. Material consumed	100.0	37.0	33.0	30.0
2. Direct Wages & Salaries	30.0	15.0	6.0	9.0
3 Direct Expense	20.0	5.0	6.0	9.0
4. Production Overheads (absorbed from cost centres)	30.0	10.0	8.0	12.0
5. Conversion Cost	80.0	30.0	20.0	30.0
6. Administrative Overheads	30.0			
7. Administrative Overheads (Production) appointed and absorbed	20.0	7.5	5.0	7.5
8. Administrative Overheads (Selling & Distribution)	10.0			
9. Selling and Distribution Overheads	40.0			
10. Total Selling and distribution Overheads (8+9	50.0	20.0	13.7	16.3
11. Cost of Sales	250.0	94.5	71.7	83.8
12. Net Sales Value (excluding Taxes & Duties)	300.0	120.0	80.0	100.0

Note : Administrative Overheads (6) have been segregated to production activities and Selling and Distribution activities in the ratio of Conservation cost (5) and Selling & Distb. Overheads (9) (80:40). Administrative overheads relating to production activities (7) have been apportioned to three products in the ratio of their conversion costs (3:2:3) and absorbed on the basis of actual capacity which is in this case higher than normal capacity. Total Selling and Distribution Overheads (10) are absorbed to products in the ratio of their net sales value (120:80:100).

CAS - 4
COST ACCOUNTING STANDARD ON
"COST OF PRODUCTION FOR CAPTIVE CONSUMPTION"

4.12 Cost Accounting Standard 4 : "Cost of Production for Captive Consumption"

COMMENTS (CAS 4) :

4.12.1 *COST ACCOUNTING STANDARD 4 (CAS 4) regarding 'Captive Consumption' has been issued mainly to bring uniformity in the principles and methods used for determining the cost of production of excisable goods used for captive consumption. The cost statement prepared based on this standard will be used for determination of assessable value of excisable goods used for captive consumption. It is envisaged that the standard and its disclosure requirement will provide better transparency in the valuation of excisable goods used for captive consumption.*

4.12.2 *CBEC, vide its circular No. 643/34/2002-CX dated 1-7-2002, had earlier clarified that if same goods are partly sold by assessee and partly consumed captively, goods captively consumed should be assessed on basis of rule 8. The reason is, as per new section 4, transaction value has to be determined separately for each removal. In case goods are sent to sister concerns for further processing valuation should be will be done on the basis of cost of production plus 15%. [Proviso to rule 9].In other words, For captive consumption in one's own factory, valuation would be done as per rule 8 of the Valuation Rules i.e. the assessable value will be 115% of the "cost of production" of the goods. If the same goods are partly sold by the assessee and partly consumed captively, the goods sold would be assessed on the basis of "transaction value" [provided they meet the conditions of sec.4(1)(a)] and the goods captively consumed would be valued as per Rule 8 of the Valuation Rules.*

4.12.3 *The Central Board of Excise & Customs has subsequently issued a Circular No 692/8/2003-Cx dated 13th February 2003 clarifying that the Board had earlier vide Circular No.354/81/2000-TRU dated 30.6.2000 (para 21) indicated that for valuing goods which are captively consumed, the general principles of costing would be adopted for applying Rule 8. The Board had subsequently interacted with the Institute of Cost & Works Accountants of India (ICWAI) for developing costing standards for costing of captively consumed goods. The circular further provides that cost of production of captively consumed goods will henceforth be done strictly in accordance with CAS-4. The validity of this standard has been accepted by Supreme Court also in the case of Commissioner of Central Excise, Pune vs. Cadbury India Limited [2006 (200) ELT 353]. Even though the circular issued by the Central Excise refers to CAS 4 only, CAS 4 is incomplete without CAS 1 (Classification of Cost), CAS 2 (Capacity Determination) and CAS 3 (Collection, Allocation, Apportionment and Absorption of overheads). Therefore, practically it can be concluded that cost of production of captively consumed goods is required to be determined taking into account CAS 1, CAS 2, CAS 3 and CAS 4 issued by ICWAI.*

4.12.4 *The term 'Cost of Production' for captive consumption has been defined in para 4.1 that,'Cost of production shall consist of Material Consumed, Direct Wages and Salaries, Direct Expenses, Works Overheads, Quality Control cost, Research and Development Cost , Packing cost, Administrative Overheads relating to production. To arrive at cost of production of goods dispatched for captive consumption, adjustment for Stock of work-in-Process, finished goods, recoveries for sales of scrap, wastage etc shall be made. In other* *words, 'cost of production' for captive consumption shall include all direct expenses (including packing cost, quality control cost and research & development cost), production overheads and proportionate share of administrative overheads.*

4.12.5 *Para 5.1 of the standard provides that the cost of material consumed shall consist of cost of material, duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement. Trade discount, rebates and other similar items will be deducted for determining the cost of materials. Cenvat credit, credit for countervailing customs duty, Sales Tax set off, VAT, duty draw back and other similar duties subsequently recovered/ recoverable by the enterprise shall also be deducted. Similarly, direct wages and salaries shall include house rent allowance, overtime, incentive payments and all other fringe benefits made to employees directly engaged in the manufacturing activities. The cost accounting standard further provides that the administrative overheads in relation to production activities shall be included in the cost of production. Administrative overheads in relation to activities other than manufacturing activities e.g. marketing, projects management, corporate office expenses etc. shall be excluded from the cost of production. Similarly, Interest and financial charges being a financial charge shall not be considered to be a part of cost of production. Like-wise sales overheads, advertisement expenses, bad-debts etc. shall also not be considered.*

4.12.6 *The cost of production as defined under the standard shall also include the cost of 'quality control' and 'research and development' also. The quality control expenses shall include salaries & wages relating to employees engaged in quality control activity and other related expenses and the research and development cost incurred for development and improvement of the process or the existing product shall be included in the cost of production. If product is transferred/dispatched duly packed for captive consumption, cost of such packing shall be included. Packing cost includes both cost of primary and secondary packing required for transfer/ dispatch of the goods used for captive consumption.*

4.12.7 *If a production process results in more than one product being produced simultaneously or joint products are produced, joint costs are to be allocated between the products on a rational and consistent basis. In case by-products are produced, the net realisable value of by-products is credited to the cost of production of the main product. The production process may generate scrap or waste. Realized or realizable value of scrap or waste shall be credited to the cost of production. Similarly, miscellaneous income relating to production shall be adjusted in the calculation of cost of production, for example, income from sale of empty containers used for despatch of the captively consumed goods produced under reference. In case of moulds, tools, Dies & Patterns etc received free of cost, the amortization cost of such items shall be included in the cost of production.*

4.12.8 *The Cost Accounting standard also provides for the inclusion of landed cost of such input material, if any, whether of direct or indirect nature, including packing material supplied free of cost by the user of the captive product. However, the abnormal cost shall not form the part of cost of production. Abnormal costs have been defined as abnormal and non-recurring cost arising due to unusual or unexpected occurrence of events, such as heavy break down of plants, accident, market condition restricting sales below normal level, abnormal idle capacity, abnormal process loss, abnormal scrap and wastage, payments like VRS, retrenchment compensation, lay-off wages etc.*

4.12.9 *The disclosure requirements of the standard provide that if there is any change in cost accounting principles and practices during the concerned period which may materially affect the cost of production in terms of comparability with previous periods, the same should be disclosed. Similarly, if opening stock and closing stock of work -in-progress and finished goods are not readily available for certification purpose, the same should be disclosed.*

4.12.10 *Appendix – 1 provides the format for computing cost of production to be verified by the cost accountant. The CAS 4 as issued by ICWAI is reproduced as under:*

CAS - 4

COST ACCOUNTING STANDARD ON COST OF PRODUCTION FOR CAPTIVE CONSUMPTION

The following is the text of the COST ACCOUNTING STANDARD 4 (CAS-4) issued by the Council of the Institute of Cost and Works Accountants of India on "Cost of Production for Captive Consumption". The standard deals with determination of cost of production for captive consumption. In this Standard, the standard portions have been set in bold italic type. These should be read in the context of the background material which has been set in normal type.

1. Introduction

The Cost Accounting principle for determination of cost of production is well established. Similarly, rules for levy of excise duty on goods used for captive consumption are also well defined. Captive Consumption means the consumption of goods manufactured by one division and consumed by another division(s) of the same organization or related undertaking for manufacturing another product(s). Liability of excise duty arises as soon as the goods covered under excise duty are manufactured but excise duty is collected at the time of removal or clearance from the place of manufacture even if such removal does not amount to sale. Assessable value of goods used for captive consumption is based on cost of production. According to the Central Excise Valuation (Determination of Price of Excisable Goods) Rules 2000, the assessable value of goods used for captive consumption is 115% of cost of production of such goods, and as may be prescribed by the Government from time to time.

2. Objective

2.1 The purpose of this standard is to bring uniformity in the principles and methods used for determining the cost of production of excisable goods used for captive consumption.

2.2 The cost statement prepared based on standard will be used for determination of assessable value of excisable goods used for captive consumption.

2.3 The standard and its disclosure requirement will provide better transparency in the valuation of excisable goods used for captive consumption.

3. Scope

3.1 The standard is to be followed for determining the cost of production to arrive at an assessable value of excisable goods used for captive consumption.

3.2 Cost of production will include various cost components. They are already defined in Cost Accounting Standard-1 (' Classification of Cost' – CAS-1). Thus, this standard has to be read in conjunction with CAS-1.

4. Definitions

4.1 Cost of Production : Cost of production shall consist of Material Consumed, Direct Wages and Salaries, Direct Expenses, Works Overheads, Quality Control cost, Research and Development Cost , Packing cost, Administrative Overheads relating to production.

To arrive at cost of production of goods dispatched for captive consumption, adjustment for Stock of work-in-Process, finished goods, recoveries for sales of scrap, wastage etc shall be made.

4.2 Captive Consumption : Captive Consumption means the consumption of goods manufactured by one division or unit and consumed by another division or unit of the same organization or related undertaking for manufacturing another product(s).

4.3 Normal Capacity is the production achieved or achievable on an average over a period or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance. (CAS-2)

5. Determination Of Cost Of Production For Captive Consumption

To determine the cost of production for captive consumption, calculations of different cost components and adjustments are explained below :

5.1 Material Consumed

Material Consumed shall include materials directly identified for production of goods such as :

(a) indigenous materials

(b) imported materials

(c) bought out items

(d) self manufactured items

(e) process materials and other items

Cost of material consumed shall consist of cost of material, duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement. Trade discount, rebates and other similar items will be deducted for determining the cost of materials. Cenvat credit, credit for countervailing customs duty, Sales Tax set off, VAT, duty draw back and other similar duties subsequently recovered/ recoverable by the enterprise shall also be deducted.

5.2 Direct wages and salaries

Direct wages and salaries shall include house rent allowance, overtime and incentive payments made to employees directly engaged in the manufacturing activities.

Direct wages and salaries include fringe benefits such as :

(i) Contribution to provident fund and ESIS

(ii) Bonus/ ex-gratia payment to employees

(iii) Provision for retirement benefits such as gratuity and superannuation

(iv) Medical benefits

(v) Subsidised food

(vi) Leave with pay and holiday payment

(vii) Leave encashment

(viii) Other allowances such as children's education allowance, conveyance allowance which are payable to employees in the normal course of business etc.

5.3 Direct Expenses :

Direct expenses are the expenses other than direct material cost and direct employees costs which can be identified with the product.

Direct expenses include :

(i) Cost of utilities such as fuel, power, water, steam etc

(ii) Royalty based on production

(iii) Technical Assistance / know –how fees

(iv) Amortized cost of moulds, patterns, patents etc

(v) Job charges

(vi) Hire charges for tools and equipment

(vii) Charges for a particular product designing etc.

5.4 Works Overheads

Works overheads are the indirect costs incurred in the production process.

Works overheads include the following expenses:

(i) Consumable stores and spares

(ii) Depreciation of plant and machinery, factory building etc

(iii) Lease rent of production assets

(iv) Repair and maintenance of plant and machinery, factory building etc.

(v) Indirect employees cost connected with production activities

(vi) Drawing and Designing department cost.

(vii) Insurance of plant and machinery, factory building, stock of raw material & WIP etc

(viii) Amortized cost of jigs, fixtures, tooling etc

(ix) Service department cost such as Tool Room, Engineering & Maintenance, Pollution Control etc

5.5 Quality Control Cost

The quality control cost is the expenses incurred relating to quality control activities for adhering to quality standard. These expenses shall include salaries & wages relating to employees engaged in quality control activity and other related expenses.

5.6 Research and Development Cost

The research and development cost incurred for development and improvement of the process or the existing product shall be included in the cost of production.

5.7 Administrative Overheads

Administrative overheads needs to be analysed in relation to production activities and other

activities. Administrative overheads in relation to production activities shall be included in the cost of production. Administrative overheads in relation to activities other than manufacturing activities e.g. marketing, projects management, corporate office expenses etc. shall be excluded from the cost of production.

5.8 Packing Cost

If product is transferred/dispatched duly packed for captive consumption, cost of such packing shall be included.

Packing cost includes both cost of primary and secondary packing required for transfer/ dispatch of the goods used for captive consumption.

5.9 Absorption of overheads

Overheads shall be analysed into variable overheads and fixed overheads.

Variable Overheads are the items which change with the change in volume of production, such as cost of utilities etc.

Fixed overheads are the items whose value do not change with the change in volume of production such as salaries, rent etc.

The variable production overheads shall be absorbed in production cost based on actual capacity utilisation.

The fixed production overheads and other similar item of fixed costs such as quality control cost, research and development costs, administrative overheads relating to manufacturing shall be absorbed in the production cost on the basis of the normal capacity or actual capacity utilization of the plant, whichever is higher.

5.10 Valuation of Stock of work-in-progress and finished goods

Stock of work-in-progress shall be valued at cost on the basis of stages of completion as per the cost accounting principles. Similarly, stock of finished goods shall be valued at cost. Opening and closing stock of work-in-progress shall be adjusted for calculation of cost of goods produced and similarly opening and closing stock of finished goods shall be adjusted for calculation of goods despatched.

In case the cost of a shorter period is to be determined, where the figures of opening and closing stock are not readily available, the adjustment of figures of opening and closing stock may be ignored.

5.11 Treatment of Joint Products and By-Products

A production process may result in more than one product being produced simultaneously. In case joint products are produced, joint costs are allocated between the products on a rational and consistent basis. In case by-products are produced, the net realisable value of by-products is credited to the cost of production of the main product.

For allocation of joint cost to joint products, the sales values of products at the split off point i.e. when the products become separately identifiable may become the basis. Some other basis may be adopted. For example, in case of petroleum products, each product is assigned certain value based on its certain properties, may be calorific value and these values become the basis of apportionment of joint cost among petroleum products.

5.12 Treatment of Scrap and Waste

The production process may generate scrap or waste. Realized or realizable value of scrap or waste shall be credited to the cost of production.

In case, scrap or waste does not have ready market and it is used for reprocessing, the scrap or waste value is taken at a rate of input cost depending upon the stage at which such scrap or waste is recycled. The expenses incurred for making the scrap suitable for reprocessing shall be deducted from value of scrap or waste.

Illustration

A production process has three stages.

Stage	Input material cost	Processing cost	Total
	(Rs/ MT)	(Rs/MT)	(Rs/MT)
1	2000	500	2500
2	2500	1000	3500
3	3500	1000	4500

If during the production process at stage3, the scrap is produced and the same is recycled at stage2 after making an expenditure of Rs 200 per MT to make it suitable for re-processing at stage2, then scrap will be valued @ Rs (2500 – 200) i.e Rs 2300. If no expenditure is involved to make scrap re-usable, the scrap value will be @ Rs 2500. The scrap value for the scrap produced during a period calculated at the rate as explained above may be deducted to find out the cost of production for the period.

5.13 Miscellaneous Income

Miscellaneous income relating to production shall be adjusted in the calculation of cost of production, for example, income from sale of empty containers used for despatch of the captively consumed goods produced under reference.

5.14 Inputs received free of cost

In case any input material, whether of direct or indirect nature, including packing material is supplied free of cost by the user of the captive product, the landed cost of such material shall be included in the cost of production.

5.15 Moulds, Tools, Dies & Patterns etc received free of cost

The amortization cost of such items shall be included in the cost of production.

5.16 Interest and financial charges

Interest and financial charges being a financial charge shall not be considered to be a part of cost of production.

5.17 Abnormal and non-recurring cost

Abnormal and non-recurring cost arising due to unusual or unexpected occurrence of events, such

as heavy break down of plants, accident, market condition restricting sales below normal level, abnormal idle capacity, abnormal process loss, abnormal scrap and wastage, payments like VRS, retrenchment compensation, lay-off wages etc. The abnormal cost shall not form the part of cost of production.

6. Cost Sheet

The cost sheet should be prepared in the format as par Appendix – 1 or as near thereto as possible. The manufacturer will be required to maintain cost records and other books of account in a manner, which would facilitate preparation and verification of the cost of production. For manufacturers covered under the ambit of Section 209(1)(d) of the Companies Act, 1956, i.e., where Cost Accounting Records are statutorily required to be maintained, the Cost Accountant certifying the cost of production for captive consumption shall verify the correctness of the cost from these records. However, for manufacturers not covered under Section 209(1)(d) of the Companies Act, 1956, it is desirable that they also maintain cost accounting records in line with the records so prescribed as to facilitate determination and certification of cost of production.

7. Disclosure

(i) If there is any change in cost accounting principles and practices during the concerned period which may materially affect the cost of production in terms of comparability with previous periods, the same should be disclosed.

(ii) If opening stock and closing stock of work -in-progress and finished goods are not readily available for certification purpose, the same should be disclosed.

Appendix – 1

Name of the Manufacturer :

Address of the Manufacturer :

Registration No of Manufacturer :

Description of product captively consumed:

Excise Tariff Heading :

Statement of Cost of Production of _____________ manufactured / to be manufactured during the period _____________

		Qty	
Q1	Quantity Produced (Unit of Measure)		
Q2	Quantity Despatched (Unit of Measure)		
	Particulars	Total Cost (Rs)	Cost/unit (Rs)
1.	Material Consumed		
2.	Direct Wages and Salaries		
3.	Direct Expenses		
4.	Works Overheads		
5.	Quality Control Cost		
6.	Research & Development Cost		
7.	Administrative Overheads (relating to production activity)		
8.	Total (1 to 7)		
9.	Add : Opening stock of Work - in –Progress		
10.	Less : Closing stock of Work -in- Progress		
11.	Total (8+9-10)		
12.	Less : Credit for Recoveries/Scrap/By-Products / misc income		
13.	Packing cost		
14.	Cost of production (11 - 12 + 13)		
15.	Add: Inputs received free of cost		
16.	Add: Amortised cost of Moulds, Tools, Dies & Patterns etc received free of cost		
17.	Cost of Production for goods produced for captive consumption (14 + 15 + 16)		
18.	Add : Opening stock of finished goods		
19.	Less : Closing stock of finished goods		
20.	Cost of production for goods despatched (17 + 18 - 19)		

Seal & Signature of Company's

Authorised Representative

I/We, have verified above data on test check basis with reference to the books of account, cost accounting records and other records. Based on the information and explanations given to me/us, and on the basis of generally accepted cost accounting principles and practices followed by the industry, I /We certify that the above cost data reflect true and fair view of the cost of production.

Date : Seal & Signature of Cost Accountant

Place : Membership No.

CAS - 5
COST ACCOUNTING STANDARD ON "DETERMINATION OF AVERAGE (EQUALIZED)
COST OF TRANSPORTATION "

4.13 Cost Accounting Standard 5 : "Determination of Average (Equalized) Cost of Transportation"

COMMENTS (CAS 5) :

4.13.1 COST ACOUNTING STANDARD 5 (CAS 5) regarding 'determination of average (equalized) cost of transportation is the fifth cost accounting standard issued by ICWAI. The object of CAS 5 is stated to be to bring uniformity in the application of principles and methods used in the determination of averaged/ equalized transportation cost. It also aims at prescribing a system to be followed for maintenance of records for collection of cost of transportation, its allocation/ apportionment to cost centers, locations or products.

4.13.2 The Finance Act 2003 specified the certification requirement of transportation cost for claiming deduction while arriving at the assessable value of excisable goods cleared for home consumption/ export. It was, therefore felt that there is a need to standardize the record keeping of expenses relating to transportation and computation of transportation cost. In addition, this standard is envisaged to be used for working out claim for equalization freight subsidy under Fertilizer Industry Coordination Committee besides administered price mechanism of freight cost element. This standard is valid for Insurance claim valuation also

4.13.3 The term 'Cost of Transportation' has been defined to comprises of the cost of freight, cartage, transit insurance and cost of operating fleet and other incidental charges whether incurred internally or paid to an outside agency for transportation of goods but does not include detention and demurrage charges. However, abnormal costs and non-recurring costs relating to transportation, if any, are to be excluded from the computation of average transportation cost. Similarly, Penalty, detention charges, demurrage and cost related to abnormal break down will not be included in transportation cost.

4.13.4 This 'Cost of transportation' can be classified as inward transportation cost or outward transportation Cost. Inward Transportation cost is the transportation expenses incurred in connection with materials /goods *received at factory or place of use or sale/removal and Outward Transportation cost is the transportation expenses incurred in connection with the sale or delivery of materials or goods from factory or depot or any other place from where goods are sold / removed. Separate records shall be maintained with respect to inward transportation and outward transportation cost.*

4.13.5 *The term "Equalized Transportation" has been defined as average transportation cost incurred during a specified period. Equalised freight means average freight. The standard requires the detailed record to be maintained w.r.t collection, allocation and apportionment of transportation cost as detailed in para 5 of the standard. It provides that proper records shall be maintained for recording the actual cost of transportation showing each element of cost such as freight, cartage, transit insurance and others after adjustment for recovery of transportation cost. In case of a manufacturer having his own transport fleet, proper records shall be maintained to determine the actual operating cost of vehicles showing details of various elements of cost, such as salaries and wages of driver, cleaners and others, cost of fuel, lubricant grease, amortized cost of tyres and battery, repairs and maintenance, depreciation of the vehicles, distance covered and trips made, goods hauled and transported to the depot. Similarly, in case of hired transport charges incurred for dispatch of goods, complete details shall be recorded as to date of dispatch, type of transport used, description of the goods, destination of buyer, name of consignee, challan number, quantity of goods in terms of weight or volume, distance involved, amount paid, etc.*

4.13.6 *The standard recommends the treatment of transportation cost also. It provides that the inward transportation costs shall form the part of the cost of procurement of materials which are to be identified for proper allocation/ apportionment to the materials / products. However, outward transportation cost shall form the part of the cost of sale and shall be allocated / apportioned to the materials and goods on a suitable basis.*

4.13.7 *The following basis may be used, in order of priority, for apportionment of outward transportation cost depending upon the nature of products, unit of measurement followed and type of transport used :*

- *i) Weight*
- *ii) Volume of goods*
- *iii) Tonne-Km*
- *iv) Unit / Equivalent unit*
- *v) Value of goods*
- *vi) Percentage of usage of space*

4.13.8 *The standard recommends that for determining the transportation cost per unit, distance shall be factored in to arrive at weighted average cost. However, once a basis of apportionment is adopted, the same should be followed consistently.*

4.13.9 *The standard provides for the format of the cost sheets to be prepared and presented in a form as per Appendices 1,2 and 3 or as near thereto. Appendix 1 and Appendix 2 show the details of information to be maintained for compilation of transport cost for own fleet and hired transportation charges respectively. Appendix 1 is applicable where the organization is having its own fleet. This Cost Accounting Standard shall be applied for calculation of cost of transportation, required under any statute or regulations or for any other purpose. For example, this standard can be used for :*

(a) determination of average transportation cost for claiming the deduction for arriving at the assessable value of excisable goods

(b) *Insurance claim valuation*

(c) *Working out claim for freight subsidy under Fertilizer Industry Coordination Committee*

(d) *Administered price mechanism of freight cost element*

(e) *Determination of inward freight costs included or to be included in the cost of purchases attributable to the acquisition.*

(f) *Computation of freight included in the value of inventory for accounting on inventory or valuation of stock hypothecated with Banks / Financial Institution, etc.*

The standard further provides that transportation cost for goods involved exclusively for trading activities shall not be included for claiming any deduction calculating assessable value of excisable goods cleared for home consumption. The CAS 5 as issued by ICWAI is re-produced as under:

CAS - 5

COST ACCOUNTING STANDARD ON DETERMINATION OF AVERAGE (EQUALIZED) COST OF TRANSPORTATION

The following is the text of the Cost Accounting Standard 5 (CAS-5) issued by the Council of the Institute of Cost & Works Accountants of India on "Determination of Average (Equalized) Cost of Transportation". This standard deals with the determination of average transportation cost of a product. In this standard the standard portions have been set in bold italic type. These are to be read in the context of the background material which has been set in the normal type.

1. Introduction

1.1 *The cost accounting principles for tracing/identifying an element of cost, its allocation/apportionment to a product or service are well established. Transportation cost is an important element of cost for procurement of materials for production and for distribution of product for sale. Therefore, Cost Accounting Records should present transportation cost separately from the other cost of inward materials or cost of sales of finished goods. The Finance Act 2003 also specifies the certification requirement of transportation cost for claiming deduction while arriving at the assessable value of excisable goods cleared for home consumption/ export. There is a need to standardize the record keeping of expenses relating to transportation and computation of transportation cost.*

2. Objective

2.1 *To bring uniformity in the application of principles and methods used in the determination of averaged/ equalized transportation cost.*

2.2 *To prescribe the system to be followed for maintenance of records for collection of cost of transportation, its allocation/apportionment to cost centres, locations or products.*

For example, transportation cost needs to be apportioned among excisable, exempted, non-excisable and other goods for arriving at the average of transportation cost of each class of goods.

2.3 *To provide transparency in the determination of cost of transportation.*

3. Scope

3.1 This standard should be applied for calculation of cost of transportation required under any statute or regulations or for any other purpose. For example, this standard can be used for :

(g) determination of average transportation cost for claiming the deduction for arriving at the assessable value of excisable goods

(h) Insurance claim valuation

(i) Working out claim for freight subsidy under Fertilizer Industry Coordination Committee

(j) Administered price mechanism of freight cost element

(k) Determination of inward freight costs included or to be included in the cost of purchases attributable to the acquisition.

(l) Computation of freight included in the value of inventory for accounting on inventory or valuation of stock hypothecated with Banks / Financial Institution, etc.

4. Definitions

The following terms are used in this standard with the meaning specified :

4.1 Cost of Transportation comprises of the cost of freight, cartage, transit insurance and cost of operating fleet and other incidental charges whether incurred internally or paid to an outside agency for transportation of goods but does not include detention and demurrage charges.

Explanation :

Cost of transportation is classified as inward transportation cost and outward transportation Cost.

4.2 Inward Transportation cost is the transportation expenses incurred in connection with materials /goods received at factory or place of use or sale/removal.

4.3 Outward Transportation cost is the transportation expenses incurred in connection with the sale or delivery of materials or goods from factory or depot or any other place from where goods are sold /removed

4.4 Freight is the charges paid or payable to an outside agency for transporting materials/ goods from one place to another place.

4.5 Cartage is the expenses incurred for movement of goods covering short distance for further transportation for delivery to customer or storage.

4.6 Transit insurance cost is the amount of premium to be paid to cover the risk of loss /damage to the goods in transit.

4.7 Depot is the bounded premises /place managed internally or by an agent, including consignment agent and C & F agent, franchisee for storing of materials/goods for further dispatch including the premises of Consignment Agent and C&F Agent for the purpose.

Depot includes warehouses, go-downs, storage yards, stockyards etc.

4.8 Equalized transportation cost means average transportation cost incurred during a specified period.

4.9 Equalized freight means average freight.

5. MAINTENANCE OF RECORDS FOR ASCERTAINING TRANSPORTATION COST

5.1 *Proper records shall be maintained for recording the actual cost of transportation showing each element of cost such as freight, cartage, and transit insurance and others after adjustment for recovery of transportation cost. Abnormal costs relating to transportation, if any, are to be identified and recorded for exclusion of computation of average transportation cost.*

5.2 In case of a manufacturer having his own transport fleet, proper records shall be maintained to determine the actual operating cost of vehicles showing details of various elements of cost, such as salaries and wages of driver, cleaners and others, cost of fuel, lubricant grease, amortized cost of tyres and battery, repairs and maintenance, depreciation of the vehicles, distance covered and trips made, goods hauled and transported to the depot.

5.3 In case of hired transport charges incurred for despatch of goods, complete details shall be recorded as to date of despatch, type of transport used, description of the goods, destination of buyer, name of consignee, challan number, quantity of goods in terms of weight or volume, distance involved, amount paid, etc.

5.4 Records shall be maintained separately for inward and outward transportation cost specifying the details particulars of goods despatched, name of supplier / recipient, amount of freight etc.

5.5 Separate records shall be maintained for identification of transportation cost towards inward movement of material (procurement) and transportation cost of outward movement of goods removed /sold for both home consumption and export.

5.6 Records for transportation cost from factory to depot and thereafter shall be maintained separately.

5.7 Records for transportation cost for carrying any material / product to job-workers place and back should be maintained separately so as include the same in the transaction value of the product.

5.8 Records for transportation cost for goods involved exclusively for trading activities shall be maintained separately and the same will not be included for claiming any deduction for calculating assessable value excisable goods cleared for home consumption.

5.9 Records of transportation cost directly allocable to a particular category of products should be maintained separately so that allocation in appendix –3 can be made.

5.10 For common transportation cost, both for own fleet or hired ones, proper records for basis of apportionment should be maintained.

5.11 Records for transportation cost for exempted goods; excisable goods cleared for export shall be maintained separately.

5.12 Separate records of cost for mode of transportation other than road like ship, air etc are to be maintained in appendix –2 which will be included in total cost of transportation.

6. TREATMENT OF COST

6.1 Inward transportation costs shall form the part of the cost of procurement of materials which are to be identified for proper allocation/ apportionment to the materials / products.

6.2 ***Outward transportation cost shall form the part of the cost of sale and shall be allocated / apportioned to the materials and goods on a suitable basis.***

Explanation:

Outward transportation cost of a product from factory to depot or any location of sale shall be included in the cost of sale of the goods available for sale.

6.3 ***The following basis may be used, in order of priority, for apportionment of outward transportation cost depending upon the nature of products, unit of measurement followed and type of transport used :***

(i) ***Weight***

(ii) ***Volume of goods***

(iii) ***Tonne-Km***

(iv) ***Unit / Equivalent unit***

(v) ***Value of goods***

(vi) ***Percentage of usage of space***

Once a basis of apportionment is adopted, the same should be followed consistently.

6.4 *For determining the transportation cost per unit, distance shall be factored in to arrive at weighted average cost.*

6.5 ***Abnormal and non-recurring cost shall not be a part of transportation cost.***

Explanation :

Penalty, detention charges, demurrage and cost related to abnormal break down will not be included in transportation cost.

7. COST SHEET

The cost sheets shall be prepared and presented in a form as per Appendices 1,2 and 3 or as near thereto. Appendix 1 and Appendix 2 show the details of information to be maintained for compilation of transport cost for own fleet and hired transportation charges respectively. Appendix 1 is applicable where the organization is having its own fleet.

The directly allocable cost of own fleet (outward) shall be identified against different categories of products as shown in Appendix 3 and same shall be indicated there. Similarly, total common cost of own fleet (outward) shall be apportioned to different categories of products as shown in Appendix 3 on a basis which should be specified. The basis of apportionment may be adopted depending on the nature of product as indicated in para 6.3. Similar approach shall also be applied for hired outward transport charges.

More columns may be required to be shown in Appendix 3 specifying different types of transactions. For example : Sale on specific rate basis, sale of waste, scrap, return from customer, goods sent for job work, goods received after job work etc.

Unit of Measurement (UM) may vary depending upon the nature of the product. For example, Number, MT, Meter, Litre etc.

Proper records shall be maintained to show separately the Transportation Cost relating to sending of jobs to job contractors/convertors and receipt back of processed jobs/converted materials.

An enterprise shall be required to maintain cost records and other books of account in a manner which would facilitate preparation and verification of cost of transportation and other related charges and its apportioning to various products.

8. TRANSACTION VALUE

'Transaction value' shall have the meaning assigned to it in Section 4 of The Central Excise Act, 1944 or Section 14 of The Customs Act , 1962 or as defined in any other Act or Regulations as the case may be.

9. The Standard Will Be Operative From The Date Of Issue.

Appendix 1

Name of the Manufacturer:

Address of the Manufacturer:

Statement of Operating Cost of own Fleet for the period…….

Sl No		
A	**QUANTITATIVE INFORMATION**	
A1	Number of Vehicles	
A2	Number of trips	
A3	Goods Transported – inward (UM)	
A4.	Goods transported – outward (UM)	
A5.	Goods transported – inward – Km	
A6.	Goods transported – outward – Km	
A7.	Total Goods transported inward – basis of apportionment (Specify)	
A8.	Total Goods transported outward – basis of apportionment (Specify)	
A9	**Total (A7+A8)**	
B	**COST INFORMATION**	(Rs)
	Cost of Operation	
	Variable Cost	
B1.	Salaries & Wages of Drivers, Cleaners and others	
B2.	Fuel & Lubricants	
B3.	Consumables	
B4.	Amortized cost of Tyre, Tube & Battery	
B5.	Spares	
B6.	Repair & Maintenance	
B7.	Other Variable Cost (specify)	
B8.	**Total Variable Cost (B1 to B7)**	
	Fixed Cost	

B9.	Insurance	
B10.	Licence Fee, Permit Fee and Taxes	
B11.	Depreciation	
B12.	Other Fixed Costs (Specify)	
B13.	Total Fixed Cost (B9 to B12)	
B14.	Total Operating Cost (B8+B13)	
C	APPORTIONMENT (Basis to be specified) - usage	
C1.	Inward Transport Cost (B14 *A7/ A9)	
C2.	Outward Transport Cost (B14 *A8/A9)	
C3.	Transit insurance for inward movement	
C4.	Transit insurance for outward movement	
C5.	Total transportation cost for inward movement (C1+C3)	
C6.	Total transportation cost for outward movement (C2+C4)	

Note :

a. Cost of Battery, and Tyres and Tubes shall to be amortised over its useful life.

b Asset Register shall be maintained for determination of depreciation and amortization cost.

c. Separate Cost Sheet shall be prepared for different types of vehicles.

Appendix 2

Name of the Manufacturer:

Address of the Manufacturer:

Statement of Hired Outward Transportation Cost for the period ending…….

A	**Quantitative Information**	
A1	Quantity of goods transported – outward (UM)	
B	**COST INFORMATION)**	(Rs)
B1	Hired Transport Charges	
B2	Transit Insurance	
B3	Other (specify)	
B4	Total Transportation cost (B1 to B3)	

Appendix -3

Name of the Manufacturer:

Address of the Manufacturer:

Statement of apportionment of Outward Transportation Cost to different goods and Determination of Averaged Outward Transport Cost for the period ending

A	Quantitative Information	Total	Excisable goods			Specific Rated goods	Goods cleared for Export	Exempted goods	Goods Cleared on MRP Basis	Goods cleared from factory to customer	Goods cleared from Depot to Customer	Others (specify)
			Product-group 1	Product-group 2	Product-group 3							
A1	Goods transported Outwards (UM *)											
A2	Goods Transported Outward (K.M.)											
B	**Outward Transport Cost (Rs)**											
B1	Directly allocated own fleet transportation cost (Rs)											
B2	Basis of Apportionment of own fleet cost (Specify)											
B3	Common own fleet transport cost to be apportioned											

B4	Directly allocated hired transp- ortation charges (Rs)											
B5	Basis of Apportion- ment of hired transporta tion cost (Specify)											
B6	Common hired transport charges to be apportioned											
B7	Total Transport Cost (B1+B3+B4+B6)											
B8	Averaged transport cost per unit (Rs) (B7/A1)											

* UM is the Unit of measurement

authorized representative

I /We, have verified above data and calculation in the appendix 1, 2 and 3 on test check basis with reference to the books of account, cost accounting records and other records. Based on the information and explanations given to me/us, and on the basis of generally accepted cost accounting principles and practices followed by the industry, I /We certify that the above cost data reflect true and fair view of averaged transport cost.

Date : Seal & Signature of Cost Accountant

Place : Membership No.

DRAFT CAS - 6

COST ACCOUNTING STANDARD ON "DETERMINATION OF ARM'S LENGTH PRICE"

4.14 DRAFT COST ACCOUNTING STANDARD 6 : "DETERMINATION OF ARM'S LENGTH PRICE"

COMMENTS (CAS 5) :

4.14.1 The draft Cost Accounting Standard 6 (CAS-6) on "Determination of Arm's Length Price" has not been finally approved till date. Hence it is at draft stage till now.

4.14.2 The history of Transfer Pricing Regulations in India is not very long. The Finance Act 2001 had introduced the detailed Transfer Pricing Regulations (TPR) in India w.e.f. 1st April, 2001 corresponding to the assessment year 2002-03. The rules for transfer pricing were subsequently notified in August 2001.

4.14.3 The opening up of Indian economy had brought many of the multi-national companies to open their business in India. It was felt that the country was losing significant amount of revenue due to absence of transfer pricing regulations in the country to determine reasonable and equitable amount of profits in respect of cross-country transactions between the related parties. Therefore valuation of "related party transactions" is a very critical issue. Even though, the underlying principle for valuation of related party transactions still remains the "Arm's Length Pricing", its interpretation w.r.t. risks and implications remain very critical both from a tax compliance stand point and from a risk management perspective.

4.14.4 The Institute of Chartered Accountants of India has issued AS 18 regarding Related Party Disclosures. This Accounting Standard is based on International Accounting Standard 24 (IAS 24) regarding Related Party Disclosures. The objective of above Accounting Standard is to establish requirements for disclosure of (a) related party relationships; and (b) transactions between a reporting enterprise and its related parties.

4.14.5 AS -18 is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004 for the enterprises which fall in any one or more of the following categories, at any time during the accounting period.

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at anytime during the accounting period.

The enterprises which do not fall in any of the above categories are not required to apply this Standard.

4.14.6 AS-18 defines related party as parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

4.14.7 The Cost Accounting Standard on the other hand has given its own similar definition to "Related Parties", which is reproduced as under :

"Related parties: In the context of a company, parties connected to the common through relation with directors and persons having substantial controlling interest in the company, companies under the same management and subsidiaries. In particular, in the context of a company it means an entity: a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of such company or vice versa; or b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital of such company or vice versa.

An entity (which includes an individual, a Hindu Undivided Family, a partnership firm, an association of persons, a trust or a company) shall be deemed to be a related party in relation to a company if, at any time during the previous year: a) the entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in such company or vice versa: or b) any person or entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in each of the entities: or c) a long advanced by the entity to the company constitutes not less than fifty-one per cent of the book value of the total assets of the company or vice versa: or d) the entity guarantees not less than fifty-one per cent of the total borrowings of the company or vice versa: or e) more than half of the board of directors or members of the governing board, or one or more executive members of the governing board of the entity, are appointed by the company or vice versa: or f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the entity and the company are appointed by the same person or persons: or g) the manufacture or processing of goods or articles or business carried out by the entity is wholly dependent on the use of know how, patients, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the company is the owner or in respect of which the company has exclusive eights or vice versa: or h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by the entity, are supplied by the company, or by persons specified by the company, and the prices and other conditions relating to the supply are influenced by such company or vice versa: or i)the goods or articles manufactured or processed by the entity , are sold/transferred to the company or to persons specified by the company, and the prices and other conditions relating thereto are influenced by such company or vice versa: or j)where the entity is controlled by an individual, the other company is also controlled by such individual or his relative or jointly by such individual and relative of such individual: or k) where an entity has the power to direct, by statute or agreement, the financial and operating policies of the company or vice versa: l) there exists between two entities, any relationship of mutual interest as may be prescribed provided one of them is a company."

1.8 The paragraph 3 of the Accounting Standard defines the 'related party relationships'. The same definition has been adopted in various Cost Accounting Records Rules also. The Accounting Standard also provides that no disclosure is required in the consolidated financial statements in respect of intra-group transactions. Similarly, no disclosure is required in the financial statements of state controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

1.9 It is clear from above that AS-18 restricts its scope to disclosure of certain defined related party transactions. It does not have any application i.e., guidelines for computation of "Arms Length Pricing".

1.10 The draft Cost Accounting Standard issued by ICWAI, on the other hand provides methodology for determination of Arm's Length Price required to be carried out for any purpose or under the provisions of any Act, Rules or Regulations except transaction includible intangibles, where value has to be determined otherwise under any statute. The draft CAS 6 is reproduced as under :

DRAFT CAS - 6

DRAFT COST ACCOUNTING STANDARD
DETERMINATION OF ARM'S LENGTH PRICE

The following is the COST ACCOUNTING STANDARD 6 (CAS 6) issued by the Council of the Institute of Cost and Works Accountants of India on "Determination of Arm's Length Price ". The standard deals with the principles and methods of apportionment of determination of Arm's Length Price. In this standard, the standard portions have been set in bold italic type. These should be read in the context of the background material, which has been set in normal type.

1. Introduction

The sheer complexity of the determination of Arm's Length Price has made it a widely debated topic among the accounting professionals, with diverse views floating around. Traditionally Arm's Length Price is associated with transfer Pricing, which has been defined as the price at which goods are transferred from one division/department of an enterprise to another division/department of the same enterprise. With the passage of time the transactions between related parties have come to occupy the center stage on the issue of transfer pricing and consequently Arm's Length Price.

2. Objective

2.1 To bring uniformity in the principles to be followed in the determination and computation of Arm's Length Price.

2.2 To provide appropriate methodologies for determining Arms Length Price, for transactions between related parties.

2.3 To provide better transparency and disclosure in the ascertainment of the Arm's Length Price.

3. Scope

3.1 The standard should be followed for determination of Arm's Length Price required to be carried out for any purpose or under provisions of any Act, Rules or Regulations except transactions includible intangibles where value has to be determined otherwise under any statute.

3.2 This standard has to be read in conjunction with the earlier Cost Accounting Standards issued by the Council of the Institute of Cost and Works Accountants of India.

4. Definitions

Price: " Price" by definition is the rate at which a product/service is sold by a seller to the buyer. The legal definition of "price", in relation to the sale of any goods or to the performance of any services, includes every valuable consideration, whether direct or indirect, or deferred, and includes any consideration which in effect relates to the sale of any goods or to the performance of any services although ostensibly relating to any other matter or thing;

Market Price: It is the Price, which is determined by the interaction of various forces in the market.

Explanation: Sometimes, the Government may also intervene to fix a 'fair price' or 'controlled price' or a 'subsidized price'.

Transfer Price (TP): Transfer Price is an 'internal price' which can be fixed by the management of an enterprise or group of enterprises for transfer of products and services intra enterprise/group/related parties who may be in a position have "undue influence" to intervene in the process of fixing the price.

Undue influence: Parties who may be in a position to intervene in the process of fixing the transfer price, as above, may intervene in a manner so as to lead to an advantage or disadvantage to the transferor or transferee. Such Intervention can be termed as undue influence on the price

Arms Length Price (ALP) : means the price, which is applied in a transaction between persons other than related parties in uncontrolled conditions.

Explanation: This means that this is a 'fair price' – fair and reasonable to both transferor and transferee. ALP is the TP based on some logical methods, which have been modified by various tax legislations in the country under Income tax, Customs, Excise and sales tax, etc., as per the cannons of taxation.

(Proper Corporate Governance demands that the TP is fixed based on generally accepted principles in order to ensure that there is an element of fairness in the financial results and financial position of the enterprise).

Related parties: In the context of a company, parties connected to the common through relation with directors and persons having substantial controlling interest in the company, companies under the same management and subsidiaries. In particular, in the context of a company it means an entity: a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of such company or vice versa; or b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital of such company or vice versa.

An entity (which includes an individual, a Hindu Undivided Family, a partnership firm, an association of persons, a trust or a company) shall be deemed to be a related party in relation to a company if, at any time during the previous year: a) the entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in such company or vice versa: or b) any person or entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in each of the entities: or c) a long advanced by the entity to the company constitutes not less than fifty-one per cent of the book value of the total assets of the company or vice versa: or d) the entity guarantees not less than fifty-one per cent of the total borrowings of the company or vice versa: or e) more than half of the board of directors or members of the governing board, or one or more executive members of the governing board of the entity, are appointed by the company or vice versa: or f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the entity and the company are appointed by the same person or persons: or g) the manufacture or processing of goods or articles or business carried out by the entity is wholly dependent on the use of know how, patients, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the company is the owner or in respect of which the company has exclusive eights or vice versa: or h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by the entity, are supplied by the company, or by persons specified by the company, and the prices and other conditions relating to the supply are influenced by such company or vice versa: or i)the goods or articles manufactured or processed by the entity , are sold/transferred to the company or to persons specified by the company, and the prices and other conditions relating thereto are influenced by such company or vice versa: or j)where the entity is controlled by an individual, the other company is also controlled by such individual or his relative or jointly by such individual and relative of such individual: or k) where an entity has the power to direct, by statute or agreement, the financial and operating policies of the company or vice versa: l) there exists between two entities, any relationship of mutual interest as may be prescribed provided one of them is a company.

Tangible Transactions refer to Transactions involving physical goods or services.

Intangible Transactions refer to the transactions having intellectual content like inventions, patents, design, trademark, franchises, licenses, brand, know-how, etc.

5. Methods Of Computation Of ALP

The following methods may be adopted for determination of Arm's Length Price, having regard to the nature of transaction or class of transactions.

I. For Tangible Transactions.

1. Comparable Uncontrolled Price Method (CUP)
2. Resale Price Method
3. Cost Plus Method
4. Profit Split Method
5. Transactional Net Margin

II. For Intangible Transactions (Method described later).

5.1 Comparable Uncontrolled Price Method

The price charged or paid in a comparable uncontrolled transaction or a number of such transactions shall be identified. Such prices shall be adjusted to account for differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market. The adjusted price shall be taken as arm's length price. The uncontrolled transaction means a transaction between independent enterprises other than related parties and shall cover goods or services of a similar type, quality and quantity as those between the related parties and relate to transactions taking place at a similar time and stage in the production/distribution change with similar terms and conditions applying.

5.2 Resale Price Method

The price at which the goods purchased/service obtained from a related party is resold or is provided to an unrelated entity shall be identified. Such resale price shall be reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar goods or services in a comparable uncontrolled transaction or a number of such transactions. The price so arrived at shall be further reduced by the expenses incurred by the enterprise in connection with the purchase of goods or services. Such price shall be further adjusted to take into account the functional and other differences including differences in accounting practices, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market. The adjusted price shall be taken as arm's length price in respect of goods purchased or services obtained from the related party.

Applicability: The resale price method would normally be adopted where the seller adds relatively little or no value to the product or where there is little or no value addition by the reseller prior to the resale of the finished products or other goods acquired from related parties. This method is often used when goods are transferred between related parties before sale to the independent party.

5.3 Cost Plus Method

The total cost of production incurred by the enterprise in respect of goods transferred or services provided to a related party shall be determined. The amount of a normal gross profit mark-up to such costs arising from the transfer of same or similar goods or services by the enterprise or by an unrelated enterprise in a comparable uncontrolled transaction or a number of such transactions, shall be determined. The amount of a normal gross profit mark-up shall be adjusted to take into account the functional and other differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market. The total cost of production referred to above increased by the adjusted profit mark-up shall be taken as arm's length price. It is also important here to ensure that the cost base to which mark-up is applied is comparable to the cost base of the third party transaction which serve as comparable. For example, it may be necessary to make an adjustment to cost where one person leases its business assets while other owns its business assets.

Applicability: The cost plus method would normally be adopted if CUP method or resale price method cannot be applied to a specific transaction or where goods are sold between associates at such stage where uncontrolled price is not available or where there are long term buy and supply arrangements or in the case of provision of services or contract manufacturing.

5.4 Profit Split Method

The combined net profit of the related parties arising from a transaction in which they are engaged shall be determined. This combined net profit shall be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of transaction in which it is engaged with reference to market returns achieved for similar types transactions by independent enterprises. The residual net profit, thereafter, shall be split amongst the related parties in proportion to their relative contribution to the combined net profit. This relative contribution of the related parties shall be evaluated on the basis of function performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. The combined net profit will then be split amongst the enterprises in proportion to their relative contributions. The profit so apportioned shall be taken into account to arrive at an arm's length price.

Applicability: This method would normally be adopted in those transactions where integrated services are provided by more than one enterprise or in the case multiple inter-related transactions, which cannot be separately evaluated.

5.5 Transactional Net Margin Method

The net profit margin realized by the enterprise from a related party transaction shall be computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base. The net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions, shall also be computed having regard to same base. This net profit margin shall be adjusted to take into account the differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which would materially affect such net profit margin in the open market. The cost of production referred to above increased by the adjusted profit mark-up shall be taken as arm's length price.

Applicability: This method would normally be adopted in the case of transfer of semi-finished goods; distribution of finished products where resale price method cannot be adequately applied; and transaction involving provision of services.

6. Transfer Price For Intangibles

Intangibles refer to the property having intellectual content like inventions, patents, design, trademark, franchises, licenses, brand, etc.

The intangibles are classified as

- Trade
- Market

Trade intangibles are created out of Research & Development like know-how, designs, etc. There can be 3 types of such arrangements.

- One enterprise does research and keeps the property rights.
- One enterprise carries on research on behalf of other members as per a contract.
- One enterprise carries on research on behalf of the group engaged in a common activity and all share the ownership.

Market intangibles are trade names (brands including symbols, pictures, etc.). This again can be owned by one enterprise or shared with others. Brand valuation should be done taking into account all the variables like quality control and R&D, availability, success of promotion expenses, value of the market, etc.

ALP is applicable for intangibles. It is a difficult exercise and it is difficult to establish or prescribe any standard or guidelines for the legal and economic ownership of the marketing intangible.

ALP for Intangibles:

The utility of the property is an important criterion while determining comparability of intangible properties.

The following aspects should be given proper weightage while applying the Arm's length principles.

- Area of right
- Export restriction
- Nature of right (exclusive or non-exclusive)
- Capital investment
- New or special machinery
- Start-up expenses/ development work required in the market
- Possibility of sub-licensing
- Licensee's right for participation in further development of property by licensor.

For intangibles, CUP or Resale Price method would be appropriate. Where transfer of highly valuable intangible is involved profit based method (Profit split method or Transactional Net Margin method) is more appropriate.

7.0 Presentation And Disclosure

7.1 The method of determination of Arm's Length Price should be properly disclosed. If there is any change in the method of determination of Arm's Length Price, such change and the effect of such change should be disclosed, along with reasons for such change.

7.2 Where, the enterprise follows policies and methods that are different from that prescribed under this cost accounting standard, policies, methods, rationale and circumstances for adopting such methods should be disclosed.

7.3 If there is any statutory requirement for a particular industry on the method of determination of Arm's Length Price , proper disclosure about the method prescribed should be annexed to the cost statements.

Annexure 1: Comparable Uncontrolled Price Method (CUP) illustrated

Arms Length Price – Comparable Uncontrolled Price Method (CUP) MANUFACTURING SECTOR

Example 1:

XYZ of Japan sells to ABC of India (related) and to MNO of UK (unrelated) its CD players. The product is identical. The terms are one-year warranty for India and 6 months warranty for UK. The cost of one-year services is estimated as Rs.500/- per piece in India and UK. Sales to ABC is CIF and to MNO is FOB. As the products are identical, warranty and insurance and freight will have to be normalised for comparison of both the prices. We have to determine the ALP on CUP basis for sales from XYZ to ABC.

Calculation:	**Rs.**	**Rs.**
Particulars	XYZ to ABC	XYZ to MNO
Selling Price (converted to Rs. on the date of invoices for ABC)	5000.00	4000.00
Less: Cost of service	500.00	250.00
	4500.00	3750.00
Add: Insurance & freight (actual)	Nil	250.00
Normal comparable price	4500.00	4000.00

No. of pieces purchased by ABC
10000
Arm's Length Price
Rs.4000/-
Transfer price charged to ABC
Rs.4500/-
Excess TP charged per piece
Rs.500/-
Total excess income of ABC under CUP method
Rs.50 lakhs

Arms Length Price – Comparable Uncontrolled Method (CUP) SERVICES SECTOR FINANCIAL

Example 2:

A Ltd. a bank promotes B Ltd. a merchant banking subsidiary jointly with a foreign collaborator. B Ltd. wants a loan from A Ltd. at the Prime Lending Rate (PLR) of A Ltd. A Ltd. normally lends at PLR to its borrowers having the highest credit rating score as per its internal rating score. B Ltd. being a new company does not have the highest score but will qualify as "Average" if credit rated. The foreign collaborator is a company having an excellent credit score. The foreign collaborator offers to give a guarantee to B Ltd.'s borrowing from A Ltd. or any other bank.

A Ltd.: Details			
Rate of interest charged to B Ltd. (Through out the year)	10% p.a.		
Frequency	Quarterly interval		
PLR charged by A Ltd to 'A+' customers (rate charged during the mid year)	10% p.a. for 6 months 12% p.a. for 6 months		
Average PLR	11% p.a. (weighted average for the period)		
Credit rating of B Ltd. as per internal score	Average		
Lending rate of A Ltd to "average" borrowers	11% p.a. for 6 months 13% p.a. for 6 months		
Average Lending Rate of A Ltd for "Average" Rated Borrowers	12% p.a. (weighted)		
PLR of Bank 'C Ltd.' (independent) Average for the year	11.5% p.a.		
PLR of Bank 'C Ltd.' charged out of pocket expenses,			
Cost of inspection, etc. for all corporates	0.5% p.a.		
Total interest costs charged by A Ltd. for B Ltd.	Rs.5 lakhs p.a.		
Out of pocket expenses recover by A Ltd. from B Ltd.	Nil		
Comparable Uncontrolled Price	A Ltd. To B Ltd. (Related party)	Other Bank	
Interest rate applied	10% p.a.	11.5% p.a.	
Add: Out of pocket expenses	Nil	1.0% p.a.	
Effective Rate	10% p.a.	12% p.a.	
Transfer Price advantage passed to 'B Ltd.'	2% p.a.		
However, ARMS LENGTH PRICE is PLR charged by A Ltd. for all other "Average" customers (unrelated)		12% p.a.	
Transfer Price advantage as per CUP		2% p.a.	
Actual interest paid Rs.5,00,000/-			
Transfer price advantage passed to B Ltd. @ 2% as per CUP - 5,00,000 x 2/10 Rs.1,00,000/-			
Interest earning of A Ltd. as per CUP		Rs.6,00,000/-	

Annexure 2: Resale Price Method illustrated

Arms Length Price under Resale Price Method --- physical goods-

This method is ideally used for enterprises doing only marketing, sales and distribution functions with an insignificant value addition.

Example 1:

UK Company 'A' sells a cosmetic perfume to its related enterprise 'B' at Rs.60/- per piece. 'B' resells to unrelated parties at Rs.100/-. The total cost of the product to 'B' is Rs.80/- including administration and selling and distribution cost of Rs.20 per piece. In this trade, the normal gross margin is 25%.

ALP is resale price Rs.100/- less Gross Profit Rs.25	–	Rs.75
Less: Costs incurred for administration	–	Rs.20
ALP per unit	–	Rs.55

The Transfer Price of Rs.60/- under controlled condition is in excess by Rs.5/- per unit reducing the profit of 'B' causing revenue leakage to the country.

Here, the costs incurred for unrelated parties require proper analysis and record. The CAS-1 6.3.5 to 6.3.9 should be applied for determining the cost of administration, selling and distribution. It may be noted that the resale price method does not envisage incurring of costs under the head 'Research & Development'.

Example 2:

X Ltd. markets imported Injection sets of insulin

Imports are made from A Ltd. (Related enterprise) and B Ltd. (Unrelated enterprise)

Additional Information available:

1. A Ltd.'s supplies are in 100's packs on CIF basis (Insurance Rs.2,00,000/- for 1,00,000 units and freight Rs.5,00,000/- for 2,00,000 units)
2. B Ltd.'s supplies are in 50's packs on FOB basis
3. A Ltd.'s supplies are at Rs.15,000/- per pack of 100's
4. B Ltd.'s supplies are at Rs.6,000/- per pack of 50's
5. Actual freight incurred for supplies from B Ltd. – Rs.50,000/- for 10000 packs
6. Actual insurance incurred for supplies from B Ltd. – Rs.30,000/- for 10000 packs
7. Actual purchases by X Ltd. during the year- 25000 packs from A Ltd.

   - 10000 packs from B Ltd.
8. Costs incurred by X Ltd. for the year

Rent of premises	Rs.60,000/-
Office expenses	Rs.50,000/-

Wages paid for repacking	Rs.1,50,000/-
Packing materials for repacking	Rs,1,50,000/-
Freight and Insurance outward	Rs.30,000/-
Free samples for marketing	Rs.50,000/-
Wastage (broken) not allowed by Insurance	Rs.5,000/-

9. Selling Price Rs.200/- per unit

10. All the units purchased are sold in the same year and no stock is left (If stocks are left they should be valued at cost excluding selling and distribution overheads)

Computation of ALP under Resale Price Method

Particulars	From A Ltd.	From B Ltd.	Total
No. of units purchased & sold	25,00,000	5,00,000	30,00,000
Resale price per unit	Rs.200/-	Rs.200/-	Rs.200/-
Sales value (Rs. In lakhs)	5000.00	1000.00	6000.00
Costs incurred (Rs. In lakhs)			
Purchases	3750.00	600.00	4350.00
Freight	Nil	0.50	0.50
Insurance	Nil	0.30	0.30
Administrative expenses Rent Rs. 60,000/- Office Exp. Rs. 50,000/- Rs.1,10,000/- (distributed in the proportion of Net Sales Value as per IAS 7.2)	0.92	0.18	1.10
Selling Costs Repacking materials 1,50,000 Wages for repacking 1,50,000 Freight & Insurance 30,000 Free samples 50,000 Wastage 5,000 Total 3,85,000	3.21	0.64	3.85
(distributed based on Net Sales Value as per IAS 7.2)			
TOTAL COSTS	3754.13	601.62	4355.75
GROSS PROFIT	1245.87	398.38	1644.25
GROSS PROFIT % on SALES	24.92	39.83	
Independent Enterprise GP %		39.83	

ALM Calculation:		
Resale Price of X Ltd. for purchases from A Ltd. (related) per unit		
Rs. 200.00		
Total sales of purchased from A Ltd. (25000X100X200)		Rs. 5000.00 lakhs
Less: Normal Gross Profit on independent transaction		@39.83% Rs.1991.50 lakhs
Normal Cost of Sales		Rs. 3008.50 lakhs
Less: Other specific costs		
Administration cost	Rs. 0.92	
Selling costs	Rs. 3.21	
Total		Rs. 4.13 lakhs
Purchase Cost as per Resale Price method		Rs. 3004.37 lakhs
For purchases from A Ltd.		
ALM Purchase cost per pack of 100's (Rs.3004.37 lakhs 25000)		Rs.12,017.48
Actual Purchase cost per pack of 100's		Rs.15,000.00
Extra purchase cost per pack paid to A Ltd.		Rs.2,982.52
there by making X Ltd. to suffer a disadvantage		
Income additionally chargeable to X Ltd. as per		
Rs.745.63 lakhs		
Transfer Price Margin in Resale Price Method		
(i.e. loss of income to X Ltd. and undue benefit passed on		
to A Ltd. due to related party transaction)		

Annexure 3: Arms Length Price under Cost Plus Method illustrated

Arms Length Price under Cost Plus Method-manufacturing

This method is useful in case of services, transfer of goods requiring further processing or long-term agreements for buying / selling are applicable.

Explanation: If ABC Ltd. is transferring goods/services to XYZ Ltd., a related enterprise, the total costs incurred by ABC Ltd. are determined.

If similar/same goods are or services are transferred to unrelated parties or such transfer is done by an unrelated enterprise in comparable uncontrolled transaction, the normal Gross Profit Mark-up to costs will be determined. The normal GP Mark-up will be adjusted for the differences materially affecting such profit mark-up in the open market.

ALP = Total cost of production + Adjusted Gross Profit Mark-up.

Here, cost bases are to be comparable in both transactions. An adjustment to costs may be necessary to make it comparable.

Costs may be classified as per CAS 1, 2, 3 & 4		
Illustration:	ABC Ltd. transfers goods to	
	XYZ Ltd. (Related party) Rs. / unit	MN Ltd. (Comparable transaction) Rs. / unit
Direct Material	10.00	10.00
Direct Wages	15.00	15.00
Direct Expenses	10.00	10.00
Prime Cost	35.00	35.00
Factory Overheads	5.00	5.00
Administrative Overheads	3.00	3.00
Cost of Production	43.00	43.00
Gross Profit Mark-up	8.60	17.20
	(@ 20%)	(@ 20%)
(@ 40%)		
Selling Price	51.60	60.20
Gross Profit Mark-up %	20%	40%
Gross Profit Mark-up	8.60	17.20
Less: Selling costs	Nil	1.40
Less: Distribution costs	4.20	2.00
Adjusted GP Margin	4.40	13.80
Adjusted GP Margin % on cost	10.23%	32.09%
Adjusted GP Margin (comparable independent)		32.09%
Adjusted GP Margin (actual)		10.23%
Difference in GP Margin		21.86%
Actual cost of production per unit		Rs.43.00
Increased GP per unit		Rs.9.40
Actual selling price		Rs.51.60
Arms Length Price per unit		Rs.61.00
Actual revenue booked for XYZ Ltd. (50000 x 51.60)		Rs.25,80,000/-
Sales at ALP (50000 x 61.00)		Rs.30,50,000/-
Increased income as per ALP under Cost Plus Method		Rs.4,70,000/-

Annexure 4: Arms Length Price under Profit Split Method illustrated

Arms Length Price under Profit Split Method

This method is suitable for those transactions where integrated services are provided by more than one enterprise or in case of multiple inter related transactions which cannot be separately evaluated.

It is necessary to identify the total profit and split it based on the activities performed assets employed and risks assumed by each party with a comparison of valuation of such activities done by unrelated enterprises on a comparable basis.

Illustration (services sector)

A Ltd. and B Ltd. (related parties) jointly do an assignment of computerisation together with an unrelated party C Ltd. A Ltd. is the main contractor and B Ltd. and C Ltd. are the sub-contractors. A Ltd. supplies all hardware and B Ltd. supplies a portion of the software and C Ltd. supplies another portion of the software.

The total gross earnings received by A Ltd. is Rs.100 lakhs and it pays Rs.10 lakhs to B Ltd. and Rs.20 lakhs to C Ltd. This has to be adjusted to calculate the Arms Length Price from A Ltd. to B Ltd. Under this situation Profit Split Method could be adopted.

The total profit earned by A Ltd. and B Ltd. in this transaction is determined as follows:

	A Ltd.	B Ltd.	C Ltd.	Total
Earnings (Rs. in lakhs)	70.00	10.00	20.00	100.00
Costs (Direct+Indirect as per CAS-4) Rs. in lakhs	30.00	7.00	10.00	47.00
Profits before ALP	40.00	3.00	10.00	53.00
Return on costs in %	133%	43%	100%	
Basic Return (Surplus to be split)	6.00 @ 20%	7.00 100%	10.00 100%	23.00
Surplus return to be shared				30.00
Share of contribution for the Job	50%	25%	25%	
Surplus return distributed in the ratio of share of contribution to the job	15.00	7.50	7.50	30.00
Total share of surplus	21.00	14.50	17.50	53.00
ALP from A Ltd. to B Ltd.		21.00		
Actual earnings for B Ltd.		10.00		
Additional revenue as per ALP		11.00		

Here assuming the C Ltd. transaction is more or less similar and comparable, the return of 100% on costs may be applied to find out the ALP for B Ltd.'s transaction with A Ltd.

This method has a limitation as to availability of the costs/revenue from the main contractor to ascertain the overall profits, etc. Because of this limitation, this method is not widely used.

A normal return for each industry/task may have to be determined involving detailed backup for each assumption. Collection of cost input details for each job/transaction as prescribed under CAS 1 to 4 will be helpful giving proper backup for the assumptions on cost inputs, capital employed, risks assumed etc. to determine the relative contribution.

Illustration 2:

		(Rs. In lakhs)
Total Earnings	In a Contract	100.00
Share of:	A Ltd.	70.00
	B Ltd.	10.00
	C Ltd.	20.00
Costs:	A Ltd.	30.00 X_1
	B Ltd.	7.00 X_2
	C Ltd.	10.00 X_3
Total		47.00 $\sum X$
Normal Return on Costs:*	A Ltd. 30%	9.00 Y_1
	B Ltd. 20%	1.40 Y_2
	C Ltd. 20%	2.00 Y_3
	Total	12.40 $\sum Y$
Costs + Normal return		59.40 $\sum X + \sum Y$
Excess surplus (Total Earnings – Costs – Normal Return)		40.60
Excess surplus distributed in the ratio of costs incurred:		
	A Ltd. 40.60 x 30/47	25.91
	B Ltd. 40.60 x 7/47	6.05
	C Ltd. 40.60 x 10/47	8.64
Aggregate Profits:	A Ltd.	34.91
	B Ltd.	7.45
	C Ltd.	10.64
Earnings based on ALP:	A Ltd.	64.91
	B Ltd.	14.45
	C Ltd. $\sum$	20.64
ALP for B Ltd.:	ALP Earnings	14.45
	Actual Earnings	10.00
Excess to be recognised as Earnings under ALP thru profit split method		**4.45**

Annexure 5: Transactional Net Margin Method (TNMM) illustrated

Arms Length Price – Transactional Net Margin Method (TNMM)-services sector

This method suits for transfer of semi-finished goods and distribution of certain services where the resale price method is difficult to apply.

Illustration:

A Ltd. is an international bank engaging B Ltd. a related party for call centre services. B Ltd. also does call centre services for other banks. According to this method, the net margin for related party and comparable unrelated party should be arrived at. The net margin could be based on the total costs incurred, capital employed, number of man-hours spent for each bank by MIS, etc. A weighted return could be arrived at as under:

Facts of the case:		(Rs. In lakhs)
Total Fixed Assets employed (Gross value) (Building on Rent)		100.00
Risks involved: Obsolescence		
Fire		
Loss of life, etc.		

Of the above, obsolescence is the high risk factor requiring the Fixed Assets to be fully recovered in 2 years.

Therefore, return expected on Fixed Assets is 100%, i.e. 50% for costs excluding depreciation and profit and 50% for depreciation.		100.00
No. of persons employed (3 shifts – 24 hrs.)	200	
Maximum human hours 200 x 6 x 365 per year	4,38,000	
Salary & Perks costs per person	Rs.20,000/-	
Total salary costs per year	40.00	
Other costs: Rent (Rs.1,00,000/- p.m.)	12.00	
Insurance	5.00	
Electricity	10.00	
Local taxes	2.50	
Other expenses (transport, etc.)	5.00	
Total	34.50	
Total Weighted Costs		**174.50**
Total Revenue billed		**300.00**
Net Margin (Aggregate)		**125.50**
Net Margin % on weighted costs		**71.92%**
Activity spread: (No. of calls attended)		
A Ltd. (related party)	5000	
X Bank (unrelated)	2000	
Y Bank (unrelated)	2500	
Z Bank (unrelated)	3000	
Total	12500	

Billing: (Rs. in lakhs)

A Ltd. (related party)	100.00	
X Bank (unrelated)	60.00	
Y Bank (unrelated)	70.00	
Z Bank (unrelated)	70.00	
Total	300.00	

Total costs distributed to customers on Activity basis:

A Ltd. (related party)	69.80	
X Bank (unrelated)	27.92	
Y Bank (unrelated)	34.90	
Z Bank (unrelated)	41.88	
Total	174.50	

Net Margin (Billing minus distributed costs):

A Ltd. (related party)	30.20	
X Bank (unrelated)	32.08	
Y Bank (unrelated)	35.10	
Z Bank (unrelated)	28.12	
Total	125.50	

Net Margin % on distributed costs:

A Ltd.	3020/6980 x 100	43.27%
Comparable (X, Y & Z)	95.30/104.70 x 100 91.02%	

Applying the comparable Net Margin of 91.02% on the costs

incurred in respect of A Ltd.

A Ltd. costs	69.80	
Add: Net Margin @ 91.02%	63.53	
Total	133.33	

Arms Length Price (Earning) **133.33**

Actual Billing **100.00**

Excess to be taken as income for B Ltd.

Based on the ALP **33.33**

Under Transactional Net Margin Method

4.15 DRAFT CAS - 7

COST ACCOUNTING STANDARD ON "COSTING OF JOINT PRODUCTS & BY-PRODUCTS"

The following is the COST ACCOUNTING STANDARD 7 (CAS 7) issued by the Council of the Institute of Cost and Works Accountants of India on "COSTING OF JOINT PRODUCTS AND BY-PRODUCTS ". The standard deals with the principles and methods of apportionment of joint costs to joint products and by-products. In this standard, the standard portions have been set in bold italic type. These should be read in the context of the background material, which has been set in normal type.

1. Introduction

The multi-product/ multi-process and multi service industries always face an uncertainty on the issues of identifying and allocating/apportioning common costs to several products or output services. The final product/service cost will reflect the full cost only if these common costs are allocated or apportioned in some way to the individual final products. The problem of allocation or apportionment of common or joint costs becomes significant in the case of process industries, where the process flow is common upto a stage and then segregates into two or more process lines to produce more than one product from a common initial process. The essence of joint product / by-product costing lies in the allocation/apportionment of joint processing costs to the individual products in as equitable a manner as possible. The ascertainment of joint costs is very much essential for valuation of work-in-progress inventory, external financial reporting and for the purposes of valuation under various statutory and tax legislations. Since there are diverse practices prevailing in the industry, it is necessary to follow standard cost practices for the apportionment of joint costs to individual products in the cost statements.

2. Objective

2.1 To bring uniformity in the principles to be followed in the recognition of products as joint product, by-product or co-product and to prescribe generally accepted methods for apportionment of joint costs to individual products.

2.2 Determination of accurate and reliable cost of production for each product on a consistent and uniform basis.

2.3 To provide transparency and disclosure in the ascertainment of the cost of joint and by-products.

3. Scope

3.1 The cost statements prepared on the basis of this standard will be used for apportionment of joint costs to joint products and by products.

3.2 The Standard shall be applied in Cost and Management Accounting practices relating to Joint products and By products in :

(a) Determination of Cost of products, services or activities.

(b) Inventory valuation and Cost of Goods Sold computations.

(c) Cost reimbursements under Cost Plus contracts.

(d) Insurance settlement computations so far as it relates to valuation of Joint products and by products.

(e) Transfer Pricing to the extent of allocation of joint costs

(f) Cost statements for any other purpose.

3.3 This standard has to be read in conjunction with the Cost Accounting Standards issued by the Council of the Institute of Cost and Works Accountants of India.

4. Definitions

4.1 Joint Product: Multiple products arising out of a common process simultaneously which have substantial market value.

4.2 Split off point: The stage in the manufacturing process where joint products are separated and can be identified as separate items.

4.3 By-product: Products that arise from a common process which have insignificant market value at the separation point are defined as by-products. A product which is recovered incidentally from the material used in the manufacture of recognised main products, such a product having either a net realisable value or a usable value which is relatively low in comparison with the saleable value of the main products. By-products may be further processed to increase their realisable value.

The productions of the by-products are incidental to the production of main product. A by-product may get promoted to the status of joint product if the market perception changes or a joint product could be relegated to the position of a by-product in future. The classification could vary over a period time. Any such variation should be disclosed in the relative cost statement / financial reports as a footnote on the policy changes and its impact on the cost per unit of the main products/profit and loss should be disclosed.

4.4 Scrap: Discarded material which has some recovery value and which is usually either disposed of without further treatment (other than reclamation and handling), or reintroduced into the production process in place of raw material.

4.5 Waste: Discarded substances having no significant value (as distinct from scrap).

Material which emerges at any stage of a process / at continuous processes which has to be disposed off without realisation of any value or with quite an insignificant value are treated as Waste. Such waste may also require further processing before being discarded for compliance with environment safety requirements. Waste could be in a solid or liquid or gas form and may not require any physical measurement / valuation.

4.5 Joint Costs: Joint Costs are the common cost of facilities or services employed in the output of two or more simultaneously produced or otherwise closely related operations, commodities or services. (Ref. CAS1).

4.6 Co-products: The term co-products is occasionally used synonymously with the term join-products. However, co-products and join products are two different terms. In case of Co-products, the production of one or more Co-products can be produced without the production of other Co-products.

Change in production of the co-products will not necessarily lead to a change in the production of other product.

5. The Nature of Joint Product Outputs:

5.1 Fixed and Variable Proportions:

Although joint products have a definite quantitative relationship to each other, this relationship may take different forms. The nature of the joint product outputs can either be in fixed or variable proportions. The relationship between the products is fixed if an increase in the output of one product of a group results in a proportionate increase in output of the other products In contrast, if the increase in output of one product results in either a decrease or has no effect on the output of one or more of the remaining products then the relationship between the outputs is one of variable proportions. This variation in output proportions may only be controlled within certain limits and only arises in certain processes.

5.2 **Intermediate and Final Products:**

Joint products arise from a common process or series of processes, the latter giving rise to intermediate products. Intermediate products can be defined as those products to be further treated and processed to produce main products, where the main products encompass finished products selling at a relatively high market value. Therefore, joint products in a multi-process operation may take the form of intermediate products at certain stages of production and finished products at the final stage of production.

5.3 **Joint and Separable Costs:**

The fundamental feature of joint products is that they incur joint costs up to a certain stage of production, known as the split-off point, when they become recognisable as separate products. The costs incurred in the joint process cannot be separately traced to the individual product outputs.

Subsequent to the split-off point any costs incurred e.g. the additional processing costs, can be identified with specific Products and may be termed separable or attributable costs. For a cost to be separable, it must be possible to trace it with reasonable certainty to a single product.

6. **Principles To Be Followed In 'Joint Product / By-Product Costing':**

There are two basic approaches to costing of joint product and by-products, which are given below:

6.1 Joint Product approach: Under this approach, more than one product is treated as joint product and the joint processing costs are allocated between the products on an appropriate basis.

6.2 Main Product / By-product approach: Under this approach, only one product will be given the status of a main product and all other products arising from the process will be treated as by-products.

In this method, the joint costs are not allocated between the products. Instead, the net revenue (sales value less further processing expenses, selling expenses, etc. if any) generated from the products is credited to the joint costs and the remaining joint cost is totally absorbed by the main product.

6.3 Recognition of a product as joint product or by-product. Products that are incidental to the production of the main products, and products having insignificant in value compared to the main products are treated as by-products.

However, the status of a product changes from by-product to main product or vice versa due to a number of factors like changes in market price, competition, demand or technology may suggest a re-classification. The classification between the main product and by-product has to be reviewed continuously.

6.4 **Identification of Joint and By-Products:**

Recognition of joint products and by-products is purely by relative commercial values. Further, such relative values are not permanent as their relative importance of joint and by-products is evanescent in nature.

7. **Methods Of Apportionment Of Joint Costs**

The generally accepted cost apportionment methods are as follows:

7.1 Market Value Bases:

Under this method, the total cost of manufacture is to be apportioned among the joint products on the basis of their relative sales value.

The implication of this method is that joint products should absorb joint costs according to their ability to pay as reflected by the market values of the individual products.

Four differing application of the sales value method are as follows-

(i) Market value after further processing i.e. the final sales value.

(ii) Net Realisable value i.e. the final sales value less the further processing costs.

(iii) Gross Margin Percentage.

(iv) Market value at the point of separation.

(i) Market value after further processing i.e. the final sales value:

When there is a wide parity in selling prices of final products, this base is to be adopted.

While choosing a selling price, it is important to choose a representative period considering the normal cycle of fluctuations. Such a representative figure may be the daily average of the past month or quarterly average as may be appropriate. In case the products are sold to different markets, the adjusted market value, eliminating freight and brokerage or commission elements or any other cost is to be taken. (REFER EXHIBIT 1)

(ii) Net Realisable value i.e. the final sales value less the further processing costs:

When in case products require further processing after split-off point, value additions during further processing are to be assessed and deducted from the sales value to arrive at the basis for apportionment of joint cost among the products. (REFER EXHIBIT 2)

(iii) Gross Margin Percentage:

When the products have same profitability on sales, Joint costs shall be allocated on the basis of Gross Margin Percentage. (REFER EXHIBIT 3)

(iv) Market value at the point of separation:

Joint costs apportionment on the basis of sales value of the products shall be followed when no other rational basis for apportionment of join cost is available and joint products are sold without further processing at split off point.

7.2. Physical Unit Bases:

Where individual products are from a common input, and none of the products can be categorised as by-product, the benefits received by individual products from the common input is to be measured by physical units e.g. weight, length, volume, etc. The joint costs are to be allocated to individual products on the basis of this measurement.

(REFER EXHIBIT 4).

7.3 Apportionment of Joint Cost on Physical volume and some Physical Co-efficient:

When a physical co-efficient of the products is a significant index for value of the joint products, the same is to be taken as the weight with the volume of production for using the basis of apportionment of joint cost.

Example, calorific value for joint products in case of petroleum industry, food ingredients in food processing industry etc. may be the basis of apportionment.

If the physical co-efficient is subject to change due to change of raw material and other process parameters, the physical co-efficient should be measured for the output produced during a period of process where the changing conditions were controlled within a limit so that basis of apportionment itself does not represent wrong basis.

For an industry, particularly Chemical Industry, where inputs used follow strict norm and process conditions are streamlined according to the requirement of standard processing environment, the standard indices of co-efficient arrived at un-biased sampling technique may be used. **(REFER EXHIBIT 5)**

7.4 Techno Commercial Factor Evaluation Base:

When, more than one factor may play a role in the incurrence of joint costs, the adoption of any one factor alone may result in a distorted cost allocation. In such case, the weighted average of the key evaluators can be taken as a base. It has been pointed out that the basis of apportionment cannot be wholly market based or even on a purely physical base but should be a combination of both by evaluating the multiple forces that impact on production and sale and assigning due weights to each of the several factors. This is no doubt a complex exercise calling for a proper judgment by management.

For example, in the caustic soda industry, the primary process, where the three products occur: Caustic, Chlorine and Hydrogen, a stochiometric ratio of the three products is used for separating the costs. **(REFER EXHIBIT 6)**

7.5 **Cost drivers as a base:**

The development and implementation of Activity Based Costing in many enterprises have made available cost drivers, as an integral part of the Cost Management System. Therefore, the cost drivers can be used as a logical basis for cost allocation. **(REFER EXHIBIT 7)**

7.6 **Linear Programming basis**

Sometimes optimum joint product mix may be determined by Linear Programming from where joint product costs may be derived. (Refer Exhibit 10)

8. Treatment Of Cost Of By-Products

8.1 The by-products are normally additional output in the production of main products. The standardization of treatment of by-product costs is important from the point of cost accounting.

8.2 The uniform system of treatment of cost accounting for by-product shall be followed. Sales value of by-products less further processing cost administrative expenses and selling and distribution expenses shall be credited to the total cost of main product. (REFER EXHIGBIT 8)

8.3 When a by-product is used internally (as bagasse used as fuel) a value may be assigned to it being the value of fuel oil replaced, based on the calorific value.

8.4 When the realization from the by-product is not significant, the amount realized may be treated as other income and directly credited to P & L Account.

9. Joint Cost Allocations In Decentralized Environment

9.1 The allocation of joint costs may reflect alternative needs for 'cost information'. The cost allocation should serve to approximate the long-run cost of resources so that in a large, decentralized firm, where many alternative uses for a joint product exist, the decision-making process can be decomposed and simplified. The Exhibit 9 will illustrate an economic purpose for joint-cost allocations. **(REFER EXHIBIT 9)**

9.2 To develop periodically a join-cost allocation based on current net realisable values and to use this cost allocation as an estimate of the long-run marginal cost of the joint-product.

9.3 Suppose an alternative use of one of the products is proposed that can bear this joint-cost allocation, may trigger consideration of alternative use of the product.

9.4 The cost allocation shall be designed to approximate long-run cost to facilitate co-ordination in a highly decentralised situation where many uses of the joint products exist.

10. Accounting For Joint Product / By-Product

10.1 Cost of production of joint and by-products will include various cost components. They are already defined in Cost Accounting Standard 1 (Classification of Cost – CAS1). Thus, this standard has to be read in conjunction with CAS1.

11. Presentation And Disclosures

11.1 The method of apportionment of joint cost to individual products should be properly disclosed. If there is any change in the treatment of product as joint or by-product, such change should be disclosed and their effect on the cost of the recognised main product.

11.2 Any change in the method of apportionment of joint cost should be disclosed with the reasons for such change.

11.3 Where, the enterprise follows policies and methods that are different from that prescribed under this cost accounting standard, policies, methods, rationale and circumstances for adopting such methods should be disclosed.

11.4 If there is any statutory requirement for a particular industry on the method of apportionment of joint cost, proper disclosure about the method prescribed should be annexed to the cost statements.

11.5 In the existence of any statutory regulation regarding treatment of waste from a particular industry a proper disclosure to the effect should be annexed with the cost statements.

Exhibit 1:

(i). Apportionment of Joint cost on the basis of sales value:

Joint production cost of the Products	Rs	Product1	Product2	Product 3
Raw Materials	1,20,000			
Process Chemical	10,000			
Employees cost	50,000			
Production Overhead	45,000			
	2,25,000			
Apportioned on the basis of use of services				
- Administration Overhead*	25,000	10,000	10,000	5,000
- Selling & Distribution Overheads*	30,000	15,000	5,000	10,000
Total cost	2,80,000			

	Total	Product 1	Product 2	Product 3
i) Unit produced	1150	400	400	350
ii) Sales Price per unit (Rs.)		250	300	200
iii) Sales Value (Rs)	2,90,000	1,00,000	1,20,000	70,000
iii) Joint production cost apportioned on the basis sales value (Rs)	2,25,000	77,586	93,104	54,310
iv) Administration	25,000	10,000	10,000	5,000
v) Selling & Dist. Overheads (Rs.)	30,000	15,000	5,000	10,000
vi) Total Cost	2,80,000	1,02,586	108,104	69,310
iv) Cost per Unit		256.47	270.26	198.03

* For Distribution of Administration, selling and distribution overheads, appropriate bases of allocation have been assumed.

Exhibit – 2

Apportionment of joint costs on the basis of net realisable value

	Total	Prod.1	Prod.2	Prod.3
I. Units produced	1150	400	400	350
II. Sale Price per unit (Rs.)		300	350	200
III. Sale Value	3,30,000	1,20,000	1,40,000	70,000
IV. Further Processing Cost	22,000	10,000	12,000	--
V. Net Realisable Value	3,08,000	1,10,000	1,28,000	70,000
VI. Joint Cost Apportioned on the Basis of V (35.71%, 41.56%, 22.73%)	2,25,000	80,357	93,507	51,136
VII. Administration Overhead	25,000	10,000	10,000	5,000
VIII. Selling & Distribution Overhead	30,000	15,000	5,000	10,000
IX. Total Cost	2,80,000	1,05,357	1,08,506	66,136
X. Joint Cost Per Unit		200.89	233.77	146.10
XI. Further Processing Cost Per Unit		25.00	30.00	
XII. Cost Per Unit Of Finished Goods		225.89	263.77	146.10

Note: As a variation of the method given in 6.5.1, the market value after further processing i.e., the final sales value may be used as the basis for apportionment of joint costs.

Exhibit 3

(iii) Apportionment of Joint Cost on the Basis of Gross Margin Percentage.

	Total	Product 1	Product 2	Product 3
Unit produced	1150	400	400	350
Sales Price per unit (Rs)		300	350	200
Sales Value (Rs)	3,30,000	1,20,000	1,40,000	70,000
Joint cost	2,25,000			
Further Processing Cost	22,000			
Gross Margin	83,000			
Gross Margin Percentage	25%			
Deduct Gross Margin @ 25%	83,000	30,000	35,000	18,000
Cost of Goods Sold	2,47,000	90,000	1,05,000	52,000
Less: Further Processing Cost	22,000	10,000	12,000	-
Joint Cost Allocated	2,25,000	80,000	93,000	52,000

The obvious assumption in this method is that all the products have the same profitability ratio on sales.

Exhibit 4:

7.2 Physical measurement basis

Joint production cost of the Products	Rs	Product1	Product2	Product 3
Raw Materials	1,20,000			
Process Chemical	10,000			
Employees cost	30,000			
Production Overhead	40,000			
	2,00,000			
Apportioned on the basis of use of services				
Administration Overhead	15,000	40%	30%	30%
Marketing Expenses	20,000	20%	40%	40%
Total cost	2,35,000			

	Total	Product 1	Product 2	Product 3
i) Unit Produced (No)	1,00,000	50000	30000	20000
ii) Joint production cost apportioned on the basis of Units of production (Rs)	2,00,000	1,00,000	60,000	40000
iii) Administration overhead (Rs)	15,000	6,000	4,500	4,500
iv) Marketing expenses (Rs)	20,000	4,000	8,000	8,000
v) Total Cost	2,35,00	1,10,000	72,500	52,500
iv) Cost per Unit (Rs)		2.20	2.42	2.63

Exhibit: 5

7.3 Apportionment of Joint Cost on Physical volume and some physical co-efficient:

It is assumed that the same joint costs are incurred as given in Exhibit 2 with physical co-efficient of different products as given in the table

	Total	Product 1	Product 2	Product 2
i) Unit produced	1150	400	400	350
ii) Sales Price per unit (Rs.)		300	300	350
iii) Sales Value (Rs)	3,30,000	1,20,000	1,40,000	70,000
iv) Co-efficient index		1.5	1.8	1.0
v) Basis of Appointment (I) x (iv)		600	720	350

vi) Joint cost apportioned on the basis of (v) (Rs	2,25,000	80,838	97,006	47,156
vii) Administration overhead (Rs)	25,000	10,000	10,000	5,000
viii) Selling & Dist. Overheads (Rs)	30,000	15,000	5,000	10,000
ix) Total Cost (vi+vii+viii)	2,80,000	1,05,838	1,12,006	62,156
xi) Joint Cost per Unit (Rs)		264.60	280.02	177.59

EXHIBIT 6:

7.4 Techno Commercial Factor evaluation base:

For Instance of the two products A and B jointly produced, A may be more difficult to produce but B relatively easy. From the marketing angle the reverse is the case. Hence management may assign points say, on a scale of 10 as below.

	Production	Marketing	
A	8	4	12
B	2	8	10
			22

Hence joint cost to be distributed between A and B on the basis of 12/22 and 10/22 respectively.

This method has to be prudently used, as the basis of allocation has a subjective element to it.

EXHIBIT 7

7.5 Input based cost drivers for apportionment of joint cost*

7.5.1 In certain industries one or more cost drivers have a significant impact on the production cost. Energy, for instance, is the dominant cost in the compression of air for producing oxygen, nitrogen and Argon and there is no other raw material cost. Hence a fair basis for distribution of the joint cost over the various products could be the cost driver of energy. The apportionment method is given below:

	Oxygen	Nitrogen	Argon
Standard energy usage per unit of output	25 Kw	5 Kw	135 Kw
Proportion of energy cost borne by each product	25/165	5/165	135/165
	15%	3%	82%
Ratio of output of product	21%	78%	1%

It will be seen that there is an inverse relationship between the output proportion yielded and the energy required to separate a product. Hence Argon representing the smallest output of 1% bears the majority of cost.

7.5.2 In an Oil refinery, a number of individual products are obtained from the crude oil. The general consensus in the oil refinery industry is that no purpose will be served by allocation of joint costs and the most important item is the profit on a barrel of crude oil. J.J.Butler suggests that management should identify all the feasible alternative combination of the input and rank them as follows.

$$\text{Rank Number} = \frac{\text{Total Profit of the combination}}{\text{Number of units of base input required.}}$$

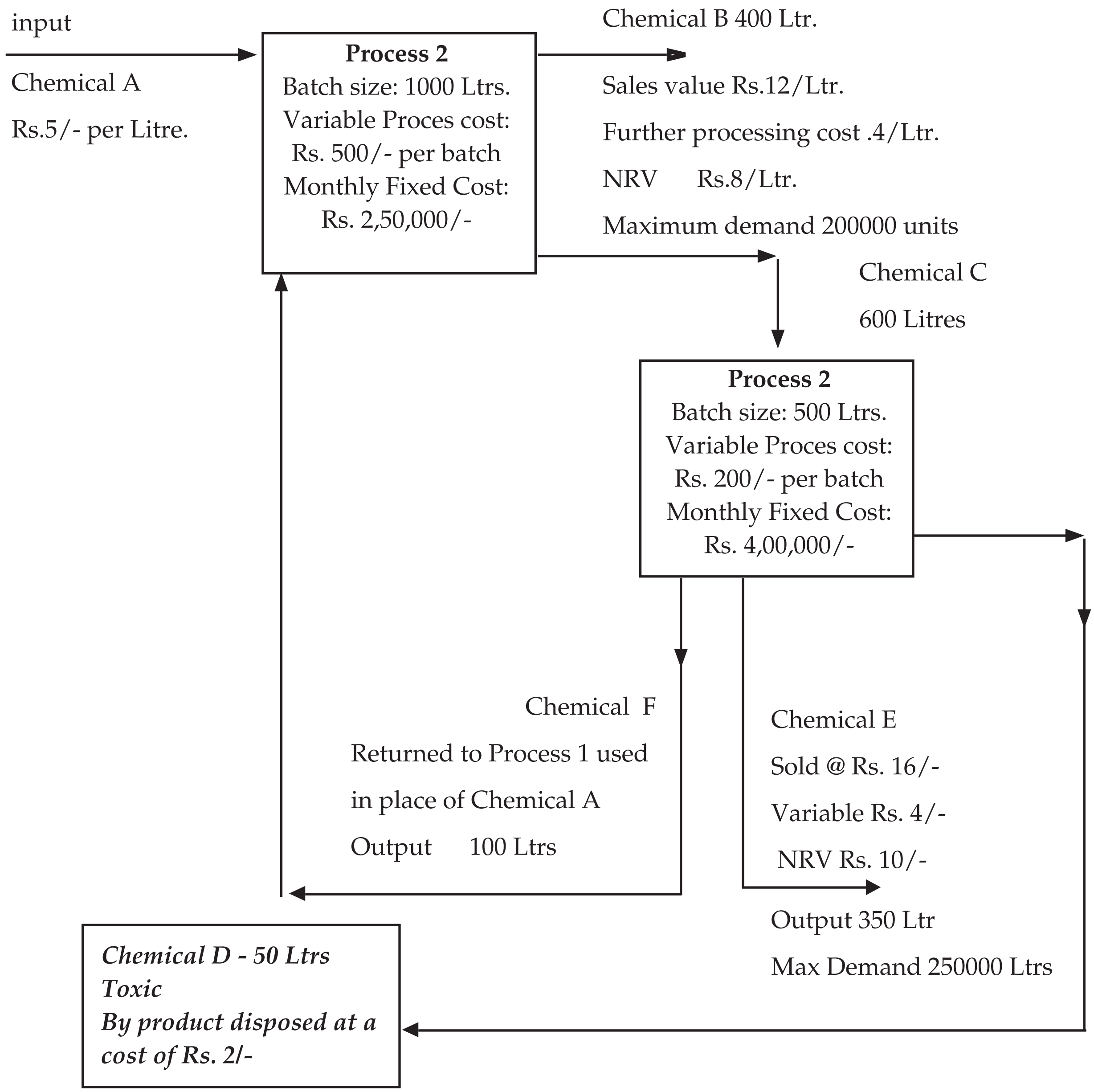
By treating the basic input as a scarce resource he sees the objective of the firm as one of the yielding the greatest return form the scare resources. Here, the profit becomes a key driver for allocating the costs. The advantage of this method over the market value method is that the value addition becomes a key factor in allocation of joint costs.

Exhibit: 8

Joint Cost		Rs 2,80,000
Sales value of by-product	Rs 15,000	
Less: Further processing cost.	Rs. 3,000	
Administration & selling and Distribution Cost	Rs 2,000	
Amount to be credited to Joint Cost		Rs 10,000
Joint Cost to be apportioned among joint products		Rs 2,70,000

EXHIBIT 9:

A chemical industry manufactures a variety of chemicals used in the plastics and pharmaceuticals industries. In a particular product line, Chemical 'A' (input) is processed in batches of 1000 Ltrs. in Process 1 which results in an output of Chemical 'B' & 'C'. Chemical 'B' is sold as it is after further processing. Chemical 'C' is introduced into Process 2 which results in Chemical 'E' which is sold after further processing, Chemical 'D' – toxic waste (disposed off at a cost of Rs.2/- per litre) and Chemical 'F' – used in Process-1 in place of Chemical 'A'.



Analysis of Process 2 – Marginal Revenue of Rs. 3,900/- calculated as follows:

Chemical E -	3,500	
Chemical F -	500	(based on Cost of Chemical A)
Chemical D	(100)	
Marginal Revenue	3,900	
Process Cost	200	
NRV	3,700	

NRV per Ltr = 3,700 / 500 = Rs. 7.40

Turning to Process 1 – Marginal Revenue of Rs. 7,640/- calculated as follows

Chemical B	400 units @ Rs.8	3,200
Chemical C	600 units @ Rs. 7.40	4,440
Marginal Revenue		7,640
Process Cost		500
		7,140
Material Cost		5,000
Net Contribution		2,140

The Marginal Cost of Process 1 = 5,500.

Marginal Revenue will drop to Rs, 4,440 if output of Chemical B exceeds 2,00,000 Litres. (Output of Chemical C will be 250,000 Litres). At this point, MR will drop below MC and additional process should cease. Maximum of 500 batches can be operated so that maximum contribution is achieved.

In process 2 maximum 714 batches to produce output of 250,000 litres of Chemical E can be operated, and if exceeded MR will drop to Rs. 400, since the opportunity to sell additional unit Chemical E will be lost. By restricting 500 batches in Process 1, 600 batches of Process-2 only can be operated.

The economic analysis of determining the optimal output level by setting MR to MC was done at the level of the 'Batch' and not at the level of 'Individual Products'. Decision Making at the product level is impossible because of the presence of Joint Costs. The analysis must always be performed at the level where joint costs disappear and are replaced by Marginal Costs. Also, not have to allocate joint costs in order to determine the best production plan.

Joint cost of Rs. 30,00,000 of Process 1 is allocated on NRV method to chemicals B and C:

Chemical B 16,00,000 /34,20,000 x 30,00,000 = 14,03,509

Rs. 7.02 per litre

Chemical C 18,20,000 /34,20,000 x 30,00,000 = 15,96,491

Rs. 5.32 per litre

Joint cost of Process 2 is

Chemical C	15,96,491
Variable Cost Rs. 200 x 600 batches	1,20,000
Disposable Cost of Chemical D Rs. 2 x 600 x 50	60,000
Fixed Cost	4,00,000
	21,76,491

is allocated on NRV method to chemicals E and F:

Chemical E: 21,00,000 /24,00,000 x 21,76,491 = 19,04,430

Rs. 9.07 per litre

Chemical F: 3,00,000 /24,00,000 x 21,76,491 = 2,72,061

Rs. 4.53 per litre

Allocation of joint-cost per unit of the final chemicals (Chemical B and E) and intermediate chemicals (Chemical C and F) have been effected as above on NRV method. These cost allocations played no part in determining the best production plan to follow. Nor could any of these costs be used to evaluate the economic desirability of producing and selling additional units for new uses or markets.

However, by visualizing a much more complex situation where the huge corporate employing hundreds of decentralized decision makers and intermediate chemicals used by many possible processes, no single person can predict all the alternative uses for intermediate products. So no central planning model exists to determine the optimal quantity of chemical C to be produced and distributed to the various possible processes. Examples of such a situation are common: In the fish processing industry many profitable uses can be found for broken pieces of fish that cannot be packaged and sold as whole fillets. In the wood products industry many profitable uses exist for the chip as and sawdust generated when saw logs are processed into lumber.

Decision process should be guided by formulation of rules so that a mechanism to encourage more profitable uses of intermediaries can be developed. Suppose one of the joint products is in excess supply; say the joint product is routinely produced in amounts that exceed its profitable uses so that some amount is scrapped or stored indefinitely. Its further use should be encouraged, by reducing the joint costs allocated, by defining such a product to be a By-product.

Many firms are finding uses for products that were originally considered to be by-products. A toxic chemical that was a by-product of the pulp producing process, and that had to be disposed of at considerable cost at a special site, was adapted to become a mud thinner in the oil drilling industry. A fish-processing firm has built a fertilizer plant that just breaks even in order to process fish waste that had formerly inflicted significant disposal costs on the firm.

In general, cost equal to its net realizable value in its most profitable use be is assigned for calculating cost of the main product; By assigning the opportunity cost of using the by-product, each subsidiary product just breaks-even. The by-product thereby reduces the cost of the main products by the sum of their net realizable value.

Exhibit 10 (See 7.6)

A firm processes a chemical X (in department 1) at a cost of Rs. 80 per unit of X, which yields jointly 3 units of joint product A and 2 units of another joint product B from each unit of X.

A may be sold as it is or optionally processed further in Department 2 at a cost of Rs. 30 per unit A..

B may be sold as it is or optionally processed further in Department 3 at a cost of Rs. 40 per unit B..

Unit selling prices are: A: Rs. 40; B: Rs. 50; Processed A: Rs. 75; Processed B: Rs. 100.

All the 3 departments use a common facility, which is limited to 3500 hours. 1 hour of this service is required per unit of X; ½ hour per unit of A and 1/3 hour per unit of B. Material constraint is 2000 units.

Since (number of units of A produced)/3 = number of units of X we get, $3X – A = 0$

Similarly, $2X – B = 0$

Replacing A by A1 + A2 (A1 is A sold as it is and A2 is A further processed) and B by B1 + B2 we gwt:

$3X – A1 – A2 = 0$ ....(i)

and, $2X – B1 – B2 = 0$.......(ii)

The service facility constraint: X + ½ A2 + 1/3 B2 < or = 3500.........(iii)

The material constraint: X < or = 2000.........(iv)

Now for maximizing contribution one has to maximize 40A1 + 45 A2 + 50B1 + 60B2 – 80X

(Since contribution from A2 in Rs. is 75 – 30 = 45 and that of B2 in Rs. is 100 – 40 = 60)

subject to constraint equations (i), (ii), (iii), (iv) above from where optimum joint product mix can be had.

4.16

Circular No. 692/08/2003-CX

13th February, 2003

F.No.6/29/2002-CX.I
Government of India
Ministry of Finance and Company Affairs
Department of Revenue

Subject:- Valuation of goods captively consumed.

I am directed to say that on introduction of Central Excise Valuation (Determination of Price of Excisable goods) Rules, 2000, w.e.f. 1.7.2000, it was clarified by the Board vide Circular No.354/81/2000-TRU dated 30.6.2000 (para 21) that for valuing goods which are captively consumed, the general principles of costing would be adopted for applying Rule 8. The Board has interacted with the Institute of Cost & Works Accountants of India (ICWAI) for developing costing standards for costing of captively consumed goods.

(2) The Institute of Cost & Works Accountants of India [ICWAI] has since developed the Cost Accounting Standards, CAS 2, 3 and 4, on capacity determination, overheads & cost of production for captive consumption, respectively, which were released by the Chairman , CBEC on 23.1.2003.

(3) It is, therefore, clarified that cost of production of captively consumed goods will henceforth be done strictly in accordance with CAS-4. Copies of CAS-4 may be obtained from the local Chapter of ICWAI.

(4) Board's Circular No.258/92/96-CX dated 30.10.96, may be deemed to be modified accordingly so far as it relates to determination of cost of production for captively consumed goods.

(5) This Circular may be brought to the notice of the field formations.

(6) Suitable Trade Notices may be issued for the benefit of the Trade.

(7) Hindi version will follow.

(8) Receipt of these instructions may be acknowledged.

4.17 Self-examination Questions

1 What are Cost Accounting Standards? How are they different from Accounting Standards issued by ICAI?

2 What are the objectives of Cost Accounting Standards Board? What is the enforceability of Cost Accounting Standards?

3 How are the Cost Accounting Standards different from Cost Accounting Records Rules?

4 What are the advantages of Cost Accounting Standards over the Cost Accounting Records Rules?

☆☆☆

STUDY NOTE - 5

Basics of Internal Audit and Operational Audit

This Study Note includes:

- Concept of Internal Control
- Origin of Internal Auditing
- Operational Audit
- Budgetary Control System
- Capacity Utilization
- Management Information System
- Nature and Scope of Management Audit
- Audit of Management Process and Function

5.1 Concept of Internal Control

5.1.1 A control can be defined as *any action taken by the management to enhance the likelihood that established objectives and goals will be achieved.* It results from management's planning, organizing, and directing to ensure that an organization is working toward its stated objectives. It is known by various names like management control, internal control etc.

5.1.2 This can be explained other way also. The 'Corporate objectives and goals' are the statement of corporate intent (for example, to increase the market share of the product by 15% in the next financial year). To achieve this 'corporate objective', management defines its own action as how the corporate objectives will be met i.e., 'management objective' (for example, market share will be increased only by leveraging some of the customers' current and future wants and needs). Internal control ensures that the 'action plan' to achieve management objectives is properly planned and executed (periodic checks will be made of the integrity of the information forming basis of the action plan regarding customers' current and future wants and needs and steps taken by marketing staff for full use of data mining tools in order to satisfy their information needs). Control responsibility is clearly management's job and encompasses planning, organizing, and directing.

5.1.3 In a narrow sense *internal control* is often seen as involving certain checks and procedures to prevent direct financial fraud or misappropriation of assets. They are sometimes also seen as mere accounting guidelines. But *nowdays* the concept of internal control has undergone complete change. It is now defined to include various methods and procedures to safeguard the assets of an organization, to ensure that accounting and statistical data produced are reliable and accurate ensuring greater efficiency in operation. According to W.W. Bigg, internal control "is best regarded as indicating the whole system of controls, financial or otherwise, established by the Management in the conduct of a business, including internal check, internal audit and other forms of control". So it is clear from the above definition that the internal control is a very wide term which includes financial and other forms of control including internal checks.

5.1.4 The Information Systems Control & Audit Association (ISACA) defines 'internal control system' as "The policies, procedures, practices and organizational structures, designed to provide reasonable assurance that business objectives will be achieved and that undesired events will be prevented, or detected and corrected." The Institute of Chartered Accountants, England and Wales, defines internal control as "By internal control is meant not only internal check and internal audit but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records".

5.1.5 In view of above, internal control system can be defined to be the policies, practices, procedures, and tools designed with the objective to: (1) safeguard corporate assets, (2) ensure accuracy and reliability of data captured and information products, (3) promote efficiency, (4) measure compliance with corporate policies, (5) measure compliance with regulations, and (6) manage the negative events and effects from fraud, crime, and deleterious activities.

5.1.1 Scope of Internal Control

5.1.1.1 It is clear from above that internal control is an essential pre-requisite for efficient and effective management of any organization and is therefore, a fundamental ingredient for the successful operation of the business in modern days. In fact, an effective internal control system is a critical success factor for any organization in the long term. They are indispensable tools for the ever-increasing risks, exposures, and threats to accounting systems, data, and assets. It embraces the whole system of controls – financial, operational or otherwise, established by the management in the functioning of a business including internal check, internal audit and other forms of control. In fact, internal control has now been recognized as fundamental and indispensable to modern auditing. Thus internal control has its all-embracing nature and is concerned with the controls operative in every area of corporate activity as well as with the way in which individual controls interrelate.

5.1.1.2 The scope of internal control, according to the aforesaid definitions, extends well beyond accounting control. Thus, the latest definition of internal control encompasses operational controls like quality control, work standards, budgetary control, periodic reporting, policy appraisals, quantitative control, etc., as all parts of the internal control system. In an independent financial audit or the statutory audit, the auditor is concerned mainly with the financial and accounting controls. However, in an operational audit (as part of internal controls), the auditor reviews all the controls including operational functions. The internal controls can be broadly classified into following four main categories: financial & accounting controls, administrative controls, operational controls and compliance controls.

(i) ***Administrative control*** – Administrative controls include all types of managerial controls related to the decision-making process. An example of administrative controls is the maintenance of records giving details of customers contacted by the salesmen.

(ii) ***Operational control*** – This is exercised through "management accounting" techniques viz. budgetary control, standard costing etc.

(iii) ***Financial and Accounting control*** – This control refers primarily the management plans, objectives and procedures that are concerned with the safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records, and timely preparation of reliable financial information.

(iv) ***Compliance control*** – These controls aim at ensuring compliance with applicable laws and regulations. These controls also help to ensure compliance with laws regarding the system and intellectual property.

5.1.2 Structure of Internal Control

5.1.2.1 There is no uniform or identical in its approach of internal control in all the organizations. It often varies in concept and applications, having regard to the following:

(a) Type of business;

(b) Magnitude of the business

(c) Infrastructure available in the organization.

(d) Potentiality of the human resources and their outlook.

Therefore, while designing an internal control system, the following factors must be considered to ensure greater chances of successful internal control system.

- **Segregation and Rotation of duties:** It is very necessary for successful internal control system that no one person handles the complete transaction i.e., those who physically handle assets are not those who record the asset movements also. The systems are so designed that no single individual is responsible for all the stages involved in a transaction i.e., duties are allocated in such a way that no single individual has an exclusive control over any one transaction or a group of transactions. Similarly, the people responsible for authorizing these transactions or reconciling of the records should also be different i.e., the work done by one person is either complementary to the work done by other person or the accuracy or correctness of work done by one person is independently checked by another person. The broad functions which are generally segregated are:

  (a) Execution of transactions;

  (b) Authorization of transactions;

  (c) Maintenance of records and documents; and

  (d) Physical custody of related assets.

Apart from segregation of duties, it is sometimes considered more desirable to rotate the duties of various officers and staff in an attempt to ensure that a fraud or error, if any may not remain undetected for a very long time. It also ensures that a person does not develop a vested interest by holding to a post for a very long time. In addition, it removes the impression of indispensability about an employee. This also ensures that the job profile of each post is well defined because employees can be rotated only if the content of each respective job is well defined.

- **Competence and integrity of people:** Internal control systems are not an end to themselves unless these systems are manned by the competent people, who are honest enough to consistently do so. The controls to be successful and effective necessitate the need for competent people to enforce such controls. In other words, the presence of detailed procedures may have no meaning unless these procedures are carried by the competent people, who can also envisage the changes required in the system over a period of time.

- **Appropriate levels of authority.** A common error usually made is to grant too much authority within control boundaries. Sometimes, this is deliberately done to expedite the things or to handle the emergencies. This is sometimes done to reduce the number of people i.e., cost reduction. However, controls to be effective require the authority to be granted on a need-to have basis only. If there is no need for a particular person to have a specific authority, he/she should not be granted such authority.

- **Accountability.** The internal controls to be successful presuppose that there is full accountability for all the decisions taken and there are controls present, which allow the determination with acceptable level of confidence of a person taking particular decision or authorizing particular transaction or took specific action. However, mere presence of these controls may have no meaning or may give a false sense of security unless strict action is taken every time, a discrepancy is noticed. Otherwise these controls may be left with no meaning.

- **Adequate resources:** Controls that are enforced with inadequate resources (manpower, finance, equipment, materials, and methodologies) will generally fail whenever they come under stress. Therefore, it is very necessary that minimum resources necessary to enforce the controls must always be present to enable the controls to be successful and effective.

- **Supervision and periodical updation:** Unfortunately, many people prefer to work only if they are being supervised or watched. It is, therefore very necessary for the controls to be adequately supervised and periodically updated in line with changing environment to be effective and successful. For example, in case of banks, if new service i.e., internet banking is also being started, it is very necessary that internal control system is also updated accordingly.

5.1.3 Limitations of Internal Control

5.1.3.1 An important ingredient in development of an effective internal control system aimed at the achievement of management's objectives is to ensure that the organization has adequate relevant policies accompanied by effective monitoring and reporting mechanism. Moreover, while establishing the management objectives, the management must take into consideration the cost of attempting to achieve them. In other words, the cost of achieving objectives must be less than the anticipated benefits to be derived by achieving the objectives. One extreme is to achieve objectives *"As quickly as possible"* implying zero controls, while other extreme of achieving of objectives with *"No errors"* implies strong internal controls covering all aspects of objective. Controls must therefore be practical, useful, achievable, and compatible with both operating and control goals and there is always a trade-off between cost and benefit. Since all controls cost resources in terms of money, personnel, equipment, and time, internal controls always imply a trade-off between the anticipated cost and benefit envisaged. (Is it worth to spend rupees ten thousand to prevent a possible loss of rupees five thousand?).

5.1.3.2 For example, those risks that have a low probability and low cost should simply be *ignored*. But for those with high probability and high costs, control activities need to be implemented to *prevent* the risk from occurring. For example, a disaster may have a low probability but it has a high cost, therefore management should employ *insurance and/or backup plan* as an appropriate control activity. This model requires management to identify what needs protecting, what the risks are for those assets, and the level of cost impact and probability for each risk. Therefore, the organization must do a comprehensive risk assessment before actually designing an internal control system, i.e., identify the risks to which it is subjected to and the corresponding amount of loss if that risk comes true. In other words, any Internal Control System must ensure that all anticipated risks are taken care up to the point of cost benefit analysis i.e., cost of effecting control or managing a risk does not exceed the estimated amount of losses, if that risk actually happens or comes true. However, this condition may not be strictly applicable to those controls, which are aimed at ensuring compliance with applicable laws and regulations.

5.1.3.3 The second ingredient or evaluation parameter is that of reasonable assurance. Even though in actual practice, there is no such thing as 'perfect internal control system'. No computer system is impervious to hacking attacks, malicious activities or sometimes genuine errors. Moreover as already stated above, controls have a cost and the concept of cost-benefit needs to be applied even to controls also. If it costs Rs. 2 crores per annum to make computer hacking free or error free and the risk assessment shows an estimated loss of Rs. 5 lakhs only, it may be better to have reasonable controls only to avoid prohibitive costs. Therefore, internal controls are designed to provide management with *reasonable assurance* regarding the achievement of these objectives.

5.1.3.4 It may be added here that most of the internal controls are aimed at anticipated risks or transactions of usual nature. Therefore, unanticipated event or the transactions of unusual nature may still escape all controls despite all precautions. Further, all controls need to be updated regularly to keep pace with changing conditions. So rigorous and effective internal controls of past may no longer be effective in present or future.

5.1.3.5 Lastly no depth of internal control can avoid losses due to potential human error or due to collusion between two or more persons. For example *'Disgruntled employees'* probably present the highest risk—even more than hackers external to the firm. These people can always be motivated to cause harm to the organization and depending on their knowledge and access to systems, data or other assets, they can cause extensive damage. Similarly, a person who has an extreme cash flow problem for any reason (like gambling, excessive lifestyle, etc.) may sometimes be tempted to steal assets to cover personal losses; often with the intention to "pay back" after some time. It is also sometimes possible that someone in the organization may become an industrial spy.

5.1.3.6 Sometimes, management itself is a risky group. They can very easily override controls because of their unique position and hence can more easily commit fraud etc. Sometimes, managements are forced to do 'window dressing' of their balance sheets to show higher profits to contain the declining share prices or to earn their bonuses (if based on profits). Even the normal aggressive nature of managers can sometimes become a risk if not mitigated by strong personal and corporate ethics, and an effective internal control system (e.g., audit committee). For example, one management accountant reported his dilemma when his boss wanted him to reverse a correct accounting transaction because it resulted in the department missing its profit goals for the first time in three years. Such actions are indicative of ethical soft spots that can lead to fraud, theft, or material misstatements. These risks are very difficult to anticipate because of their nature. However this aspect should be thoroughly analyzed by external auditors during financial audits.

5.1.3.7 Therefore, an evaluation of internal controls is necessary to establish the effectiveness of those controls. The Auditor should keep in mind the following two sets of basic objectives while evaluating internal control –

(a) to safeguard assets and control transactions; and

(b) to provide reasonable assurance, through his opinion report' that there is no material errors in the financial statements.

5.1.4 Evaluation of Internal Control

5.1.4.1 The guiding factor for audit operations by the auditor depends to a great extent on the soundness or otherwise of the internal controls in the business. Due to the limitation of time, an auditor can spend limited time only on a company's audit. Therefore, he has to decide the extent of in-depth audit of many areas, particularly the checking and verification of routine aspects of financial transactions. Sub-para (iv) of para 4 read with para 3 of the Companies (Auditor's Report) Order, 2003 (CARO) requires that the auditor's report on the account of a company to which this Order applies shall inter-alia include a statement as to whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory, fixed assets and for the sale of goods. It will also include whether there is a continuing failure to correct major weaknesses in internal control.

5.1.4.2 Section 292A of the Companies Act, 1956 provides for establishment of a committee of the Board known as "Audit Committee" by every public company having paid-up capital of Rs. 5 crore or more. The sub-section (5) of said section provides that the statutory auditor, the internal auditor, if any and director in-charge of finance shall attend every meeting of the audit committee but shall not have the right to vote. Sub-section (6) of this section clearly provides that the Audit Committee should have discussions with the auditors periodically about internal control systems, scope of audit including the observations of auditors and review of the half yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems. Moreover, Clause 49 of the uniform listing agreement prescribed by Securities and Exchange Board of India, which is applicable to all the listed companies provides that the Audit Committee is empowered to investigate any activity within terms of reference, seek information from any employee, obtain outside advice and secure attendance of outsiders, if necessary. Its role shall *inter-alia* include recommending appointment and removal of external auditor, reviewing the adequacy of internal audit function, reviewing the company's financial and risk management policies etc.

5.1.4.3 The evaluation of internal controls including internal accounting controls gives an opportunity to the auditor to a clearer insight into the operational systems and an overall view of the organizational workings to spot weaknesses in the systems and procedures both in respect of financial and operational areas of the business. The audit process effectively evaluates the auditee's existing internal controls through the use of questionnaires and flow charts. The internal control questionnaire is a list of systematically and logically prepared questions designed to find out and evaluate the effectiveness of internal control systems regarding various aspects and accounting transactions of an organization. The questionnaires are to be comprehensive in nature to ensure that all aspects and accounting transactions are covered which are to be replied by the officials of the department or division concerned. The criteria for replies against each question are "yes", "no", "not applicable", "explanatory notes" and comments". Normally the affirmative answers suggest satisfactory internal controls while negative answers suggest weaknesses of internal controls.

5.1.5 Internal Control Questionnaire

5.1.5.1 While conducting audit, the statutory auditor will submit to the organization a complete questionnaire for reply by the relevant officials, which will help the former to form an opinion as to the adequacy and reasonableness of the internal systems. The statutory auditor may make do test checks or in-depth checking depending on the circumstances to make sure that the replies to the questionnaires are accurate and complete. In respect of many of the replies, the statutory auditor may have to make sure that the internal control systems are really in operation through proper verification. In respect of negative replies, he may have to qualify his audit report depending on the seriousness of the situation. In other words, the auditors will use sample testing techniques as a means of validations. Such sampling techniques will vary depending upon the internal control evaluation and results of prior tests. These techniques allow the auditors to review a limited number of transactions as a representative to the whole. In essence, the more testing required due to lack of internal control and lack of accuracy in the accounting records takes additional audit time therefore increases the cost of the audit also.

Internal Control Questionnaire regarding Purchases and Creditors:

	Questions	Yes/No	Not Applicable	Comments regarding all negative answers and further information as to answer
Internal Control Questionnaire regarding Purchases and Creditors:				
(1)	Whether Purchase Department is centrally responsible for all purchases?			
(2)	Whether purchases are initiated only against the valid demands for procurements?			
(3)	Whether the authorities competent for sanctioning of purchases have been clearly specified? Whether limits or ceilings have been prescribed within which purchases can be sanctioned by respective authority?			
(4)	Whether a list of approved suppliers is maintained for each major item? Whether the list is updated regularly?			
(5)	Whether there is competitive bidding for costly items or there is a list of approved short listed suppliers?			
(6)	Whether deviations for procurement from other than approved short-listed vendors permitted? If so, under what circumstances?			
(7)	Whether any long-term purchase contracts have been entered into with the suppliers? Whether the stipulations regarding price, specification of goods, etc., in such contracts clear and unambiguous?			
(8)	Whether cash purchases or other direct small purchases by production deptts. allowed. If so, under what circumstance?			
(9)	Whether specific approvals required for the following :			
	(a) Purchase from organizations in which managerial personnel are interested or stakeholders (related party transactions). Whether there is a system by which all managerial personnel up to a certain level are required to disclose their interest in various organizations? (b) High value purchases. (c) Long-term purchase contracts involving large amount in the long run.			

(10)	Whether the same procedure followed in respect of purchase of both trading and capital goods?			
(11)	How reasonability of prices is ensured especially in case of non-competitive biddings or emergency purchases or purchases involving small amounts? Whether the system is reasonable?.			
(12)	Where tenders/competitive quotations are invited, whether it is ensured that no supplier gets an undue advantage? For example, what is the procedure for custody of sealed priced bids?, Whether sealed price bids opened transparently in presence of senior official and the representatives of the suppliers? If negotiations are conducted after the opening of the price bids, whether an equal opportunity given to all the short-listed suppliers or to the lowest quoted vendor only?			
(13)	Whether a record of the prices quoted by different suppliers maintained to serve as the basis for authorizing any purchase?			
(14)	Whether an item-wise (or code head wise) record of all the prices paid during previous procurements maintained?			
(15)	Whether a special approval necessary where any procurement is not based on the lowest price bid received?			
(16)	Whether the procurement prices are firm and fixed?			
(17)	Whether special authorization is required for insertion of price variance clause in a procurement contract?			
(18)	Whether purchase orders serial numbered?			
(19)	Whether unused blank purchase orders kept in proper custody?			

(20)	Whether purchase orders contain the following information: (a) Serial Number; (b) Name of supplier; (c) Quantity; (d) Detailed Technical Specifications; (e) Price; (f) Terms of delivery; (g) Terms of transport; (h) Terms of payment; (i) Any other terms, such as packing, etc.			
(21)	Whether there are standard terms and conditions for all procurements?			
(22)	Whether any variation from these standard terms and conditions need any special authorization?			
(23)	Whether the copies of the purchase orders are marked to the Accounts Department and the Goods Receipt Department?			
(24)	Whether the purchase department keeps a track record of pending purchase orders?			
(25)	Whether follow up action is taken with the user department with respect to pending Purchase Orders, so that the production schedule is not affected.			
(26)	Whether all goods and materials purchased are received by the Goods Receipt Department along with copy of invoice from Supplier (sometimes without price)?			
(27)	Whether the Goods Receipt Department physically counts, weighs or measures the goods received?			
(28)	Whether the Goods Received are also inspected with respect to their technical specifications?			
(29)	Whether the Goods Receipt Department prepares a Goods Received Note and Goods Inspection Note in respect of each consignment?			

(30)	Whether the copies of the Goods Received Note and Goods Inspection Note are marked to the Accounts Department, Purchase Department, Stores Department and the demand initiating department?			
(31)	Whether the Goods Received Notes are serial numbered?			
(32)	Whether the Goods Inspection Notes are serial numbered?			
(33)	Whether the Goods Receipt Department rejects the materials in case of shortage of quantity, defective goods or variations from specifications given in the purchase order? Whether whole consignment is rejected or defective goods only rejected.			
(34)	Whether in case of defective goods, an outward return note is prepared indicating the quantity and specifications of goods to be returned?			
(35)	Whether the goods returned promptly and an acknowledgement or return of goods obtained from the supplier? Where materials are accepted despite shortage or variations from specifications, whether these facts are mentioned on the challan sent to the supplier as well as on the goods received note?			
(36)	Whether the Accounts Department is informed about short-receipts or defective goods returned to the suppliers, so that Debit Notes may be prepared in the name of the suppliers?			
(37)	Whether claims are filed with the insurers in case of goods lost or damaged in transit?			
(38)	Whether debit notes are serial numbered and the unused ones are kept in safe custody?			
(39)	Whether the invoices are received directly by the Accounts Department from suppliers?			
(40)	Whether each invoice received given a running serial number? Whether this serial number as marked on an invoice also marked on the supporting documents attached to the invoice such as purchase order, goods received note, etc.?			

(41)	Whether it is ensured that duplicate invoices are accepted only with proper authorization and only in such cases where the original invoices were not received? Whether duplicate invoices prominently marked 'duplicate' and attached with the supporting documents regarding the relevant purchase?			
(42)	Whether there are adequate precautions to prevent double payments against duplicate invoices?			
(43)	Whether there is a procedure for processing the invoices and credit notes along with check-list at each stage?			
(44)	Whether proper records are maintained to link the respective invoices with all advance payments and stage payments to suppliers?			
(45)	Whether the accounts department reconciles the quantity/value of goods received and as specified in the invoices and the stock records?			
(46)	Whether the Accounts Department keeps track of those Goods Received Notes or Goods Inspection Notes, where payment is pending for want of any reason including non-receipt of invoice despite satisfactory receipt of goods?			
(47)	Whether all invoices are entered promptly in the purchase book?			
(48)	Whether the first copy of all Goods Received Notes and Goods Inspection Notes is linked to respective invoices before the invoices are processed for payments?			
(49)	Whether the Accounts Department compares the quantities and value as shown in the suppliers' invoice with the Goods Received Note and the purchase order?			
(50)	Whether the goods received without corresponding invoices are accepted at the Goods Receipt Department? If yes, whether these are independently checked by persons other than those in Goods Receipt Department?			

(51)	Whether the invoices are finally cleared for payment only after linking with first copy of Goods Received Note, Goods Inspection Notes and the relevant purchase order?			
(52)	Whether the Accounts Department reviews the accounts of vendors, who are both customer as well as suppliers to determine set-off of mutual claims?			
(53)	Whether the debit notes are serial-numbered? Whether the missing numbers duly enquired into?			
(54)	Whether there is a proper control over the issue of debt notes especially with regard to the competent authority to ensure their accuracy?			
(55)	Whether all debit notes are recorded promptly in the books of account?			
(56)	Whether there is a periodic review of the accounts statements received from suppliers' with the respective ledger accounts?			
(57)	Whether the differences between the statements received from suppliers' and their respective ledger accounts properly investigated and reconciled?			
(58)	Whether cash, cheques etc., are received only by persons authorized to do so?			
(59)	Whether there is a clear cut policy regarding granting of cash discounts and rebates, issue of credit notes, etc? Whether the officials, who are entitled to grant cash discounts/rebates are clearly specified in the policy along with the broad limits within which they can operate?			
(60)	Whether cash receipts are recorded in cash registers and serial numbered cash receipts issued?			
(61)	What are the controls over miscellaneous receipts like sale of scrap/waste etc.? Whether these transactions are executed under the supervision of a responsible officer?			
(62)	Whether cash receipts are issued in all cases of cash received, or receipts are issued only if so required by the party making the payment?			

(63)	Whether the cash receipts are pre-numbered?			
(64)	Whether sufficient controls are there to ensure that the details on counterfoils/ copies of receipts are the same as those on the original receipts? (For example, use of receipts having automatic carbons whereby anything written on the original gets automatically transcribed on the copy or issue of cash receipt through the automatic cash register.)			
(65)	Whether all cash receipts are entered in the cash book on the same day? Whether the supervisor independently checks the cash book everyday to ensure up-to-date recording?			
(66)	Whether there is a system ensuring that all alterations in the copies/counterfoils of receipts, other documents, cash book and the ledger are made clearly, without overwriting and only under the initials of the supervisor?			
(67)	Whether a specific person is responsible for opening all the mails containing remittances. Whether he is required to prepare immediately a list of all cheques, drafts, etc., and mark them 'Account Payee Only'?			
(68)	Whether the customers and all other parties required or encouraged to make payment only through account payee cheques/ drafts?			
(69)	Whether all cheques, drafts, cash etc., which are received up to a stipulated time during the day required to be deposited in the bank on the same day?			
(70)	Whether there is a system to ensure that cash, cheques, etc., collected by the authorized representatives of the enterprise (e.g. sales representatives) are recorded, deposited and reconciled promptly?			
(71)	Whether there is a system of sending periodic statements of account to customers and other parties from whom cash, cheques or drafts are received on a regular basis and requesting them to confirm the correctness of the statements?			

(72)	Whether there is a regular reconciliation of cash-in-hand as per the books of accounts and the physical balance in hand?			
(73)	Whether the counter-foils of the pay-in-slips used for deposits in bank are retained by the cashier?			
(74)	Whether there is a daily cross-checking between total receipts in cash or by cheques, and total credits to customers' accounts in the ledger?			
(75)	Whether all unused cash receipts books and cheque books kept in safe custody under the charge of a senior official and issued only after verifying that the previous cash receipt book/cheque book has been fully accounted for?			
(76)	Whether an internal audit of cash receipts conducted regularly? Whether surprise count of cash balance carried out periodically by the internal auditor or by another independent official, who does not have any duties relating to handling of cash or accounting for it?			
(77)	Whether the bank reconciliation statement is prepared periodically say every week to ensure proper reconciliation? Whether proper follow-up action is taken with regard to outstanding entries?			
(78)	Whether the balances in the Debtors' Accounts are periodically reviewed to keep them to minimum?			
(79)	Whether the old creditors' accounts, where payments are not being claimed by the suppliers are periodically reviewed to know the exact reasons?			

5.1.6 Internal Control and Internal Auditor

5.1.6.1 The Committee of Sponsoring Organizations of the Treadway Commission (COSO) had recently issued the "COSO report", which was jointly sponsored by the Institute of Internal Auditors (IIA), the American Institute of CPAs, the Financial Executives Institute, the American Accounting Association, and the Institute of Management to provide a common, widely accepted definition of internal control and provide a framework of internal control which can be used as a benchmark for assessing its effectiveness. The COSO report defines internal control as follows:

…*a process, effected by an entity's board of directors, management and other personnel,* which is designed to provide reasonable assurance regarding the achievement of objectives in one or more categories:

– effectiveness and efficiency of operations

– reliability of financial information

– compliance with applicable laws and regulations

5.1.6.2 The COSO definition of internal control acknowledges that both management and non-management personnel play a significant role in making the internal control process function. The COSO study identifies five interrelated components of internal control:

(a) the control environment;

(b) risk assessment;

(c) control activities;

(d) information and communication; and

(e) monitoring.

5.1.6.3 The underlying foundation of internal control, termed as 'the control environment' is dependent on the people in an organization including their competence, attributes and their ethical values. The management must assess the anticipated risks (risk assessment) and devise mechanisms (control activities) to manage those risks to achieve its goals and objectives. Information and communication among people are vital links in the effective control system. Lastly, monitoring of internal controls is an ongoing process like managerial reviews or periodic reviews like internal self-assessment or an audit. The internal audit function is a part of internal control as part of the monitoring process.

5.1.6.4 Internal auditing has been defined as an independent, objective assurance and consulting activity designed to add value 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. It is essentially a management control mechanism that operates through measurement and evaluation of effectiveness of other controls.

5.1.6.5 We know control compels events to conform to plans. Internal control is an essential part of control mechanism within an organization, which functions for the success of an organization by way of implementation of organizational objectives, policies, plans and philosophy. To assess the effectiveness of internal control measures, it is essential to measure the extent of accomplishment of objectives through appraisal, review and evaluation of the related factors. Now, because appraisal, review and evaluation, in most of the organizations are done by the internal auditor through internal audit functioning, the importance of role of an internal auditor in the context of internal control cannot be exaggerated.

5.1.6.6 The importance of internal auditor in the field of internal control can also be brought about if reference is made to "Standards for professional practice of Internal audition" issued by the Institute of Internal Auditors Inc., USA, which *inter alia* include :

(a) The purpose of the review of the systems of internal control is to ascertain whether the system established provides reasonable assurance that the organization's objectives and goals will be met efficiently and economically.

(b) The purpose of the review for effectiveness of the system of internal control is to ascertain whether the system is functioning as intended.

(c) The purpose of the review for quality of performance is to ascertain whether the organization's objectives and goals have been achieved.

(d) The primary objectives of internal control are to ensure –

(i) reliability and integrity of information;

(ii) compliance with policies, plans, procedures, laws and regulations;

(iii) the safeguarding of assets;

(iv) the economical and efficient use of resources; and

(v) the accomplishment of established objectives and goals of operation or programmes.

5.1.6.7 As a matter of fact management is usually on the lookout for someone who can assure them that control systems implemented are being followed and periodically reviewed/cross checked for their suitability vis-à-vis adaptability to changing circumstances, so that management can earn confidence in managing the business in the desired direction. Then, the question arises as to the scope of appraisal by the internal auditor to aid management in keeping up confidence in running a business and in achieving organizational objectives. The internal auditor is to go beyond the ambit of control measures determined by appraising and assessing the extent of implementation of the management control systems, ensuring as well as assuring the management control systems are as effective as these are expected to be and thereby converting hopes and aspirations of the organization into reality and accomplishments.

5.1.6.8 Internal auditing, as has been seen, can therefore reveal a sound internal control system but nevertheless the support of the top and middle management is a must. Since control mechanism operates through men only, the human side of the enterprise is to be relied on for efficient of control functions. Hence along with appraisal of control measures there has to be appraisal of performance of personnel.

5.2 Origin of Internal Auditing

5.2.1 The origin of internal audit goes back to thousands of years. There are records available, which show that the Greeks, Romans, and Egyptians were conducting audits before the birth of Christ. Interestingly, the scope of all these early audits was in many ways similar to that of modern internal audits. The audit in Government during the modern time dates back to the year 1789, when the first U.S. Congress approved an 'Act' that included a provision for the appointment of a secretary of the treasury, a comptroller, and an auditor. The auditor's job was to receive all public accounts, examine them, and certify the balances.

5.2.2 In the modern era, railroad companies in USA are often credited for being the first to introduce internal audit during the latter part of the nineteenth century. These railroad companies had traveling auditors to visit the railroads' ticket agents and determine that all the accounting for all monies was properly handled. Krupp Company in Germany had employed some type of internal audit staff at least as early as 1875, since there is an audit manual dated January 17, 1875, which *inter-alia* includes the following provisions:

The auditors are to determine whether laws, contracts, policies and procedures have been properly observed and if all business transactions were conducted in accordance with established policies and with success. In this connection, the auditors are to make suggestions for the improvement of existing facilities and procedures, criticisms of contracts with suggestions for improvement, etc.

5.2.3 The growth of large corporate houses during the early part of the twentieth century necessitated the need for extended span of control by the managements employing thousands of employees with manufacturing plants at many locations and sales & marketing all around the world. The traditional form of audit by the public accountant was not very effective in these companies because of huge distances between different locations besides being proving very costly also as it necessitated lot of traveling. Therefore, a need was felt for internal auditors at all the locations mainly for protection of assets. The objectives of internal audit during this period have been explained as under:

Protection of company assets and detection of fraud were the principal objectives. Consequently, the auditors concentrated most of their attention on examinations of financial records and on the verification of assets that were most easily misappropriated. A popular idea among management people a generation ago was that the main purpose of an auditing program was to serve as a psychological deterrent against wrongdoing by other employees.

5.2.4 However, this role of internal auditor has undergone a vast change during the second half of twenty first century. Earlier, internal auditing was essentially to check the records after those had been created to ensure accuracy. These internal auditors were also concerned with the possibility of fraud. Thus, the main role of internal auditor was that of a verifier, or a "police-man," or a "detective" to protect the companies' assets.

5.2.5 The emergence of war economy during 1940s is attributed credit for the initial expansion in scope of internal audit. With huge back-log of orders, managements became more concerned with production scheduling, shortages of materials and laborers, and compliance with regulations. Most of these contracts were on cost plus basis. Therefore, cost reporting also became more important. As a result, internal auditors began directing their efforts towards other areas also, which were till then outside the purview of internal audit.

5.2.6 The fast technological leaps and global expansion are also responsible for the fast changing and ever expanding role of internal auditors. With emergence of very powerful and cheap computers, accounting has become mechanized and computerized. These are subject to automatic checking procedures. Thus, there may no longer be the need to check each and every transaction. Therefore, the modern concept is that internal auditors are an arm of the management and are just as concerned with waste and inefficiency as with fraud.

5.2.7 Arthur H. Kent's published an article, "Audits of Operations," in March 1948 describing the expanded-scope of audit. Kent made frequent mention of an *operations audit* in that article. However, by the 1970s, the paradigm shift in the role of internal auditors from financial perspective only to wide operational perspective had become profound and permanent. The modern work of the internal auditor had become more of auditing for efficiency and effectiveness than financial propriety. Thus, the main objective of the Internal Audit function has shifted from fraud detection to assisting managements in making decisions. This has also ensured that the internal auditor was now an important integral part of the management team.

5.2.8 Section 301 (Public Company Audit Committee) of the Sarbanes-Oxley Act passed by the U.S. Congress in the year 2002 requires an audit committee in all the listed companies. Section 404 (Management Assessment of Internal Controls) of the said Act requires an annual report on management of the internal controls and their effectiveness. The law requires annual reports to contain an assessment of the effectiveness of internal control over financial reporting. In addition, it also requires the adoption of standards for independent auditors to attest to management's report on internal control. Separately, the act requires a company's CEO and CFO to certify quarterly and annual reports. These developments will ensure the necessity for the adequate and effective internal audit department in all the listed companies to assist management with these requirements. Similar provisions are already in place under the Indian Companies Act, 1956.

5.2.1 Internal Check and Internal Audit

5.2.1.1 As already explained above, internal check and internal audit are important ingredients of any system of internal control. Internal check is a system of instituting 'checking' on the day-to-day transactions as part of the routine system, whereby the work of one person is proved independently or is complementary to the work of another person i.e., the prevention and early detection of errors or fraud. Therefore, the systems are so designed that no single individual is responsible for all the stages involved in a transaction i.e., duties are allocated in such a way that no single individual has an exclusive control over any one transaction or a group of transactions. Thus, making it difficult for a fraud to take place unless there is a collusion between two or more persons. In addition to the complementary allocation of duties, an internal check system also involves prompt and independent validation of an individual's work by including cross-checks and cross-reconciliations as a part of the operating procedure itself. For example, in case of banks, there are always two or more persons involved in payment of cash withdrawal against cheques. One bank employee will receive the cheques, issues token against it, checks the balance amount available in the account and makes the necessary entry in the ledger. The supervisor then authorizes the payment to be made by the cashier after verifying the signatures etc. Thus, the responsibilities in any bank are always divided in such a way that that no one person can authorize, execute, and record the transaction.

5.2.1.2 Internal auditing, on the other hand is "an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed." The scope of internal audit is by definition determined by the management. For example, one organization may have very narrow scope of internal audit concerning itself mainly with the routine checking of accounting transactions on a daily basis, whereas the scope of internal audit in another enterprise may be wide enough to include reviewing the efficiency and effectiveness of each department of an organization.

5.2.1.3 It can, thus, be concluded that the term internal control has its all-embracing nature and is concerned with the controls operative in every area of corporate activity as well as with the way in which individual controls interrelate. Therefore, internal check and internal audit are two important ingredients of internal control. Internal checks are procedures inbuilt in the overall system itself and take place concurrently with the execution of the transactions, whereas internal audit is a distinct function which is carried out after the transactions have taken place.

5.2.2 Internal Audit and its Scope

5.2.2.1 Internal auditing is an independent appraisal activity within an organization for the review of operations as a service to management. It improves managerial control by measuring and evaluating the effectiveness of other controls, and by maintaining a vigilant watch over risks.

5.2.2.2 It comprises a complete intra-company financial and operational review, which is undertaken within an organization by specifically assigned staff. The usual meaning attached to the concept of internal audit are as follows :

a) Internal audit is a continuous and a systematic process of examining and reporting the operations and records of a concern by its employees, or external agencies specially assigned for this purpose. It is, in essence, auditing for the management and its scope may vary, depending upon the nature and size of the concern.

b) H. Wasbrook in his book, "The Board and Management Auditing" has defined internal audit as "in its narrow sense, such an audit is one that is carried out by the specialist staff of the organization being audited, it concerns itself mainly with the routine checking of (usually) accounting transactions on a daily basis, with the object of quickly locating irregularities, thus making it more difficult to perpetrate a fraud, because of the constant nature of the checking".

c) Internal audit is a management tool, performed by employees of the organization to ensure correctness in accounting data and to detect fraud by way of periodical review of organizational systems and procedures.

5.2.2.3 This definition is also quite clear in explaining the term and has laid emphasis upon "independent appraisal" of the related individuals in the organization and is not mainly with the routine checking. This requires the internal auditor to go beyond the records in the books and to review and report the performance in the area of finance, accounting and other related operations.

5.2.2.4 Internal audit is in fact a control system that functions through examination and appraisal of other control mechanisms operating within the organization. It keeps close eyes on the business to ensure that all transactions are duly recorded in complete form and that faulty, inefficient or fraudulent operations are revealed and corrected. It provides a proper foundation where all assets get properly protected and the structure for better operations and higher profitability is embodied.

5.2.2.5 According to the Institute of Internal Auditors, internal audit involves five areas of operations:

1. *Reliability and integrity of financial and operating information:* Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measures, classify and report such information.

2. *Compliance with laws, policies, plans, procedures and regulations:* Internal auditor should review the systems established to ensure compliance with those policies, plan and procedures, law and regulations which could have a significant impact on operations and reports and should determine whether the organization is in compliance thereof.

3. *Safeguarding of Assets:* Internal auditors should verify the existence of assets and should review the means of safeguarding assets.

4. *Economic and efficient use of resources:* Internal auditor should ensure the economic and efficient use of resources available.

5. *Accomplishing of established objectives and goals for operations:* Internal auditor should review operation or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.

5.2.2.6 It is said that scope of internal audit is very much related to business phases. The first phase of business is basically the planning stage, and the decisions are on issues like whether to make or buy, whether to undertake a new project or export etc. These are more of managerial decisions and the scope of internal audit is often not much practical, in the initial stage, unless it takes to what is called management audit. The 2nd phase is the execution stage having its base in the subsequent recording in the books of account. In this stage, the scope of internal audit emerges out of need for correctness of accounts and proper classification of heads in a required manner. The third and final phase is the review of transactions where scope of internal auditing is immense. This internal auditing is a function distinct from authorization and recording, which concerns not only with examination of the transactions as recorded in the books of account, but also the appraisal of the procedures with a view to affecting change for better efficiency, as far as practicable. For a better understanding of nature and scope vis-à-vis objectives of internal audit, the following may be of interest:

I *Independent* appraisal, review and evaluation

N *Necessity* of specialist service

T *Thorough* in making study

E *Ensure* complete objectivity

R *Reporting* without fear or favor

N *Narrow* down the gap between management objectives and the efficiency achieved.

A *Assure* better management

L *Look* for all round efficiency

A *Aid* to management

U *Understanding* operational and management auditing

D *Discuss* to find out acceptable solution

I *Improving* internal control

T *Test* for efficiency and effectiveness

5.2.2.7 A proper organization structure for internal auditing department ensures its relative independence so that it can carry out its work freely and objectively and render impartial and unbiased decision. The institute of Internal Auditors has stated that "organizational status of the internal auditing department should be sufficient to permit the accomplishment of the audit responsibilities". So to ensure this the management and the Board of Directors must give full support to the internal auditors. The functions, responsibility and authority of the internal auditing department should be clearly and specifically laid down in a written document. The chief internal auditor should have direct communication with the Board of Directors. He should submit periodic reports to the Board highlighting significant audit findings.

5.2.3 Statutory Auditors and Internal Auditors

5.2.3.1 In view of the similarity between much of the work of internal and external auditors, it is appropriate to consider the fundamental difference between these two. The objective of internal auditing is mainly to assist the organization in the effective discharge of responsibilities by furnishing them with analyses, appraisals, and recommendations concerning all the activities reviewed. The internal auditor is concerned with every phase of business activity where he may provide service to the organization. This scope goes beyond the accounting and financial records to obtain the full understanding of the operations of the organization. The attainment of this overall objective *inter-alia* includes the following activities:

- Reviewing and appraising the correctness and adequacy of accounting, financial, and other operating controls ensuring effective internal control at optimum cost;
- Validation to ensure the compliance with established policies, plans, procedures and applicable laws and regulations;
- Accounting and safeguarding the assets of the company from losses of all kinds;
- Validation to ensure the reliability of management data developed within the organization;
- Validating the quality of performance in carrying out assigned responsibilities; and
- Recommending operational improvements and corrective measures.

5.2.3.2 The external auditor, on the other hand has a statutory responsibility to report on the true and fair view of the accounts of the company and whether proper books of accounts and other accounting record have been kept. These responsibilities cannot be delegated to others. However, the objectives and scope of the internal audit on the other hand are determined by management. It is actually a managerial control which functions within the scope determined by the management.

5.2.3.3 The external auditor is appointed by the shareholders of the company in the annual general meeting in accordance with the provisions of the relevant Companies Act and is therefore accountable to them. The internal auditor is appointed by the management and is, therefore responsible to the management. The exact role and scope of internal audit shall vary from company to company, whereas the ultimate objective of statutory audit is same in all the companies.

5.2.3.4 The qualifications of the statutory auditors are prescribed under the provisions of section 226 of the Companies Act. However, there are no minimum qualifications prescribed under the Companies Act for the persons appointed to act as internal auditors. Similarly, Section 227 of the Companies Act allows to the statutory auditor, the right of access at all times to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere. Statutory auditor is also entitled to require such information and explanation as he may think necessary for the performance of his duties as statutory auditor. However, there are no such rights available to the internal auditor.

5.2.3.5 In other words, the internal audit is an internal control from the point of view of statutory auditor, which functions by appraising and evaluating other controls. The statutory auditor evaluates the extent of the scope of the internal audit and takes this into account in determining the exact scope of his own work.

5.2.4 Assessment of Adequacy of Internal Audit Function

5.2.4.1 Sometimes it is required to assess the adequacy of internal audit function of an organization. The following questionnaire will enable to evaluate the work of the internal auditor and assess the adequacy of the internal audit function:

1. What is the organizational set up of the department?
2. Is the staff employed in the department adequate?
3. Are the qualifications of the staff adequate?
4. Is the staff competent?
5. Is the staff independent?
6. To whom do they report frequently and with what effect?
7. Is there any internal audit manual?
8. Is a programme of internal audit drawn up before the commencement of the financial year?
9. Does the programme cover the audit of all the important transactions and records of the company including statutory cost accounting records?
10. Is the scope of internal audit wide enough to extend to areas such as, management audit, operational audit and system analysis?
11. What is the system of reporting irregularities noticed during internal audit?
12. Is prompt corrective action taken by the management on the basis of internal audit reports?
13. Is there much duplication of work between the statutory audit and internal audit?

5.2.5 Auditing Government Agencies

5.2.5.1 Various governmental audit agencies throughout the world have played a role in the movement toward the modernization of internal audit procedures. In the United States, the General Accounting Office (GAO) has played a major part in broadening the role of the auditor. The GAO's publication, *Standards for Audit of Governmental Organizations, Programs, Activities and Function*s (commonly called the "Yellow Book" because of the color of its cover) explains the metamorphosis in the following manner:

- *This demand for information has widened the scope of governmental auditing so that such auditing no longer is a function concerned primarily with financial operations. Instead, governmental auditing now is also concerned with whether governmental organizations are achieving the purposes for which programs are authorized and funds are made available, are doing so economically and efficiently, and are complying with applicable laws and regulations.*

5.2.5.2 Basically, the recommended standards encompass those standards that have been adopted by the AICPA for use in audits to express an opinion on the fairness of financial statements. Governmental audits, however, go a step beyond those standards that are applicable to audits of financial statements. The scope of a governmental audit (e.g., an audit of or for a government agency) is composed of three elements:

1. Financial compliance,
2. Economy and efficiency, and
3. Program results.

5.2.5.3 The typical definition of a financial audit would not include elements 2 and 3. These are operational auditing techniques.

5.3 Operational Audit

5.3.1 The internal audit function in any organization can be broadly categorized into three major functions namely (a) financial audit (b) compliance audit and (c) operational audits. However, an operational audit is sometimes defined as an extension of a financial audit. It may be added here that even though the statutory auditors may place a degree of reliance on work performed by the internal auditors, the firm of chartered accountants still has the responsibility for certifying the true and fair view of the financial statements. Similarly, regulatory agencies or other organizations concerned with compliance generally either send in their own auditors or hire an external audit firm. Therefore, Internal Audit mainly plays a supplementary role only in financial and compliance audits, but operational auditing is the primary, albeit not the exclusive, domain of the internal auditor.

5.3.2 An operational audit (or value-for-money audit) has been defined as an organized search for ways of improving efficiency and effectiveness. The objective is to assist the organization in performing functions more effectively and economically with focus on the efficiency and effectiveness of operations, it is also stated to be an early warning system for the detection of potentially destructive problems.

5.3.3 An operational audit can lead to better management of all aspects of business organization whether it is production area or service area. Traditionally, operational audits have been conducted by means of a questionnaire interview of departmental employees. Virtually all large companies conduct operational audits in their major production and service departments. The financial audit tells where the entity was and where it is on the date of the balance-sheet. However, an operational audit tends to answer the questions as to why the entity is where it is and how it got there. It means the evaluation of management's performance and efficiency. Therefore, Operations Audit is a process to determine ways to improve production. It falls into the category of a management service by evaluating the four functions of management: (1) planning, (2) organizing, (3) directing, and (4) controlling. The operational audit can also be broken down further as a functional review; for example, Purchasing as a department versus the overall Procurement operation in coordination with production scheduling and market forecasting. The following table highlights the salient features of the traditional form of internal audit and operational audit :

	INTERNAL AUDIT	OPERATIONAL AUDIT
1.	Compliance objective	Risk identification, process improvement objective
2.	Financial accounts focus	Business focus
3.	Audit focus	Efficiency & improvement focus
4.	Transaction-based	Process-based
5.	Policies and procedures focus	Risk management focus
6.	Cost Centre wise budget monitoring	Accountability for performance improvement results
7.	Focus on policies, transactions and compliance	Focus on goals, strategies and risk management processes

5.3.4 The Committee of Sponsoring Organizations of the Treadway Commission (COSO) had recently issued the "COSO report", which was jointly sponsored by the Institute of Internal Auditors (IIA), the American Institute of CPAs, the Financial Executives Institute, the American Accounting Association, and the Institute of Management to provide a common, widely accepted definition of internal control and provide a framework of internal control which can be used as a benchmark for assessing its effectiveness. The COSO report defines internal control as follows:

…*a process, effected by an entity's board of directors, management and other personnel,* which is designed to provide reasonable assurance regarding the achievement of objectives in one or more categories:

– effectiveness and efficiency of operations

– reliability of financial information

– compliance with applicable laws and regulations

5.3.5 Operational audits concerned with the objectives of efficiency and effectiveness. There are many reasons for performing an operational audit: compliance with policies and procedures, excessive sales returns, proposed product mix, equipment down time or personnel turnover etc. Therefore, an auditor must establish the scope of an operational audit before formulating the approach to initiate an operational audit. This step will determine the extent of the scope of audit. The second step shall be to understand the auditee's operation, its purpose in the total environment of the entity, its history, its image, its staff, their skills and competence and its reporting path. The reporting path is of very critical importance because this path is the communication route along which, the audit results and conclusions will flow.

5.3.6 The prime records to be obtained in an operational audit are the organizational chart of the function/operation, applicable policies, guidelines and procedures etc. These will outline each employee's responsibility and authority. The function's/operation's performance reports for the reasonable period prior to the audit should be reviewed to do trend analyzes or the critical analyzes. These analyzes or reports could indicate potential critical areas such as over- or under-staffing, non compliance with corporate policies and procedures, weaknesses in internal controls, or inadequate job rotations etc. These indications could help the management auditor in determining scope of investigation and areas of potential improvement. Reports must be based on facts, informative, submitted in time and directed to the proper levels of management.

5.4 Budgetary Control System

5.4.1 Budget And Budgetary Control – Nature and Scope

5.4.1.1 A budget is a financial and/or quantitative statement prepared and approved prior to a period of time, to the policy to be pursued during that period for the purpose of attaining a given objective.

5.4.1.2 *Budgetary control* is the establishment of budget relating to the responsibilities of executives to the requirements of policy, and the continuous comparison of actual with budgeted results either to secure by individual action the objective of that policy or to provide a basis for its revision (CIMA), Budgetary control is not a type of costing but is extensively used in all types of industries, businesses, Government departments as a system of control through responsible persons – such as executives, departmental heads, foremen, supervisors, etc. The main steps under budgetary control are as follows –

(1) Establishment budgets for each section of the organization and incorporating the functional budgets in summary or master budget consisting of a forecast or budgeted profit and loss account and balance sheet;

(2) Recording of actual performances and continuous comparison of the actual performances with that of the budget so as to determine the variances from the budget; and

(3) Ascertainment of reasons for such variances and taking suitable actions to remedy the defects in order to achieve the objective under original policy or to provide a basis for its revision wherever necessary.

5.4.1.3 Budgetary control is designed to assist management in the allocation of responsibility and authority, to aid in making estimates and plans for the future, to assist in the analysis of the variation between estimated and actual results, and to develop bases of measurement or standards with which to evaluate the efficiency of operations. The objectives and consequently the advantages of budgetary control will be felt throughout the whole organization, as a sound system of budgetary control –

(1) combines the ideas of different levels of management in the preparation of the budget;

(2) coordinates all the activities of business in order to centralize control but decentralize responsibility onto each manager involved;

(3) plans and controls income and expenditure so as to achieve the highest profitability acts as a guide for management decisions;

(4) ensures sufficient working capital and other resources for the efficient operation of the business;

(5) directs capital expenditure in the most profitable direction;

(6) reduces wastes and losses to minimum and thus ensures in increase in productivity as regards men, machines and materials;

(7) provides a yardstick against which actual results can be compared; and

(8) shows management where effort is needed to remedy the situation without any delay.

5.4.1.4 In order that a budgetary control is operated effectively, there must be an efficient ogranization for budgetary control. The budgetary control organization is responsible to the chief executive of a business. An advantage to this system is that decisions can be taken at the highest level where there is a conflict between the aims of the managers of two or more divisions. Moreover, where budgetary control has the support of the chief executive, those executives or managers who are responsible to him will fully cooperate and place more reliance on budgetary control. While the chief executive bears the responsibility for the effectiveness of the budget, the detailed preparation and administration of budgetary control is always delegated to subordinates as a functional responsibility and particularly to the budget committee with the budget officer as a secretary to the budget committee.

5.4.1.5 The different types of budgets are – (1) Functional budgets and (2) Master budget. The master budget summarizes all the functional budgets in the form of budgeted profit and loss account and the budgeted balance sheet. Such master budget shows the target profit to be achieved by the organization as its main objective.

5.4.2 Adequacy of Budgetary Control System

5.4.2.1 While determining the adequacy or otherwise of the budgetary control system of an organization, it is essential that management auditor should evaluate its coverage and effectiveness i.e., whether the system in operation covers all functions rather than an accounting exercise. For this purpose, he should examine whether the system contributes towards accomplishing the basic task of planning, coordinating and controlling the activities of the organization in relation to the product under management audit. The management auditor should examine and appraise the following points:

(a) In the area of planning:

1. Where it covers all interrelated functions like production, sales, purchasing and finance.
2. Whether it determines the linkage between budget centres and responsibility centres.
3. Whether it establishes definite goals and limits for these function well in advance. The system must answer the questions such as "what they are expected to operate?" What will be the financial requirement for the functional areas? What would be the potential problems in the key areas?
4. Whether there are imbalances in the fixation of performance levels of functional budgets in relation to sales budgets.
5. Whether budget monitoring cell exists for operating the system in right perspective.

(b) In the area of coordination :

1. Whether the budget monitoring committee holds its meeting regularly with a view to ensure performance evaluation.
2. Whether it helps to prevent waste that results in duplicate or cross purpose activities.
3. Whether it reveals timelines in the process of preparation and approval of all functional budgets and master budget.

(c) In the area of control :

1. Whether system exists for measuring, comparing and quantifying the results of all functional areas.
2. Whether the budget incorporates a degree of flexibility with a provision of its periodical review.
3. Whether the variance reports are issued in time and appropriate corrective action is taken on these variances.

5.5 Capacity Utilization

5.5.1 Need for Capacity Determination

5.5.1.1 The need for determining "production capacity" in respect of industrial organization in India arises from the following reasons :

(i) To meet the requirement under Section 211 of the Companies Act, 1956, that prescribes the form and contents of the balance sheet as well as profit and loss account (Part II of the Schedule VI of the Companies Act).

(ii) For purpose of Cost Audit Report under Section 233B of the Companies Act, 1956 where a cost audit has been ordered by Government.

(iii) For internal management purpose, to be used:

(a) in planning, scheduling and controlling production, and

(b) in planning expansion of capacity and correction of imbalances.

(iv) For assessment of capacities for national level planning.

(v) For fixing the price of product(s) after ascertaining the capacity costs and per unit incidence thereof, and

(vi) For determination of allotment of scarce raw materials in the form of quotas, import licenses, etc.

5.5.2 Adequacy of Capacity Determination and Utilization Mechanism

5.5.2.1 Capacity can be defined as the rate of output at which there is no incentive to alter the size of the plant if the rate of output is expected to be permanent. The management auditor is required to give his suggestions on rectification of general imbalance in production facilities under Para 14 of the Annexure to the Cost Audit Report. He is also required to give his suggestions for improvement in capacity utilization. Capacity planning and production planning and control are the prerequisites to capacity utilization control mechanism. For capacity planning, he must consider such factors as –

(a) level of capacity planned and operated by the company,

(b) whether the capacity is expressed in machine hours, labor hours or a combination of both,

(c) whether capacity is planned on single, double or triple shift basis,

(d) whether capacity is planned at normal production level or at practical production level,

(e) key areas of production constraints in capacity achievement.

5.5.2.2 The management auditor shall consider the following points in the evaluation and measurement of capacity utilization –

1. Method of measuring base machine capacity.
2. Clear guidelines should be available regarding assessment of capacity. Technical terminology like licensed capacity, installed capacity, rated capacity etc. should be properly defined.
3. In some industries capacity is influenced by a number of factors and determining the single base figures requires adjustment of various variables such as volume of vessels, yield of product, recovery factor, cycle time etc.
4. Whether the system provides for comparative studies such as :
   (i) Rated output and actual output per unit of time.
   (ii) Normal output and actual output per unit of time.
5. Determine whether the capacity utilization report is being complied by a person not responsible for production.
6. Whether capacity measurement is based on "capital output ratio" or sundry other factors.

$$\text{Estimation of capacity} = \frac{\text{Real fixed capital}}{\text{Minimum capital output ratio*}}$$

* Capital /Real output

$$\text{Capacity utilization} = \frac{\text{Real output}}{\text{Minimum Capital Output Ratio}} \times 100$$

5.5.2.3 ICWAI has issued COST ACCOUNTING STANDARD 2 (CAS 2) regarding 'CAPACITY DETERMINATION'. The object of CAS 2 as stated in Chapter 4 is to prescribe the method of determination of capacity to be applied uniformly and consistently. The standard will also help the management to identify the bottlenecks, imbalances and idle capacity for effective use of various resources. The standard has been recommended to be followed for capacity determination required to be carried out for any purpose or under provisions of any Act, Rules or Regulations except where capacity determination has been prescribed otherwise. The standard is applicable for an undertaking, whether existing or new, where there is expansion of more than 5% of the existing capacity due to introduction of new machines or productive resources. Similarly, the standard is also applicable where there is more than 5% reduction of the existing capacity due to disposal or withdrawal or impairment of old machines or productive resources. In other words, whenever more than 5% variation in capacity (whether positive or negative) takes place in any of the units covered under Cost Audit or Cost Accounting Records Rules, the Cost Auditor is required to undertake the capacity determination under these rules as per this standard.

5.5.2.4 The Cost Accounting Standard explains the detailed methodology to determine 'installed capacity' in para 5, 'practical / achievable capacity' in para 6 and 'normal capacity' in para 7 of the standard. In view of above, it is imperative that the management auditor should determine the capacity as per the said CAS 2.

5.5.3 Suggestions to Rectify Imbalance in Production Facilities

5.5.3.1 Imbalance in production facilities is resulted when the capacities of different equipments of a plant does not match. One type of equipment is capable of producing more than the receiving equipments. As a cost auditor following suggestions can be made to rectify such imbalance :

1. The measurement must opt for "sub-contracting" outside the firm that part of the job which is restricting the production.
2. Install balancing equipment with higher output potential.
3. Introduce shift working among the operatives.
4. If there is consistent imbalance in the production facilities, entire plant can be replaced by installing new automatic plant.
5. Idle equipments can be sold so that entire attention can be diverted to the critical equipments.

5.6 Inventory Control

5.6.1 Introduction

5.6.1.1 The term "inventory" includes all idle resources kept in stock for business purpose. Thus it includes mainly stock of raw materials, work-in-progress and finished goods, stores and spare parts, etc. Inventory control is possible with the help of Perpetual Inventory System along with continuous stock taking. The following aspects may be taken into consideration for proper inventory control –

1. Maximum, minimum and reorder level fixation
2. Fixed order quantity system and different replenishment systems.
3. ABC method
4. Pareto distribution
5. VED analysis
6. Just-in time (JIT) purchasing
7. Fast moving, slow moving and non-moving analysis.

5.6.1.2 The cost auditor can get an idea about the internal control relating to inventory from the following questionnaire.

5.6.2 Internal Control Questionnaire Relating to Inventory

1. Is the storage accommodation adequate to provide production against
   - Deterioration?
   - Access by unauthorized persons?
   - Any other local hazards?

2. Are issues from stores made only on properly authorized requisition?
3. Who are authorized to sign requisition? Specify name, position etc.
4. Are bin cards or similar records maintained at stores location?
5. Are continuous stock records maintained for
   - raw materials?
   - bought out components?
   - consumable stores?
   - finished goods?
   - stocks held on behalf of third parties?
6. Are these records maintained
   - in quantity only?
   - In value only?
   - In both quantity and value?
7. Are stores record maintained by a person independent of
   - The stores keepers?
   - Those responsible for physically counting or checking stocks?
8. Are independently maintained control accounts kept for each category of stock set out in 5?
9. Is the counting system fully integrated with the financial records?
10. If not, are totals of various categories of costs (including overheads) regularly reconciled with the actual costs in the financial records?
11. Are works orders issued
    - against specific orders?
    - on the basis of predetermined production targets?
    - on some other basis. (describe)
12. How are works orders authorized? Specify.
13. On what basis are materials, labor and other direct costs charged to work-in-progress accounts? Specify.
14. Are overheads clearly divided into fixed and variable overheads?
15. What is the basis of allocation of overheads to costs and what overheads are recovered in this way? Specify.
16. Does the system ensure that excess or abortive costs are written off and not carried forward in work-in-progress?

5.7 Management Information System

5.7.1 Introduction

5.7.1.1 Management information system or MIS is an information system making use of available resources to provide managers at all levels in all functions with the information from all relevant sources to enable them to make timely and effective decisions for planning, directing and controlling the activities for which they are responsible.

5.7.1.2 Management information is an essential management tool. MIS provides for the identification of relevant information needs the collection of relevant information, processing of the same to become usable by the business managers, and timely dissemination of processed information to the users of the information for properly managing the affairs of an enterprise by informed decisions. The design of MIS reflects not only a rational approach for optimization of benefits but takes due note of behavioral impacts on organizational decision-making.

5.7.1.3 The introduction of computers as a means of processing data to produce management information has made it possible to consider sophisticated management information system.

5.7.1.4 On account of enormous technological advances in computer engineering in data capture, storage, processing and transmission, it is now practicable in most cases to record and store all the information generated by any operation or decision within an organization in one mammoth set of storage files. The comprehensive date stored in this way will then be available to provide management with any information which may be required in the future to deal with any problem. With the introduction of LAN (Local Area Network) and WAN (Wide Area Network) and INTERNET, today it is possible to obtain data through computers from one place although the manufacturing units are situated at different parts of the country.

5.7.1.5 Using the computer for audition there is no doubt that computer obviates several intermediate printouts and the hidden records in the magnetic media could be problems for the auditor not adequately trained in computer data processing, but the very facts that records are in a machine readable form suggests possibility for using the capabilities of the computer to assist the auditor in his burdensome task. This however requires that the cost auditor is sufficiently proficient in computer data processing and programming. Where the control in both data processing and user's department is adequately reliable. The stipulations of an audit may be dropped, and instead the cost auditor may comply special technique.

5.7.2 Management Information System and Cost Auditor

5.7.2.1 The cost auditor has to consider various aspects while evaluating the effectiveness of a Management Information System. At first he should consider the following aspects while appraising the MIS –

(i) the content, quality and source of information

(ii) flow of information from the originator to the receiver, and

(iii) correlation of information in the decisional areas.

5.7.2.2 **Contents and sources of information :** This may include the following :

(i) Whether the information collected is relevant to the decision problem or whether it will result in the improvement in the quality of decisions.

(ii) Whether there is any tendency of the manager to use control data for postmortem exercise.

(iii) Whether the reporting of MIS is regular and uniform for financial and non-financial information.

(iv) Whether the information contain unwanted information.

(v) Whether the MIS adequately caters to the requirements of decision makers.

5.7.2.3 **Flow of information :** A cost auditor has to proceed on the following lines :

(i) *System organization :*

(a) system is centralized or decentralized,

(b) flow of information from various units to the control section,

(c) estimating the volume of data, transmission time and cost,

(d) cost-benefit analysis of centralized v. decentralized information.

(ii) *Data collection and management :* Appraisal should include the following aspects:

(a) methodology of collecting data,

(b) whether the data is filtered and classified,

(c) whether the data is properly matched with decision problems,

(d) whether the management carried out detailed study regarding existing frequency,

(e) whether system design is free or any possible constraints.

5.7.2.4 **Correlation of MIS with the decision areas :** Cost auditor should examine this aspect from the following angles:

(i) Whether input-output analysis is attempted.

(ii) Whether MIS is helpful in reducing the effects of uncertainty.

(iii) Whether MIS is cost-effective.

(iv) Whether the information is being supplied to the users very effectively.

(v) Whether MIS is providing a feedback for corrective action, and

(vi) Whether MIS is able to optimize the value of information?

5.8 Nature and Scope of Management Audit

5.8.1 Introduction

5.8.1.1 An organization is today ridden with a number of audits – financial audit, internal audit, social audit, cost audit, energy audit, management audit, etc. Audit generally means examination taken from the Latin term "Audire" (hear). Audit, therefore, means listening to some one and deriving from the hearing, the usefulness of the action. In the case of a corporate body, audit takes the shape of examination of specific field of working viz. financial activities, organizational activities, management activities, social activities, etc. Each activity has a specific objective and responsibility and the function of Audit is to check and ensure fulfillment of responsibility delegated to the activity.

5.8.1.2 Management Audit is the total examination of transaction of an organization, or parts of it, and includes checks on the effectiveness of managers, their compliances with company on professional standard, the reliability of management date, the quality of performance of duties and recommendations for improvement. In this context, the distinction between administration and management should be recognized. Administration is concerned with the structure of the organization and the mechanism of its operations, whereas management relates to the leadership and direction of the people, the way in which they are controlled to exercise their functions within the administrative framework. The question of audit arises only because of the ownership of many companies is widely spread between a large number of shareholders, and the running of the organization lies with people holding comparatively a small portion of the equity. This dichotomy of dispersed ownership and entrenched management necessitates and examination to be done of the Management function itself by an independent authority.

5.8.1.3 In this context management audit undertakes examination of the effectiveness of management in controlling the total activities of the organization in the accomplishment of the organization objectives. Since a number of audits is conducted in various area, audit responsibility lies in avoiding any overlapping and selecting such areas not covered by an audit already, e.g., if internal audit examines adherence to procedures, management audit should examine the effectiveness of such procedures.

5.8.1.4 Management audit deals with –

(i) the objectives of an organization;

(ii) the policies and procedures in terms of the objective of the organization; and

(iii) adequate performance of an organization in terms of objectives, policies, and procedures.

5.8.2 Definition and Objects of Management Audit

5.8.2.1 Management audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management. A working director is included as a manager for purposes of management audit. It is normally presumed to be a non-routine investigation into a performance of a manager or group of managers. But in a number of organizations management audit is now a regular feature to examine and improve managerial effectiveness.

5.8.2.2 It attempts to look into all aspects of the management performance. Management audit does not concentrate on financial matters alone as in the case of financial audit. It looks into the efficiency and effectiveness of performance in an organization.

5.8.2.3 However, there is no general agreement as to the precise meaning of the term "management audit". The term has been various defined by different authorities as follows –

"Management audit may be defined as a comprehensive and constructive examination of an organization structure of a company and its plans and objectives, its means of operation and its use of human and physical facilities.

- William P. Leonard

"Management audit may be more specifically defined as being an investigation of a business from the highest level downwards in order to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with outside world and the most efficient organization and smooth running internally."

- Leslie Howard

"Management audit is performed with the objective of examining the efficiency of the information control system, management and management procedures towards the achievement of enterprise goals.

- Churchil and Cyert

5.8.2.4 H. Washbrook in the book "The Board and Management Audit" has defined "Management Audit" as –

"the total examination of an organization or parts of it, and includes in it aspects of operations audit like checks on the effectiveness of managers, their compliance with company or professional standards, the reliability of management data, the quality of performances of duties and recommendations for improvement".

"Management audit is an objective and independent appraisal of the effectiveness of the managers and effectiveness of the corporate structure in the achievement of company objectives and policies. Its aim is to identify existing and potential management weaknesses within an organization and to recommend ways to rectify these weaknesses".

- CIMA Terminology.

5.8.2.5 The above definitions lead to the following conclusions :

Management audit is the systematic and dispassionate examination, analysis and appraisal of management's overall performance. It is a form of appraisal of the total performance of the management by means of an objective and comprehensive examination of the organization structure, its components such as department, its plans and policies, methods of process or operation and controls, and its use of physical facilities and human resources.

Thus management audit is concerned with evaluation and appraisal of the control system and information in the entire or in various segments of the organization. Its scope has been widened to appraise in detail the systems and subsystems, procedures, job-description and assignment, authorization, accountability, quality of personnel, quality of information generation etc.

5.8.2.6 Management audit is carried out to –

1. appraise the management performance at all the levels;
2. spotlight the decision or activities, that are not in conformity with organizational objectives.
3. ascertain that objectives are properly understood at all levels;

4. ascertain that controls provided at different levels are adequate and effective in accomplishing management objectives or plans of operations;
5. evaluate plans which are projected to meet objectives.
6. review the company's organizational structure, i.e. assignment of duties and responsibilities and delegation of authority.

The main objectives of management audit can be summarized as follows:

(i) to ensure optimum utilization on all the resource employed, including money, materials, machines, men and methods;

(ii) to highlight efficiencies in objectives, policies, procedures and planning;

(iii) to suggest improvement in methods of operations;

(iv) to highlight weak links in organizational structure and in internal control systems, and suggest necessary improvements;

(v) to help management by providing health indicators and help prevent sickness or help cure in case of sickness; and

(vi) to anticipate problems and suggest remedies to solve them in time.

5.8.3 Need for Management Audit

5.8.3.1 Since independence India has not achieved the desired economic development as planned. Regional and Social imbalances have been continued over the years, leading to social unrest in different part of country.

5.8.3.2 In the industrial field there is an alarming growth of sickness of industries Large amount of resources of banks and financial institutions are involved in the rehabilitation of sick industries. In the unorganized sector also sickness is reported. Large amount of loans are being written off by banks and financial institutions arising out of sickness and inability to recover the loans.

5.8.3.3 The performance of the public sector enterprises is also dismal in spite of state protection in respect of product monopoly, administered prices etc. A capital outlay of over Rs. 25,000 crores is involved in the public sector enterprise, producing hardly any profits. Out of 150 manufacturing and 65 service enterprises in 1998-99, only 5 or 6 are reporting profits. Public sector also employs a large number of people. As per the report of BIFR a major cause for sickness is managerial weakness besides other causes like falling market demand, non-availability of raw materials, shortage of working capital, labour unrest etc.

5.8.3.4 The main cause of all these economic and social problems can be attributed to managerial ineffectiveness, which in turn causes other problems. It is therefore imminent than an appraisal of managerial effectiveness is undertaken to monitor and remedy weaknesses wherever exist. This is the function of management audit.

5.8.3.5 Management audit is now becoming more popular everywhere. Almost all progressive organizations undertake voluntary management audit due to its benefits as under :

(i) It helps management in framing basic policies for the organization and to define objectives.

(ii) In pursuance of the objectives of the organizations, management audit helps in preparing a viable and achievable plan for the organization.

(iii) It helps in setting up an organizational framework to implement the plans.

(iv) It assists in designing systems and procedures for smooth operation of the organization.

(v) It helps in designing and reviewing management information system (MIS) for decision making to help in coordination, motivation and control of the operations.

(vi) It assists in analyzing SWOT (strengths, weaknesses, opportunities and threats) of the organization and assists in marketing the organization stronger.

(vii) In a developing country like India, management audit through CAG, public accounts committee and parliamentary committee on public undertakings, has helped the Government in identifying improper or wasteful use of funds, checking extravagant organization practices and curving ineffective use of physical resources.

(viii) Indian financial Institutions, banks and Board for Industrial Finance and Reconstruction (BIFR) have found management audit (called concurrent audit) useful in monitoring sick industrial units and to help the units in their rehabilitation.

(ix) The Railways of India have subjected their finances to open discussion by public to improve resource mobilization, reduce cost of operations and conserve their scarce resources which are main objectives of management audit.

(x) It can help in analyzing social-cost benefit analyzes for public projects like dams, power houses, national highways etc.

(xi) It is essential whenever a unit is planned to be taken-over or an amalgamation or merger with other unit is proposed.

(xii) Growing number of professional managers, the continuing separation of ownership from management, the wider distribution of stockholders, increasing competition and sickness in industry will sooner or later make certified management audit compulsory just as financial audit has become statutory.

5.8.4 Scope and Usefulness of Management Audit

5.8.4.1 The scope of management audit is decided by each organization on its own needs. It has no limitations. It generally extends over all the resources deployed and commercial activities of the organization including Directors and their functions.

— Managers, supervisors and their functions.
— Organizational structure.
— Equipment and facilities, and their utilization.
— Methods and systems.
— Security of information.
— Resources utilization – their adequacy and efficiency.
— Planning and control etc.

5.8.4.2 The scope of management audit extends over all the functions of an organization viz. management, personnel, administration, material administration, marketing, finance, etc. wherever the effectiveness of management needs to be examined.

5.8.4.3 Accordingly, the scope of management audit may include –

(i) The suitability, practicability and present compliance or otherwise of the organization with its desired objectives and aims.

(ii) The current image of the organization among customers, general public within its own particular industrial or commercial field.

(iii) Efficient utilization of resources of the organization.

(iv) The rate of return of investors' capital – whether poor, adequate or above average.

(v) Relationship of the business with its own shareholders and investing public in general.

(vi) Employee relation.

(vii) The aims and effectiveness of management at its various levels such as top level, middle level, and operational level.

(viii) Financial policies and control relating to production, sales and distribution and in other functions of the organization.

5.8.4.4 An organization is accountable not only to its internal owners like shareholders but also socially accountable to creditors, Government, tax payers and consumers. Management audit extends to examination of accountability between the management and others at large. Audit mechanism ensures this accountability. Since the right to exercise control lies entirely with different set of people away from the owners, the examination of accountability and ensuring shareholders' and other participants' welfare becomes important. This is based on "Agency Theory" put forward by Jenson and Meckling.

5.8.4.5 The implications of separation of ownership and control were first analysed in depth by Berie and Menes in their study of development of Corporate Business in the USA. They observed that economic power was becoming increasingly concentrated in small number of people in large corporations and that within the corporation itself the right to exercise control which in law was vested in the hands of dispersed absentee shareholders, was effectively being usurped by entrenched management. Berie and Menes do not however, envisage transfer of power *per se* but lay emphasis on the initial conflict between the objectives of shareholders and managers. In this process the certification by an independent auditor gains importance.

5.8.4.6 Accountability and appropriate means for enforcing it is the main criteria of audit, particularly management audit. The process of accountability includes following elements:

(i) Description of the organization and its participants.

(ii) Identification of objectives and the provision of relevant information to those objectives.

(iii) Ability of action on the part of the participants.

5.8.4.7 The value of auditing can be only judged by its ability to promote accountability of an organization through their participants. The process of accountability is concerned with the needs of the participants of an organization to determine the extent to which the behaviour of the organization conforms with their expectations. The monitoring mechanism should have sufficient variety to provide appropriate information to enable the participants to attempt the affect the behavior of the organization.

5.8.5 Uses of Management Audit

(1) Management audit is useful in synthesizing, accounting, economic and other data required by management in constructing basic policy framework.

(2) Management audit assists in establishing, reviewing and improving the planning system.

(3) Management audit makes substantial contribution to system of goal setting in the organization.

(4) Management audit ensures that the management is getting the adequate information for correct decisions.

(5) Management audit ensures that the management properly uses the information that it is getting.

(6) Management audit aids in the design and maintenance of adequate authority structure.

(7) It helps in the improvement information system to expedite flow of information among responsibility centres.

(8) It substantially contributes for improvement of entire communication system.

(9) It helps management in pinpointing key functions or operations in the profit-making process.

(10) It helps management in establishing better criterion for measuring results.

(11) It helps management to avoid wasteful, unnecessary and extravagant use of resources.

5.8.6 Coverage of Management Audit

Unlike statutory audits, management audit does not have any specific area for conducting audit. It covers the entire arena of management operations including organization, personnel, administration, manufacturing, marketing, finance, research and development and other areas. The audit is expected to cover every activity of the organization undertaken in pursuance of organizational objectives or policies decided by the Board of Directors from time to time. It is left to the creativity of the auditor to lay down for himself the areas to be taken up for audit. In the result, management audit covers examination of efficient performance of the activities of the organization.

The areas covered are discussed in detail in the following sections.

5.9 Audit of Management Process and Functions

5.9.1 Concept of Management Audit

5.9.1.1 The concept of management audit was developed by T.G. Rose as a logical system of evaluating the quality of management. He employed it for evaluation 52 publicly owned companies over a period from 1948 to 1960. The demand for information on performance had become necessary subsequent to the oil crisis of 1073 to evaluate the performance of the management and to take consequent decisions.

Conceptually management audit covers areas which are not normally covered by other audits. Secondly, management audit does not go into the vouchers or other similar evidence but comprises of the appraisal of management effectiveness in various areas of managerial operations.

Management function include –
Planning.
Organizing.
Staffing.
Coordinating.
Communicating.
Directing.
Motivating.
Controlling.
Communicating.
Directing.
Motivating.
Controlling.
Innovating.

5.9.1.2 As such management audit covers the above functions of management in various areas of operations as detailed in the Table below :

	Function of an organization	Marketing	Manufacturing	Materials management	Human resource management	Finance	R&D	Others
Management Process								
Planning								
Organizing								
Staffing								
Coordination								
Communication								
Direction								
Control								
Innovation								

Management audit should not be confused with organizational audit or administrational audit, which may form part of management audit. Management audit by concept goes into the details of managerial effectiveness in conducting the operations of an organization.

Functions: The functions of management audit extend to audit of the effective functioning of every area of operations coming under the management purview from the stage of its planning to proper implementation and execution. Every manufacturing or service organization could broadly be identified into the following functional areas –

(i) Marketing, including selling and distribution.

(ii) Manufacturing/servicing, including maintenance of supply chain, machinery and equipment, etc.

(iii) Human resource management from selection to recruitment, training, motivating, retaining, advancement, etc.

(iv) Personnel policies and industrial relations.

(v) Finance including maintenance of accounts and providing accounting information to guide the management of its performance and position.

(vi) Research & development including application research and basic research, if any.

5.9.1.3 An understanding of the objectives of each functional area at every level of the organization and effectively achieving such objectives shall be the prime responsibility of management. Checking of such effective achievement is the function of management audit. These are dealt with in more detail in subsequent sections.

5.9.2 Features Different Types of Audits

The Table below brings out succinctly the distinguishing features of different types of audit carried out in an organization :

	Ingredients	*Management Audit*	*Internal Audit*	*Financial, cost and other audits*
i)	Expectations	Appraising management	Assisting Management to identify problems	Specific under statutory and other's directions
ii)	Attitude	Friend, Philosopher and guide	Policeman/judge	Watch dog/judge
iii)	Agency	Outside team or management	Internal or External	Specially designated persons
iv)	Force	Voluntary	Statutory in some cases	Statutory/Voluntary
v)	Area	Complete Management or specific problems	Mainly past/ procedural	Specific objectives
vi)	Evaluation	Effectiveness/ quality of management/Policies	Quality of procedures Operations/data	Specific information
vii)	Period covered	Past, present and future	Past and present	Mainly past
viii)	Procedures	Flexible	Structured	Highly structured
ix)	Reporting level	Higher	Operational	Designated
x)	Time span	Futuristic	Current and immediate	Current and immediate past
xi)	Periodicity	Regular	Regular	Annual

5.9.2.1 **Financial audit** is statutory requirement for most of the businesses or public organizations/ institutions. Tax audit under the Income-tax Act can also be covered under this category. It is an exploratory critical review by an approved independent agency and a monitoring mechanism to determine the extent tow which the behavior of the organization conforms to the expectations within a definite framework. It leads to an opinion on the correctness of the presented data and information. It also ensures adherence to generally accepted accounting principles applied on a consistent basis. However, financial audit has a major shortcoming. It is only a postmortem. It is procedural and rule oriented. It can not be used as a management tool due to its annual reporting. The information therein comes too late, is too much in aggregate and is too little for managerial decision.

5.9.2.2 **Cost audit** is also a legal reporting exercise, connected with annual reporting to the government regarding efficiency of operations with particular reference to a specified product in a prescribed format. It restricts the freedom of the auditor to report, being confined to specific areas only. The report does not reach the investors i.e. shareholders. It does not examine and analyse the role of top management in leading and decision making. However, cost audit deals with many strategic functions of an organization and can be developed into management audit by interaction of cost auditor with Board of Directors and by widening its scope.

5.9.2.3 **Internal audit** is useful in ensuring a reliable accounting system. It helps internal monitoring of the effectiveness of control procedures. It helps in generation of reliable financial information depending on the reliability of accounting system itself. This is an indirect help to financial auditors as it reduces their work. Internal audit is compulsory for companies above a prescribed size under Manufacturing and other Companies (Auditors' Report) Order, 1988 (MAOCARO) under the Companies Act, 1956 in India. Gradually, the scope of internal audit in Indian Companies has been enlarged from merely clerical activity to a management tool of great use. It is carried out by own employees at middle level in large and medium companies who cannot report fearlessly. It is mainly confined to verification or compliance of set procedures. It does not cover top management appraisal or responsibility accounting.

5.9.2.4 **Operational audit** concentrates on seeking out aspects of operations in which waste, inefficiency and excessive costs would be subject to reduction by the introduction of improvement of operating controls. It is audit of the performance at mainly operating level i.e. supervisory level. It is also termed as micro level management audit.

5.9.2.5 **Management audit** extends to the entire management decision making areas and has a broader time frame to analyse past, present and the future. Hence it becomes a qualitative audit and not audit of only value and quantity. Management audit brings out errors or policy, decisions, and actions with recommendations to avoid them. Management audit extends beyond operations audit.

5.9.3 Management Audit – Techniques and Procedures

(1) **Steps of management audit :**

The steps of management audit are :

1. Select an area of operation of management
2. Establish what should be the objective, standard or target of the operation.

3. Determine whether the actual results meet the standards, norms or targets. If not, why not?
   (i) Is the target too difficult?
   (ii) Is failure to achieve the target costing the organization?
4. Establish what is done to ensure the achievement of the norms, target and standards.
   What steps are taken for –
   (i) planning
   (ii) operations, execution and implementation e.g. use of up-to-date technology.
   (iii) Measurement of performance and controls?
5. Carryout a detailed investigation, collective evidence as well as document for audit findings.
6. Report the findings of the audit and make recommendations.

(2) **Management auditing procedure:**

Audit procedures should be tailored to the specific needs of each situation examined. The general approach in a management audit may be outlined as follows :

1. Make a preliminary survey of the activity under audit to obtain necessary background and other working information for use in conducting the audit.
2. Study the basic charter or assignment of responsibility of the activity under audit (applicable laws and related legislative history in the case of a government activity) to ascertain the authorized purposes and related authorities of the activity and any applicable restrictions or limitations.
3. Review pertinent parts of the system of management control by studying the policies established to govern the activities under audit, testing the effectiveness of specific operating and administrative procedures and practices followed, and fully exploring all significant weaknesses encountered.
4. Report on the findings of the audit work performed to those responsible for receiving or acting them together with the recommendations for improvement.

Techniques by which the auditor can identify problems areas warranting detailed examination and source of his information are as follows:

(i) Identification of possible control weakness by survey

During the preliminary survey work through which practical working information is obtained on how the activity is supposed to function and on how the activity is supposed to function and on how control procedures are supposed to work, key features or aspects can usually be identified which appear to be difficult to control effectively or to be susceptible to abuse. In a purchasing organization, for example, the key points in the purchasing process may be –

a. the determination made of the quantities and the quality of materials to be purchased.
b. The procedure followed in obtaining the best prices, and
c. The methods for determining whether the correct quantities and quality are actually received.

If, in relation to the total purchasing operation, the auditor concludes that these processes are the most critical from the standpoint of the need for good performance, he would be justified in concentrating his testing work on them.

(ii) Review of management reports

The auditor's review of internal reports which the management itself regularly uses to obtain information on progress, status, or accomplishment of work can be valuable sources of information on possible problem areas suggesting audit attention.

(iii) Review of internal audit or inspection reports

These report can also be a valuable source of information on problem areas. Of particular interest to the management auditor are those reports which bring to light significant findings on which the management has taken no action. Inquiry into the reasons and justification for inaction in such cases should be made, since these circumstances could throw light on weaknesses in management system that have not previously been referred to the management for resolution.

(iv) Physical inspection

Physical inspections of the organization's activities and resources can be a useful way of identifying possible inefficiencies. Examples are apparently excess accumulations of material, idle or little used equipments, employee idleness, rejections of product by inspectors (or customers), executive rework operations, or disposal of apparently useful materials or equipment.

(v) Test examination of transactions

A very useful way to obtain a practical insight into the efficacy of procedures is to pursue a number of transactions pertaining to the organization's operations from initiation to final disposition. This kind of testing will provide the auditor with valuable information on the organization's business is actually transacted, on the usefulness (or pertinence) of prescribed procedure, on the capabilities of personnel involved in the various operating phases, and on possible weaknesses in procedures or practices which could represent an unnecessary drain on the organization's resources (i.e. ineffective or inefficient performance)

(vi) Discussions with the officials and employees

The management auditor can obtain valuable information on problem areas warranting audit attention through discussions with responsible officials in the organization and other employees concerned. The degree of success in obtaining useful information in this way is, in large part, dependent on the auditor's reputation for independent and constructive inquiry. If he is regarded with fear because of overly critical reporting in the past, this source of information may not be productive.

Testing procedures and practices

Testing procedures and practices first requires some preliminary review work to obtain information on how they actually work and an insight into their effectiveness and usefulness. On the basis of such review, specific matters may be identified as problem areas on weaknesses needing further probing. The general factors to be considered by the auditor in his preliminary review work on management controls are :

— Whether the policies of the organization comply with its basic charter or grant of authority.

— Whether the system of procedures and management controls is designed to carry out those policies and result in activities being conducted as desired by the top management, and in an efficient and economical manner.

— Whether the system of management controls provides adequate control over the organization's resources, revenues, costs and expenditures.

Specific factors which may well be considered by the auditor in assessing the management control system and identifying problem area warranting more detailed audit include –

The use by management of standards or goals in judging accomplishment, productivity, efficiency in the use of goods or services.

Lack of clarity in written procedures, misunderstandings or inconsistent interpretations in the organization may affect :

— capabilities of personnel

— failures to accept responsibilities

— duplication of effort

— improper or imprudent use of funds

— cumbersome or extravagant organsational patterns

— ineffective or useful use of employees and physical resources.

This; listing is indicative of the kinds of factors that an alert management auditor must keep in mind in all his work. The knowledge gained in preliminary review that is conducted in recognition of these kinds of factors provides a solid basis for more detailed examination work that can lead to constructive improvements in the management system.

(3) Techniques of management audit :

Techniques employed by a management auditor in effectively carrying out his audit are –

(i) **Accounting or economic techniques**

(a) Break-even analysis

(b) Budgetary control including flexible budget system.

(c) Cost management techniques indicating how an organization's assets should be allocated over competing projects or to decide whether it is worth proceeding with the investment, keeping in view proportionate value of expenditure on such projects.

(d) Discounted cash flow and net present value methods.

(e) Cost benefit analysis.

(f) Standard costing and marginal costing.

(g) Activity based costing to test the relevance of costs to activities.

(h) Quality analysis of company transactions.

(ii) **Scientific techniques**

(a) *Computer Models :* There are many types of problems which can be solved on a computer e.g. decision on material mix, product, mix, make or buy etc.

(b) *Network analysis :* To analyse strings of tasks to arrange them in sequential or parallel order to complete the project in shortest possible time.

(c) *Mathematical programming* solving by heuristic (trial and error) techniques to determine the best material mix, best use of organization's transport fleet, the best mix of products to obtain, to maximize profits and optimum use of labor, finance, equipments, etc. Linear programming is usually effective when relationship vary in linear order whereas quadratic programming may be used when the variations are in the order of square root of some other factors.

(iii) **Statistical techniques**

(a) Activity sampling : It is one of the many ways in which the present workloads can be measured to obtain controls to be exercised by management.

(b) Monte Carlo Simulation : In this a number of variables are drawn from large statistical population which have equal choice of being selected and obtain the best sample possible.

(c) Exponential smoothing

(d) Interfirm comparison

(iv) **Personnel techniques**

(a) Attitude survey

(b) Ergonomic (Man-machine relationship)

(c) Training methods

(d) Profitability and productivity measurement

(v) **General techniques**

(a) *Statistical theory of management* is an attempt to emphasize what should be the practical approach to a problem by –

— Analyzing the problem to establish the basic difficulties and factors involved.

— Establish management by objectives.

— Identifying the likely ways of tackling the problems in the light of objectives to develop a solution.

— Determine the key factors affecting management decision-making.

— Evaluating alternative courses of action.

— Evaluating each alternative in terms of economy, efficiency and best fit.

— Specifying the action required to exploit the situation to the best advantage of the organization.

(b) Brain storming

(c) Transfer pricing

(d) Management by objectives

(e) Management by exception

(f) Corporate planning

(g) Information theory

(4) Management Audit Evidence :

Unlike financial audit or other audits there can be no fixed items of evidence to be checked by a management auditor. A management auditor has to rely more on his experience and acumen to identify areas of review and study, particularly areas of weaknesses to be overcome, strengths to be exploited and risk to be properly covered.

The auditor's evidence comes from his discussions with the people concerned in the organization, the survey and review of various reports of the organization, including internal audit reports, inspection reports or any investigation reports, physical inspection, test examination of various transactions, inspection of important departmental files, monthly performance review statements, minutes and notes and above all personal observations.

Evidence can be gathered either by sampling techniques or by going into full details depending upon what the samples reveal. The evidence should be such that an auditory can draw valid conclusions, duly verifying the same with the people concerned. It should be understood that a management auditor does not rely on a voucher as an evidence, but shall fall back on various records, including vouchers as evidence for his audit, if the samples demand so. There is no area of restrictions for obtaining evidence.

(5) Management Audit Programme (MAP) :

Management audit programme is an essential prerequisite to conducting the audit. It is a plan of action drawn in advance of taking up the audit, and to help the auditor to cover the entire area of his function thoroughly.

He should lay down for himself a proper procedure to be followed to complete the work in time, giving thorough coverage to all aspects.

An efficient management audit programme shall comprise the following:

(i) Review of the organizational objectives and plans

(ii) Study of the policies and practices of the management

(iii) A critical review of the organizational structure

(iv) Study of the systems and procedures

(v) Evaluation of operations

(vi) Study of the efficiency of the use of physical resources available

(vii) Exercise of proper management control

(viii) Maintain suitable monitoring system through management information system (MIS)

(ix) Check on adherence to the statutory obligation and

(x) Above all, review the efficiency of manpower handling, which ultimately results in the organization's success.

An audit programme is laying down the path in its required details before conducting such audit.

A management auditor shall shrewdly assess weak and risk areas in the organization and deal with such areas in more detail. He has to lay down a programme by making a list of such weak and risk areas and follow them up in his audit.

(6) Management Auditor:

A management auditory is expected to offer special skill and expertise to his clients. He, therefore, has a special responsibility to exercise special care in the performance of his duties to ensure positive response to his opinion to motivate action thereon.

A management auditor should be competent in the exercise of his audit function and formulation of his opinion based on such audit. He should be a man of independent thinking, who can maintain an unbiased view, without any influence, either financial, sentimental or otherwise. He should be technically competent in the discharge of his duties, having had education, training and experience all round. The management auditory should be supported by a good organization i.e. a team of people who can competently execute his audit.

Qualifications of Management and Administrative Auditors.

Prime qualification of a management auditory is to process broad business experience in allied profession such as accountancy, statistics, engineering, marketing or administration. It is not possible that one person can possess all the specialized qualifications. But a special qualification in one field could have a respective view of the whole system. If a team of auditors is appointed it will be preferable to have people from different facilities, because a cross fertilization of ideas from different business fields can be a stimulating factor. Management audit should aim at highlighting any team of administration or managerial efficiency or otherwise affecting the performance of the organization.

The essential qualities of a management auditor are :

(i) Ability to grasp the business problems

(ii) General understanding of the nature, purposes and objects of the organization e.g. nationalized or government controlled organization etc.

(iii) Ability to determine or assist the progress of the organization

(iv) Knowledge of the principles of delegation of authority and control and the preparation of different budgets viz. cash budget, production budget, master budget, etc

(v) Power of grasping and understanding different internal control devices viz., flow chart, flow of work, analysis of work scheduling, use of computer, etc.

(vi) Sufficient knowledge about engineering statistical techniques, cost and management accounting, general financial accounting, production planning and control etc.

(vii) General understanding of different laws viz. company laws, tax laws, FEMA, MRTP, and other economic legislations.

(viii) Sufficient knowledge and experience in preparing various reports for submission to different levels of management including the top management

(ix) Tactfulness, perseverance, pleasing and dynamic personality.

(7) Management Audit Team – Organisation

A management auditor handling a large organization on a continuous basis or a number of audits at the same time has to build up a competent team of people, who possess the qualifications attributed to a management auditor.

As a management auditor is concerned with all aspects of the business and the organization, ranging from manufacture, to marketing and finance, the management audit team should be multi-disciplinary to make multi dimensional approach to audit function.

A competent management audit team, internal to an organization, could effectively be represented by the heads of various departments viz., production, materials management, maintenance, personnel, marketing, finance, industrial engineering, quality control, etc. Such a team can competently lead and direct the audit to attain the organizational objectives.

(8) Audit Checklist :

A management auditor shall normally maintain an audit checklist to ensure that he has not omitted any areas that require to be audited. The organizational areas covered fall under the broad categories of :

- Planning
- Organising
- Staffing
- Coordinating
- Communicating
- Directing
- Motivating
- Controlling and
- Innovating

In these areas an auditor should look for any weakness which may affect efficiency of the organization. His checklist can be made areawise and may be overlapping or complementary between different areas.

(i) Directorial weakness

(ii) Management weakness

(iii) Organisational weakness

(iv) Financial weakness

(v) Systems weakness

(vi) Procedural weakness

(vii) Functional weakness

(viii) Operational weakness

(ix) Marketing weakness

(x) Industrial relations weakness

(xi) Weakness in meeting social responsibilities, and

(xii) Security lapses etc.

A model list of audit checklist under various categories is attached in the Appendix hereto.

5.9.4 Management Audit Report (MAR)

5.9.4.1 It is of very great importance to prepare a good MAR. A good MAR can motivate the management and get the required results, whereas a bad SMAR can defeat the very purpose of audit, it may create an adverse reaction and result in the report being thrown out.

5.9.4.2 **Characteristics of a good management audit report**

The detailed characteristics of a good management audit report can be summarized as follows :

(i) Pertinence

(ii) Comprehensiveness

(iii) Brevity

(iv) Timeliness

(v) Motivating

(vi) Formatting

5.9.4.3 **Contents of the report**

The top policy executive is generally interested in four factors in operating statements – facts, person responsible, deviations in actual performance from standards and the effect of the result on financial or physical status of the organization.

The report must allow management to study comparisons, to review organization, and to appraise the effectiveness of the executives. Departmental weakness can be quickly seen by the management, if the report is properly prepared.

Management audit report should create awareness among the management of prudent management practices that can make organization come alive. It is very important function of management audit to help change of management mind-set.

A management audit report should also be discussed with the people concerned in various areas before reporting. Every point that is raised in the report should have the acceptance of the people involved in the concerned function. A report that indicates suggestions that had come from the people themselves would have a better than coming as a suggestion from auditor.

The report should be drafted and structured so that it makes a logical presentation to the management and makes it easily readable. The report should contain not only the problems and defects in the working but also should come out with solutions as if given by the operational people themselves so that it gains immediate acceptance for implementation. A management audit report relies heavily on accepted managerial practices and feasible solutions.

5.9.5 Special Reports for Banks, Shareholders, Employees and Small Business

5.9.5.1 Sometimes, the reports have to be prepared and submitted for special persons or purposes. Salient features for these special reports are briefly discussed below

(1) Reports for banks and creditors.

Form and content of financial statements and schedules are important to the lender but explanatory notes to the statements and schedules are perhaps more important to them. They require accuracy in report and confirmation of statement made, which should be properly verified and certified. Bankers are more oriented towards security due to their long-term expectation of debt servicing by the business. Hence, reliability of report is an important factor. All statements by the auditor should be clear and positive.

(2) Report to shareholders

The report are read by financial experts, bankers, tax authorities, public officials and research people. The report should, therefore, be useful in analytical details for its user, and give full facts of the organization's business. The report should also convey the right and correct message to a lay man. The reports is often used as a public relation exercise to improve relations with investors and to promote loyalty. In India, auditor's report in the prospectus at the time of public issue is very important. Experts read "between the lines" of the auditor's report. It will ultimately reflect in the auditor.

(3) Reports to employees

Reports for employees are mainly prepared for better understanding of the business, to dispel any misconceptions, counter charges by unions, or explain the need for continuance of the business in times of strike, competitions or sickness. The report to employees must gain the confidence of employees and earn respect for the statements. The report should consider the needs of employees, when the employee morale is low or where the relations with employees are strained. Auditor's views will be expected to be totally unbiased.

(4) Reports for small business

The form of annual accounts and other requirements under the Companies Act is the same for a large or a tiny private company. However, the management auditor should design his report in a very simple way as the report for a small business if specifically directed to a person or a small group of persons only. A great deal of reporting for small business is subjective, due to lack of adequate data. This poses problems of analyzing and comparing data. Suggestions in the report must be based on proper appraisal of the problem.

Conclusion : The report of the management auditory will leave a permanent impact on the user about his competence, integrity and honesty. He should, therefore, make his observations and recommendations clear even if it may affect the job of any executives or affect the fortunes of a few people concerned for interested for the organistion. He cannot escape the duty to judge the right and the wrong. The best report is one which motivates the person receiving the report to act in the manner desired in the report.

5.10 Specimen Questions with Answers

Question No. 10.1 :

As a management consultant, you have an assignment to conduct a Management Audit of the production function of a medium-scale engineering unit. Prepare a checklist of the points on which you should undertake the study.

Answer :

Checklist for carrying out management audit of production function in a medium-sized engineering unit:

1. How is the production plan prepared? Is it based entirely on market forecasts, or does it also take into account limitations of materials, personnel and finance?
2. Are the product-mix decisions based on optimum profitability? What is the proportion of standard products and tailor-made items?
3. Whether all infrastructure like machinery, materials, manpower and money have been assured at the scheduled time for uninterrupted production.
4. Are there any constraints in achieving maximum capacity utilization? Are there any imbalances in the plant? If so, what steps are being contemplated to set right the imbalance?
5. Is it possible to subcontract some jobs to increase production capacity or maintain production in times of power-cuts etc.?
6. What is the percentage of scrap, waste and rejects? Is it reasonable?
7. Is the idle time being monitored regularly? Is it being analysed reason-wise? How much of it is due to machinery breakdown which is controllable by production department?
8. Is there excess or shortage of manpower? How is the control exercised – time & motion study, incentives, labor budgets or any other means?
9. Is there any wastage in consumption of utilities like power, fuel, steam, compressed air, etc.?
10. How effective is the material handling system? Are there any avoidable movements of materials?
11. What is the system for preventive maintenance? If the in-house maintenance capability is not adequate, are there annual maintenance contracts for all important items of plant and machinery?
12. How is the control exercised on inventory of stores and spares?
13. What is the procedure to handle breakdown emergencies?
14. Are all statutory requirements in regard to safety measures complied with?
15. Are history cards available for all plant and machinery giving details of downtime, replacement of parts, etc.
16. Does the system provide for flexibility or change of production schedules to execute urgent orders or changes in the product mix?

Question No. 10.2

Prepare a checklist/questionnaire for management audit of the purchase function of a manufacturing company which has factories at different locations manufacturing the same range of products.

Answer :

A central purchase organization which caters to the needs of several factories manufacturing the same range of products, should aim at economies of scale, as it is in a better bargaining position. At the same time, it should keep in mind the logistics aspects, i.e. cost of transporting the raw materials and components from a single source to different (may be far-flung) locations. The objective should be to ensure a more or less uniform delivered cost at each location. Where the transportation cost is significant, the buyer should try to source the components from a supplier who is the nearest to the point of consumption.

Apart from the above special features, the auditor of purchase function should look into the following major points :

(a) Organization of purchase function, with special reference to the authorities who have been delegated powers for the following :

- Make purchase requisitions or authorize them
- Decide the vendors to whom enquiries should be sent
- Certifying the technical competence and production capacity of the vendors.
- Final selection of the vendor

(b) What is the machinery for the technical appraisal of the vendor's capacity and capability?

(c) Is there a regular vendor rating procedure and continuous monitoring of the performance of vendors?

(d) What is the procedure for issue of enquiries, preparing comparative statements and selection of supplier?

(e) Effectiveness of the market intelligence setup i.e., collection of data regarding various sources, building up a data base of products/suppliers/prices/technical specifications.

(f) Is there a separate setup for follow up of supplies and taking corrective action in case of delays?

(g) Are the terms of delivery standardised, or whether the purchase department is responsible for collection of stores from the vendors in some cases and the vendor responsible for delivery in some others? If the purchase department is responsible for collection, who is responsible for fixing transport charges?

(h) Is there close liaison between quality control (inward goods) and purchase department, so that quality complaints are brought to the notice of purchase department promptly?

(i) What are the built-in controls against misuse of purchasing powers?

(j) What is the quantum of emergency purchases in relation to total purchases? Are the reasons for emergency purchases analysed? - i.e. whether on account of vendor failure, or sudden change in production plans etc.

(k) Who certifies the payment of bills? Is the purchase department involved in deciding priorities for payment?

Question No. 10.3:

A company manufacturing consumer electronic goods has a fairly Research and Development set up. So far the company has been earmarking 2% of its turnover to R&D budget. Such an approach has so far paid ample dividends to the company. The company has been able to establish a reputation of introducing innovative products, which has excellent customer acceptability.

The company, however, is now worried that new players, some of whom are of international repute, entering Indian market, whether their R&D efforts are really giving them value for their money. Since your firm is well known consultancy firm, they have approached you to conduct a management audit of their R&D activities.

List out five major questions, which your audit will address.

(Hints : This is a question to test your capacity to apply general principles of management audit to a given situation. Hence the answer will reflect the creativity of the student. Just ask yourself how to identify the projects, monitor and review the progress, decided on whether to continue with the project or give it up. The question becomes one on management audit because the emphasis is not merely on recording accounting information and examining its accuracy but on managerial decision making process).

Answer :

General principles of management audit :

The major five questions, which the management audit should address are :

1. Selection process :

   It is the project selection based on prediction of market needs or responding to the market needs? What are the mechanics of consultation between the market research group and R&D group? Would the success of percentage of projects be better if R&D follows the perception of market research or would the initial advantage of breakthrough in new area give the company a sharp competitive edge?

2. Collection of project wise R&D costs :

   Are the costs collected project wise? Is there an agreed format for collecting such costs? Have the terms used in the format agreed upon between the management accounts, who would be monitoring costs and R&D would be using the collected information?

3. Monitoring of costs :

   How are the R&D budgets prepared? At the time of approval of projects for research, are any efforts made to indicate the value expected to flow from the successful completion of the projects and an attempt to match the expected cost and anticipated benefits?

   Is there a regular system of responsibilities accounting? Are the accounting criteria like target rate of return, target pay back period, target net present value built into the system? Are the criteria understood and accepted by R&D group?

4. Parameters for suspending further work:

Who takes the decision about suspending or scrapping a project initiated? What are the criteria used to arrive at such decision? If the criteria are already laid down, what is the process of authorizing deviation from such norms?

5. Customizing the results for production :

   When the project considered to be successful? How is the successful project customized for production? What are the responsibilities of R&D group in such customization vis-à-vis design and such other production support services.

Questions No. 10.4

Enumerate the points to be considered for assessing the requirements of working capital requirements and borrowing limits on behalf of the lending bank:

Answer:

1. General :

   (a) What are the limits presently being enjoyed for the various components of working capital, viz. inventory of raw materials, work-in-progress, finished goods, sundry debtors.

   (b) Are there separate limits other than cash credit, such as bill discounting, drawee bills, etc.?

   (c) What is the actual drawing during the last two years under the various limits – month by month? Was there any irregularity/excess drawal?

2. Inventory :

   (a) What is the method of material accounting followed? Are there priced stores ledgers for raw materials, components, stores and spares, etc.?

   (b) What is the method of valuation of stock (FIFO, LIFO, etc.) and is it being followed consistently? Are the manufactured intermediates and finished products valued at total cost or prime cost? Is there any difference of method of valuation between audited accounts and bank statements?

   (c) Are unpaid stocks included in bank statements?

Assessment of the quantum of limits:

a. What is the total inventory in terms of number of months/days consumption for raw materials and stores and spares, number of days production for work-in-progress and number of days sales for finished goods?

b. What is the level of sundry debtors in terms of number of days' sales?

c. Is the holding reasonable compared to industry standards as fixed by the bank?

d. Is the industry seasonal? If so, what are their requirements for the peak production season and other periods?

e. Does the company accept job works? If so, are the customers' materials separately identifiable and excluded from inventory hypothecated to bank?

f. What is the credit period available/availed for purchase of materials?

g. What is the company's history in writing off bad debts?

h. Is there any ageing analysis of book debts?

Question No. 10.5:

Given below are the abridged balance sheets and profit & loss account of AB Spinning Mills Ltd. :

	1998-99	1997-98	1996-97
		(Rs. in lakhs)	
Balance Sheet :			
Share capital	245	245	245
Reserves and Surplus	726	1,077	1,313
Long term borrowings	287	180	160
Working capital loans	1,639	451	672
Sundry creditors	1,616	1,255	1,015
	1998-99	1997-98	1996-97
		(Rs. In lakhs)	
Other Provisions	389	315	305
Total	4,902	3,523	3,710
Net block	1,009	541	612
Investments	19	19	19
Current assets :			
Inventory	1,160	1,521	1,641
Book Debts	11	114	172
Loans and advances	2,641	1,286	1,231
Cash and bank balances	62	42	35
Total	4,902	3,523	3,710
Profit & Loss Account:			
Sales	5,091	3,938	4,215
Other income	446	365	342
Total	5,537	4,303	4,557
Raw materials, stores and spares consumed	3,728	2,775	2,964
Factory wages	162	215	206
Salaries	377	322	295
Power and fuel	826	673	710

Repairs and maintenance:			
Buildings	*7*	*18*	*15*
Plant and Machinery	*38*	*54*	*48*
Vehicles	*43*	*33*	*24*
Depreciation:			
Buildings	*11*	*14*	*16*
Plant and machinery	*57*	*43*	*48*
Vehicles	*66*	*26*	*30*
Interest	*277*	*130*	*152*
Other overheads (excluding salaries and depreciation:)			
Factory overheads	*138*	*94*	*82*
Administrative overheads	*71*	*59*	*41*
Selling and distributing overheads	*87*	*83*	*80*
Loss for the year	*(-) 351*	*(-) 236*	*(-) 154*
Total	*5,537*	*303*	*4,557*
Sales for the year (Kgs.)	*4350890*	*3436921*	*3725405*

The bankers to the company appointed you as a Consultant for identifying the factors which have contributed to the continuing losses. Prepare a short note highlighting the factors which have prima facie led the company to sickness.

Answer :

Working notes	1998-99	1997-98	1996-97
Sales – quantity kgs.	43,50,890	34,36,921	37,25,405
Sales Value in Rs. Lakhs	5,091	3,938	4,215
Average sales realization per Kg.-Rs.	117	115	113
Raw Materials, stores & spares consumed (Rs. - Lakhs)	3,728	2,775	2,964
Material cost as % of sales value (%)	73.2	70.5	70.3
Direct wage cost % of sales value (%)	3.2	5.4	4.9

Observations:

From the above figures, it is apparent that the Company's declining profitability is NOT due to market conditions as revealed by the following factors :

(a) The sales price has been marginally increasing year to year.

(b) The very small increase in material cost is also in step with the increase in sales realization.

(c) The company has been able to control direct labour cost effective.

(d) The level of production has been maintained and has in fact improved in the latest year.

(e) Inventory and book debt levels have been brought down considerably.

On the other hand, the following factors present a disturbing picture and lead to the inference that the financial management is either incompetent, or the management was diverted the borrowed working funds to some other activity or invested in unproductive assets like vehicles:

	1998-99	1997-98	1996-97
Long term borrowings	287	180	160
Working capital loans	1639	451	672
Net block	1009	541	612
Loans & advances	2641	1286	1231
Depreciation, repairs & maintenance of vehicles	109	59	54
Interest	277	130	152

The increase in working capital borrowings and the consequent interest thereon were not warranted, especially when the funds blocked in inventory and book debts have come down. The additional interest burden and additional expenses on vehicles amount to Rs. 197 lakhs whereas the increase in loss as compared to the previous year is only Rs. 115 lakhs.

Preliminary conclusion:

(i) *Prima facie*, it appears that the unit has become sick due to diversion of funds by the management to other activities or for personal expenditure.

(ii) The fixed assets have doubled. But there is no profit accruing by the increased assets.

Question 10.6:

Explain whether the following activities amount to professional misconduct :

(a) A Cost Accountant takes voluntary retirement from his employer and starts practice. He continues his association with his previous employers as an advisor, on a monthly retainer.

(b) A practicing lawyer specializing in anticipating cases comes to an informal understanding with an independent practicing Cost Accountant to assist him in preparing accounting statements to support his cases, and agrees to share his fees on a percentage basis.

(c) A Cost Accountant gives a certificate of cost for a product manufactured by an SSI unit owned entirely by his son.

Answer :

Professional Misconduct :

(a) As the accountant has severed his connection with his previous employer as an employee and acts only in an advisory capacity, which is a legitimate activity of a practicing cost accountant, it does not amount to misconduct.

(b) Although the practicing cost accountant can accept the assignment for preparing the necessary statements for the antidumping cases for a specified fee, the sharing of total fees on a percentage basis between the lawyer and cost accountant amounts to an informal partnership between them, which is prohibited. Therefore, this practice falls under the definition of misconduct.

(c) The Second Schedule to the Cost and Works Accountants Act, 1959 stipulates that a Cost Accountant in practice shall be deemed to be guilty of professional misconduct if he expresses his opinion on cost or pricing statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest, unless he discloses the interest also in his report. Strictly speaking, a cost accountant issuing a certificate for a unit in which he has no direct interest is in order. However, as in this case the factory is owned by the cost accountant's son it would be prudent on the part of the accountant to desist from issuing such a certificate on moral grounds.

5.11 Self-examination Questions

1 What is meant by management audit? State the main objectives of management audit.

2 How is management audit different from the other audits?

3 Elucidate the scope of management audit in manufacturing company.

4 Indicate the important areas to which management extends.

5 Appraisal of management functions is a must for correcting problems arising out of weak management. Discuss.

6 Why is management audit resorted to even though we have financial audit, internal audit and cost audit in India?

7 Distinguish between management audit, internal audit, financial audit and cost audit. Set out a comparative statement of purposes, features, areas and scope of each of these.

8 What is operational audit? How is it different from management audit?

9 Distinguish between administrative audit and management audit.

10 Distinguish between management audit, propriety audit and social audit.

11 There are certain elements in management functions which need constant review by the management auditor. What are these?

12 A comprehensive critical review of all aspects or processes of management can be best accomplished by an experienced team of professionals drawn from various disciplines and having live experience and contact with the industrial atmosphere. Elaborate.

13 "Management audit can be potent tool for managerial control and reduction of cost". Do you agree with the above statement? Briefly comment on the potential of management audit as a tool for managerial control and reduction of costs.

14 Outline the general approach of a management audit, before commencing his audit.

15 What types of evidence would a management auditor rely upon for his audit checks?

16 Mention a few significant attribute of a management auditor.

17 What is the need for a management audit team?

18 Briefly outline management audit programme for conducting efficient management audit.

19 Draw out a model management audit programme.

20 What do you understand by management audit checklist? What considerations are required by a management auditor in preparing such checklists?

21 Suggest a suitable checklist for appraisal of organization?

22 As a management auditor for an engineering company you are requested to write a report to the management of a company suggesting suitable control procedure for wastage, scrap, spoilage and obsolescence of materials. Please draft a report explaining areas which you would highlight.

23 As a management auditor of a manufacturing concern, draft a model questionnaire for evaluation of purchase management.

24 A company whose performance and profitability has been excellent often finds itself short of cash funds. You are appointed as a management auditor to look into the problem. Indicate our plan of approach stating the aspects you will cover and why?

25 As a management auditor of a company, draft a model questionnaire for evaluation of production management.

26 You as a management auditor have been asked to conduct a review of the function of the personnel department of XYZ Ltd. State the various points which will be covered in the review.

27 What is marketing audit? What are its essential features? Marketing audit is to be successful has to be done in certain specific areas. What are they?

28 The first step in management audit of a function is a clear understanding of the operation in different areas of that function. List out five areas in marketing, briefly explaining the operations related to those areas.

29 A comprehensive critical review of all aspects or processes of management can be accomplished by an experienced team of professional drawn from various disciplines and having live experience and conduct with the industrial atmosphere. Elaborate.

30 (a) What are the special features of research and development activities as compared with other common production and selecting activities?

(b) As a management auditor how will you appraise and evaluate these activities.

31 Today's customer is more than customer of yesterday. In view of this, how would you evaluate, as a management auditor, the performance of :

(i) Quality control department; and

(ii) Customer service department

32 What do you understand by "corporate image"? As a management auditor how will you evaluate corporate image?

33 Briefly set out the characteristics of a good audit report.

34 What are the types of reports that may be required of a management audit?

35 (a) How does an auditor evaluate the internal control system in an enterprise?

(b) What are the advantages of such evaluation?

(c) Discuss the nature and usefulness of Internal Control system in an enterprise?

36 Who has the basic responsibility for internal control in an organization? To what extent the internal auditor is responsible for the internal control? Discuss the role of internal control system, giving suitable examples.

37 (a) Indicate the steps in a budgetary control system.

(b) Indicate briefly how a cost auditor will determine the adequacy of a budgetary control system.

38 (a) Indicate the need for capacity determination.

(b) How will you, as a cost auditor, suggest to rectify the imbalance in production facilities of a company under cost audit.

39 Design an internal control questionnaire relating to inventory.

40 How can one assess the adequacy of internal audit function?

41 Enumerate the points of distinction between "Cost audit" and "Financial audit".

42 The Managing Director of a company has called you in to look at the Management Information System (MIS) in his company. He complains that every month he receives a tonne of computer printouts but does not get what he wants. Would you go about carrying out an audit of the company's MIS? Start from stating the features of a good MIS and proceed to examine the changes needed.

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STUDY NOTE - 6

Management Audit in different Functions

This Study Note includes:

- Corporate Culture and Objectives.
- Corporate Services Audit
- Audit of Social Responsibility of Management - Environmental Pollution Control
- Audit Checks of Different Function
- Corporate Divisions / departments / function
- Corporate Governance and Audit Committee.
- CII code for Desirable Corporate Governance

6.1 Corporate Culture and Objectives

6.1.1 Evaluation of Corporate Objectives

6.1.1.1 *Corporate Objectives* are the overall objectives of the organization that influence the direction of corporate strategy. In other words, what the organization seeks to achieve is corporate objective. These are the specific, realistic and measurable aims which an organisation plans to achieve. These represent the charter that the organisation has laid down for itself. These corporate objectives could either be written or unwritten. Many experts feel it would be better to have a written charter for any body in the organization or outside to know what the organization stands for and to be understood and followed, rather than known by trial and error. Moreover, all good plans must support the overall corporate objectives of the organisation. For example, the corporate objectives of a company could be to become global leader in the next five years. This means that all individual plans must support the achievement of this objective. Similarly, the corporate objectives of world famous 'NIKE' company are reproduced as under:

- Protect & improve Nike's position as the number one athletic brand in America;
- Build a strong momentum in growing fitness market;
- Intensify the company's effort to develop products that women need and want;
- Explore the market for products specifically designed for the requirements of maturing Americans;
- Direct & manage the company's international business as it continues to develop;
- Continue the drive for increased margins through proper inventory management and fewer, better products.

6.1.1.2 The corporate objectives of 'General Electric Company', USA are :

"To become the most competitive enterprise in the world by being number one or number two in market share in every business the company is in."

6.1.1.3 The corporate objectives of 'Apple Computers, USA are :

"To offer the best possible personal computing technology, and to put that technology in the hands of as many people as possible."

6.1.1.4 Many companies do not have a clear understanding of their business objectives. Some of these companies go for acquiring of unrelated businesses just because others are also doing in the hope of being equally successful despite the fact that they don't know much of that business or industry. Similarly many companies do not successfully make their employees aware of its corporate objective or how they are very important part of it. Therefore, it is very important that corporate objectives are defined in concrete and understandable terms. These corporate objectives need to be defined in broad terms that allow some degree of flexibility, but should not be defined in terms that make the objective nonexistent. For example, a company making games can have any of the followings as their corporate objectives: (a) making children's games; (b) making games; or (c) providing entertainment. The set of assumptions and strategies that go with each objective are totally different and the business operations will differ dramatically depending upon the exact choice of corporate objective. Similarly, a company planning to consolidate its marketing share in the country (national market) might have totally different objectives for market as compared to another company seeking to become global leader because the needs of customers may be totally different in each of the country.

6.1.2 Evaluation of Corporate Strategies

6.1.2.1 Corporate strategy or policy is the strategy that determines the means for utilizing resources in the areas of production, finance, research and development, personnel, and marketing to reach the Corporate Objectives. These policies are laid in conformity with the objectives of the organization and are generally laid down by top management and the board of directors. These may be subject to change from time to time depending upon the external changes affecting the corporate objectives. The policy however, should not deviate from the objectives of the organization unless the objectives are restated. Therefore, it is vital for any organization that all its deptt. objectives like marketing objectives, production objectives and human resource objectives are all compatible with the overall corporate objectives.

6.1.2.2 **Evaluation of Corporate Image and Branding:**

Corporate Branding is the process of creating and maintaining a favourable reputation of the company and its constituent elements. It is an important organizational resource that enables to create, strengthen and sustain competitive advantage. It is a strategic asset that creates competitive advantage and favourable climate for the survival and development of an organization. Corporate Image is a reflection of any business. The term "image" of a company refers as to how it is perceived by the public at large. In other words, the corporate image refers to the image, which is conjured up by mention of a company's name. It is a first step of branding process. Corporate image is a strategic asset that creates competitive advantage and favourable climate for the survival and development of an organization The big corporations and organizational buyers are mainly concerned with the company's overall brand identity, rather than with the specific product they want to buy, and will generally remember the image of the company longer than any particular product information. Thus, the purpose of corporate branding is to:

- Make the organization known, as unique, distinct and credible in the mind of potential customers.
- Facilitate the building of relationships and trust.
- Portray the benefits of the organization to the customer.
- Embody and convey the value system of the organization.

6.1.2.3 Google's recent success with their public offering is an expression of corporate branding of Google's uniqueness and distinction. Similarly, no body in India can dispute the corporate brand and image of big companies like Reliance etc. Corporate image seeks to influence the people's perceptions of a company through consistent presentation of the company to public.

6.1.2.4 In developing a corporate image, an enterprise has to ensure an overall consistency while taking into account the various divergent factors such as checking the quality of its products, the ethics of its management, the corporate values upon which its people act, its style of management, attitudes towards customers, quality and service to customers and so on. The customers are usually interested in the price, quality and reliability of the company's products and services, distributors in the assurance of product availability to influence the purchasing decisions of customers and their own earnings out of them, creditors in their prompt payments and continued relationship for suppliers, shareholders are looking for their return on their investments and appreciation in investment growth, government in their realization of revenues, employees in their expectation of stability of employment, higher remuneration and good working condition and welfare measures etc.

6.1.2.5 The first point in a corporate sector is to have a definite mission – a mission to produce or to render services to satisfy the needs of the consumers. In order to fulfill such mission, the enterprise has to earn a favourable image either for its products or for itself or both. Generally it is observed that corporate image and product image go hand in hand. The messages conveyed through the medium of advertisement by an enterprise try to evoke a favourable response towards its products and brands by building product image as well as corporate image.

6.1.2.6 The magnitude and variety opportunities for external communication have considerably expanded and the potential for "public" understanding has also increased considerably. Moreover, large corporations have diversified their products range and marketing areas they serve. As a result the management of corporate branding and image assumes great importance in the formulation of an effective corporate strategy.

6.1.2.7 The evaluation of corporate image is a very complex psychological and behavioural activity. It is seen many a times that corporate image has no relationship whatsoever with the corporate objectives. The evaluation involves a purposeful observation and critical examination of events and trends concerning business environmental factors operating inside (e.g. management and employee) and outside the concern (e.g. shareholders, investors suppliers, public) despite the fact that their expectations are totally different. In order to perform an audit in these areas, the role of the management auditor will be that of an analyst. The product image may be defined as that of a brand or quality formed by the consumers' belief about specific attributes of a product. Similarly, corporate images are the qualities which the 'public' attribute to a corporate body. Thus different branded soaps such as Lux, Hamam, Margo etc. may be attached with different product attributes such as price, fragrance, medicinal values, smoothness on skin, longer lasting etc. for determining product image as well as corporate image. The following steps are included in the evaluation of product image:-

(i) Developing a benchmark for products' characteristics and that of the consumers' attitudes, suitable to an enterprise.

(ii) Collecting data based on actual observation of events and trends and restructuring them by statistical or other methods so as to help comparison.

(iii) Identifying the strengths and weaknesses in relation to the objectives set and envisaged.

6.1.2.8 The various approaches of a management auditor to evaluate corporate image are -

(a) To prepare a list of desirable attributes;

(b) To select them into main groups and under each group dovetailing the specific qualifications;

(c) To study their relative importance and assign respective weights or points to each one of them in order of priority, but keeping in view the aspects of objectivity, relevance, and materiality that might have an impact on the image of a corporate sector;

(d) Rating the specific qualifications or attributes based on facts, judgments and interpretations and technical studies made by experts in the respective fields;

(e) To summarize the rating under the selected groups; and

(f) To present to the management a comparative picture between the results anticipated and actual results.

6.1.2.9 Thus in order to arrive at the proper evaluation on a number of factors arbitrarily chosen on the subject, a management auditor has to apply a greater degree of skill in factual analysis. His approach for evaluation of corporate image should include attributes of dealing with financial stability, production efficiency, sales effectiveness, economic, and social affluences, personal satisfaction and development, growth in earnings, public relations and civic responsibility. In the process of evaluation of corporate image, the management auditor may take the help of any one or more of the following techniques -

(a) *Graphical method* : Up-to-date graphs are maintained for each of the attributes of a public under evaluation (viz. product, consumers, investors, and shareholders).

(b) *Point method* : Points are attached to each attribute concerning a profile and scaling them as very good, good, fair, poor, very poor, etc.

(c) *Index method* : Ideal indices are developed for comparison with actual ones for some attributes of a profile.

(d) *Survey method* : It indicates questionnaires to elicit information attitudes, survey, etc.

(e) *Ratio analysis* : Analysis of events and trends with the help of ratios (viz. export to total sales, own sales in the same industry).

(f) *Position analysis* : Position of an enterprise with regard to market size, market share, market stability, etc.

(g) *Method of comparison* : Comparison of actual with budget on quantifiable attributes within the enterprise. It also includes inter-firm comparison within the same class of industry.

6.1.3 Corporate Culture - Concept

6.1.3.1 **"Culture is to know best that has been said and thought in the world" – Mathew Arnold.**

Culture refers to a corporate's values, beliefs and behaviours on the basis of which people interpret experiences and behave. Generally firms with strong cultures achieve higher results. In simple language, corporate culture is the operating working environment and is shaped by the way people conduct their work, the way customers are treated and served, the way workers interact with each other or their supervisors or the way people present themselves.

6.1.3.2 Corporate culture unites the enterprise as a family and develops closeness of feeling among all. Like a family culture, customs and traditions Successful companies often boast about "our accomplishments" and "my failures", whereas unsuccessful companies generally have as the three R's in their corporate culture i.e., "resistance", "resentment" and "revenge" and these three 'R' send an organization on its way to "tiredness". Thus, the corporate culture is always visible in workers attitudes, work ethics and impacts heavily upon workers ability to make decisions and respond to customer needs, workers satisfaction and ultimately the bottom line. It must be understood that the corporate culture is always independent of corporate policies and usually comes from the corporation's leaders, even though it belongs to all employees collectively.

6.1.3.3 An example, which is often given, is that some of the companies continue to introduce market innovations, dominate markets and are highly profitable, while other companies in the same business continue to struggle with success eluding them. Since all the companies are in the same business, one can easily rule out the external factors like market conditions. This leaves one with the conclusion that the lack of success is caused directly by the company and the type of environment or culture it has for taking decisions.

6.1.3.4 In this era of globalization, successful companies have a customer driven corporate culture. They know that it is customers that can make a company successful and all employees are very important in making the company successful. Successful companies listen to their customers and provide the products that give the customer what he wants (customer satisfaction) and not what the company wants to sell. Responsiveness to the consumer is the ultimate key. Employees must believe that what they do every day has an effect upon the business' success and that these effects are cumulative. Many a times, we hear from managers in corporate life "I know it doesn't make sense, but it's the policy as long as anyone remembers?" Dynamic leadership of successful companies always constructively challenges rules and assumptions in favour of customer satisfaction leading to building up of a successful company.

6.1.3.5 Culture is reflected in every activity, speech, habit, manners, behaviour, action, dress etc., and in fact in every turn in the organization. Projection of good culture ensures a healthy corporate life. Management is not only a technique, it is also a culture. An enterprise should be identified with its culture, like Mahatma Gandhi with Ahimsa or Harishchandra with truth, similarly a corporate body with quality, schedule of delivery or ensuring payment promises etc. It is the management's responsibility to ensure the building up of a corporate culture comprising of :

- Commitment to honest productivity
- Planned performance and growth
- Informative, informing and informed, organization
- Consideration for others in partnership with the organization
- Participative management
- Good employee relations
- Good decisions and timely action
- Quality consciousness
- Mutual trust
- Futuristic outlook

- Helpful nature, inter-institutional and towards neighbourhood
- Cleanliness, timeliness, truthfulness, open home, orderliness, humility, creativity, learning, and sense of values.

6.1.4 Evaluation of Corporate Culture

6.1.4.1 Every organization has some existing culture. Therefore evaluation of corporate culture does not mean to create or invent a new culture, but to identify the existing culture, assess where improvements are needed, develop an action plan and implement it. Many organizations believe that by summing up slogans like "we have a culture of innovation" etc., they can have a unique culture.

6.1.4.2 In this area, the management auditor forms his independent opinion about corporate culture by asking questions on the following patterns:

(a) Is the pressure on employees to perform unavoidable?

(b) Is it sometimes difficult to ask questions or raise concerns?

(c) Whether the employees can act as "whistle blowers" against their seniors?

(d) Is bad conduct ignored or tolerated? Is good conduct encouraged?

(e) Is there a close tie between performance and rewards?

(f) Does short term thinking dominate in decision making?

(g) Are compliance or ethics issues marginalized or denigrated?

(h) Do employees identify sufficiently with the interest of shareholders or other stakeholders?

(i) Do employees understand and sufficiently care about the needs of the customers.

(j) Is the quality of product and/or services a high priority?

(k) Are employees proud of the products/services delivered by the organization?

(l) Are they proud of organization?

6.2 Corporate Services Audit

6.2.1 In this era of globalization, companies are always mired in tough battles for achieving greater efficiencies, differential products and services to improve their corporate services and enhance their sustainable competitive edge. The term "Corporate Services" refers to the activities that combine or consolidate certain enterprise-wide needed support services, provided based on specialized knowledge, best practices, and technology to serve internal (and sometimes external) customers and business partners. These services co-ordinate the diverse organizational units and helps them to focus on organizational goals by effectively exploiting resources and developing core competencies that enable an organization to keep its edge over its industry competitors. It sometimes amounts to combining operations with another competitor in the same industry to increase competitive strengths and lower competition among industry rivals.

6.2.2 The business world is now becoming increasingly information intensive and complex. Therefore, companies have begun to incorporate web-based services into the work place. This has opened up many new challenges and initiatives. This has radically affected many of the established functions. Some of them have been reduced, combined or eliminated. This also means that corporate boundaries are completely changing with advantageous partnering connections with outside service suppliers. Corporate services have now become integral part of the business value chain.

6.2.3 Corporate services are the support infrastructure of a company. These include public relations, customer assistance or call centers, training, engineering, human resources and procurement etc. to create new business value and help the company function more effectively by improving internal processes, managing customer relationships and extending the organization. The advantages of corporate services are productivity gains, cost savings and service improvements. The benefits of these services extend to core business areas in form of reduced costs, less inventory, less working capital requirements, improved procurements and higher profits. It also helps in much higher efficiency and productivity of the employees as new technologies can introduce an array of new possibilities with powerful computers and integration of database with web technologies. For example, if departmental managers were earlier receiving weekly or monthly reports to help them take critical decisions, all this information shall be available real time online now to help them to track the things which were important to them and take decisions.

6.2.4 The scope of corporate services audit extends to the critical examination of the different aspects of services and their extent that have been satisfactorily rendered by a corporate body, and of evaluation of degrees of responsiveness and awareness on the part of such enterprise. Thus the performance of management towards consumers, employees, shareholders, community, fellow-businessmen and Government is studied separately and properly evaluated by management auditor. The areas of corporate services audit and the scrutiny and evaluation criteria can be categorized as follows:

(i)	Consumers	Quality goods in right quantities at right prices, place and time.
(ii)	Employees	Pay, training, safety, welfare, industrial relations, etc.
(iii)	Shareholders	Safety of investment, satisfactory return, appreciation.
(iv)	Community	Social cost and social benefit, public relations.
(v)	Fellow-businessmen	Business ethics and fair trade dealings
(vi)	State	Compliance with the spirit of laws, fair trade practices, payment of taxes.

6.2.5 The appraisal system of corporate services audit should consider the level of contribution a business entity makes to society and its business environment towards raising the quality of life through better product quality and services rather than profit maximization. The corporate services audit thus attempts to distinguish between the ends (i.e. profits) and means (i.e. services) of business and provides a new dimension to the concept of audit approach. It is the fulfillment of social responsibility of a business unit. Auditor's responsibility lies in evaluating the company's response to social needs.

6.2.1 Corporate Development Audit

6.2.1.1 A corporate development audit is an independent objective study of an organization's capabilities. It aims at identifying strengths and weaknesses and moving toward state-of-the-art performance. A Corporate Development Audit gives a comprehensive picture of the status of corporate development effectiveness and highlights developmental needs. Many organizations use the corporate development audit to identify the state-of-the-art in business development in their industry and determine exactly how much they differ from that ideal. The resulting feedback report highlights all key findings, with specific recommendations for course correction or improvement.

6.2.1.2 *Corporate development audit* is a comprehensive task to assist the corporate management in various aspects of development through a process of systematic review and evaluation of long-term strategies of the company. Such corporate development audit assures that –

(a) The various factors and forces constituting a corporate enterprise are the right kind and quality.

(b) Communication remains the key to the functioning of an enterprise.

(c) The pattern of departmentalization in an enterprise adopted in the past and proposed for the future for dealing with multidirectional responsibilities is fully responsive to circumstances and business environment.

(d) The personnel problems are handled appropriately considering the overall objectives of development of the corporate enterprise.

(e) The responsibilities of planning, coordination, motivation and control at functional management levels are discharged in proper spirit.

6.2.1.3 A corporate development audit is best performed by a team consisting of different experts of different disciplines as it requires multi-disciplinary approach. Large scale corporate enterprises offer opportunities to the conduct of corporate development audit. Contrary to other forms of audit – statutory or non-statutory (viz. financial audit, cost audit, efficiency audit, propriety audit, etc.) corporate development audit plays a vital role not only tying up the loose ends, but also to forge a link in the knowledge that emanates from different quarters and on the basis of different types of experiences in dealing with varied types of problems.

6.2.1.4 As the corporate development audit is more of an introspective nature, necessary initiation and support should come from a firm decision taken by the Board of Directors and its chairman. Moreover, as this audit highlights the corporate strengths and weakness, especially failures, inefficiencies and bottlenecks, it should be undertaken by a high-powered team with the corporation and acceptability of all those concerned with it.

6.2.2 Checklists in Areas of Corporate Development

6.2.2.1 Checklists on various areas of corporate development may be helpful in appraising the structural aspect of a corporation, detailed below :

A. *Check list on corporate planning*

(a) Whether SWOT analysis has been made?

(b) What are the corporate strengths and weaknesses in relation to price, product, quality, market share, distribution net work, after sales services, technology improvement, corporate structure and qualities of its members?

(c) What are the opportunities and threats in relation to rivalry among existing firms, threat of new entrants, threat of opportunity of technical know-how, strategy of suppliers?

(d) How are the threats overcome and opportunities availed of in the past?

(e) Whether the "corporate image" is going to improve in near future?

(f) What specific techniques are applied by the management for corporate planning, long and short term exercise?

(g) Whether the corporate objectives and goals are clearly defined and qualified?

(h) Whether the corporate planning premises and plans drawn up based on adequate information?

B. *Checklist on corporate objectives*

(a) Whether the corporate objectives are clear and explicit?

(b) Whether the different elements of the enterprise have separate objectives?

(c) How are these objectives defined?

(d) Are the objectives in writing?

(e) Is there sufficient flexibility in then organizational design in the form of the responsiveness to changes taking place from time to time?

C. *Checklist on delegation of authority*

(a) Whether there are clear lines of authority from top to bottom in the corporate enterprise?

(b) Whether accountability has been properly coupled with corresponding authority?

(c) Whether responsibility and authority in each position clearly defined in writing?

(d) Whether the number of levels of authority kept minimum?

(e) Whether duties assigned to the subordinates indicative as to what exact activities are expected from them?

(f) Whether responsibility via delegation of authority created among the subordinates to complete the given task?

(g) Whether the methods of delegation compatible to the organization structure?

D. *Checklist on span of control and management*

(a) Whether span of control has been recognized in the organization?

(b) Whether everybody in department report only to one superior?

(c) Whether the accountability of higher authority for the acts of its subordinates is in accordance with current practices?

(d) Whether the corporate management recognizes the following factors that affect span of control?

   (i) Degree of interaction between the units or personnel being supervised?

   (ii) The incidence of new problems in any department?

   (iii) The extent of standard procedures adopted?

   (iv) The extent of non-managerial responsibilities?

(e) Whether the different activities and functions are grouped together in order to -

   (i) Obtain the most effective use of men and facilities

   (ii) Meet the objective in the optimum way?

   (iii) To run the most economical operation?

(f) Whether responsibilities are grouped, wherever possible, so that the overall control of a function can be established so as to hold the superior manager accountable?

6.2.3 Evaluation of Personnel Development

6.2.3.1 Market changes require continuous innovation within companies to enable them to grow successfully. Thus, successful personnel development aims at supporting and ensuring innovation processes of a company by efficient and targeted development of staff ultimately leading to organizational development. Personnel development, a vital aspect of corporate development is systematic training of managers and specialists to fill present and future needs for the company. It also helps further individual growth to ultimately facilitate corporate growth and expansion. The concept of personnel development is essentially long-range in nature. It is aimed at development of efficient, loyal and hard working employees. Since all the activities in an organisation are accomplished by the people, for the people and with the people, the aspect of personnel management gains significance.

6.2.3.2 Successful personnel development concepts must meet company-specific requirements and targets. Also, they should be efficient, economical and lean. Personal development teaches the staff as to how to become more productive and effective at work. Essentially, personal development is about having more control of self actions and emotions and staying motivated irrespective of situation or environment. Evaluation of personnel development may include the following criteria -

(a) Pre-planning as an essential feature of human resource development.

(b) Ascertaining manpower needs for appropriate education, training and development.

(c) Ascertaining the difference between future needs and existing talent i.e. gap or imbalance.

(d) Adopting a suitable programme of recruitment, selection, training and development to close the gap of imbalance.

(e) Adequate manpower planning with an appropriate blending of manpower management policies and manpower management programme.

6.2.3.3 Scope of personnel function:

"Personnel Management" is that part of the management function which is primarily concerned with the human relationships within an organization. Its objective is essentially the maintenance of those relationships, which enable all those engaged in the undertaking to make their maximum personal contribution to the effective working of that undertaking. Therefore personnel management is concerned with managing people at work. It is concerned with employees, both as individuals as well as a group. It is essentially one of development of efficient, loyal and hard working employees. Personnel management is concerned with helping the employees to develop their potentialities and capacities to the maximum possible extent. The functional areas along with the scope of human resources management and development indicated below may be identified as the component of personnel function -

(a) *Organization review and analysis :* Continuous review and analysis of organization's operation may be necessary in order to determine and develop appropriate work structure, roles and responsibilities, inter and intra-department relationship, and levels of authority.

(b) *Manpower, planning, recruitment and selection :* Forecasting and planning is essential to needs an organization for a sufficient number of qualified personnel for manning its operations.

(c) *Manpower training and development :* Appropriate methods and techniques of training and development may be adopted. Proper facilities and opportunities are to be provided for personnel to enable them to acquire necessary skills and knowledge to perform the jobs for which they are employed.

(d) *Performance appraisal :* There should be proper measuring, rating and evaluation of performance of personnel, guiding employee development and promoting motivation, communication and equity.

(e) *Employee remuneration :* This function includes developing and administering appropriate system of remuneration including job evaluation, wage and salary structure, incentive payments, fringe benefits and non-financial rewards.

(f) *Employee services :* There should be satisfactory services relating to the safety, health and welfare of all employees, including social security plans and community development programmes.

(g) *Administration and records :* This includes designing, implementing and controlling of adequate records and administrative procedures to provide useful and pertinent information for planning purposes and for the documentation for all personnel in service.

(h) *Industrial relations :* It includes establishing appropriate procedures for the resolution for personnel and institutional differences by means of appropriate measures and machinery, e.g. standing orders, grievance procedures, conciliation, collective bargaining, and joint consultation.

(i) *Auditing and research in manpower management :* These are the responsibilities of personnel management, which call for the attention of a management auditor.

6.2.4 Consumer Services Audit

6.2.4.1 The primary responsibility of a business enterprise towards consumers is to make available the products of the right qualities at the right time, in right quantity, at the right place and right price. The consumer services audit critically examines and appraise management on these aspects of services. It is therefore an audit of public responsibility of business enterprise in relation to its customers and is a part of social audit. The audit is based on the philosophy that the role of business should be conducive to raising the quality of life through its contribution in terms of better product-quality and services.

6.2.4.2 **Checklist on 'consumer services' evaluation:**

A management auditor while examining the consumer services policies and practices in an organization may use the following questionnaire -

A. Products related policies and practices:

(a) Do the products manufactured meet the needs of the customers of different classes, different tastes and different purchasing power?

(b) Whether the prices are reasonable and consistent with the quality variations, efficiency variations?

(c) Whether the prices include reasonable profit?

(d) Whether the prices have been fixed under competitive market or monopolistic conditions subject of Government restrictions?

(e) Whether detailed information regarding the product, service, company profile and policies etc. are adequately disseminated in order to ensure that the communication made to the customers regarding price, quality, services, etc. are truthful?

(f) Whether after-sales service spare parts facility etc. enable customers to derive maximum satisfaction?

(g) Whether the company undertakes adequate research in regard to products and customer behaviour so as to make their products more satisfactory to the customers?

(h) Whether constant efforts are made for improvement of the product's use value as well as esteem value?

(i) Whether the management assumes responsibility of 'product development' function as a continuous exercise in relation to society in general and the consumers in particular?

(j) Whether the product development programme considers the factors of standardization, simplification and specialization?

(k) Whether such programme is undertaken to meet only the short-term demand or long-term requirements?

(l) Whether the company policies and practices, relating to the distribution of products among different sections of customers, fair and equitable?

B. Customer Relationship

(a) Whether the customer complaints are handled promptly and efficiently?

(b) Whether the company responds quickly to the customers' enquiries relating to product or services?

(c) Whether the labels of the products contain adequate information to help the consumers to appreciate quality and other characteristics of the products?

(d) Whether the company cooperates with the groups and associations representing customers?

(e) Whether the company provides useful suggestions and renders necessary assistance to 'consumer's cooperatives' for distribution of quality goods at reasonable price?

C. General Considerations

(a) Whether safety norms relating to products are maintained as per the accepted standards laid down by the statutory bodies, such as ISI, BSS, etc.?

(b) Whether performance guarantees are explicitly stated?

(c) How do the merits of the company's own products match the advantages to the consumers, if mentioned in the advertisements?

(d) Whether the technical data given in the sales promotional media specific and not ambiguous?

(e) How does the company ensure proper remedy against customer complaints when products are made available to the consuming public through a large network of distributors as well as retail outlets?

(f) Whether the policies and practices of the company are adequate to combat artificial scarcities?

(g) Whether all the "warranties" are explicitly stated? Is the procedure for invocation of warranty stated in unambiguous terms?

(h) Whether the fundamental aspect of servicing responsibility to consumer recognized by the enterprise as a policy measure?

(i) Whether there are instances of relaxation of policy norms in respect of responsibilities to customers even when the distribution of goods is made through middlemen?

6.3 Audit of Social Responsibility of Management – Environmental Pollution Control :

6.3.1 Environment includes entire biological, physical and social milieu in which man and other organisms are placed and no organism however simple or complex can survive on their removal from the environment. In order to make progress, man has produced destructive, hazardous and often irreversible changes in the environment on which he is totally dependent. With a view to improving living and nutritional standards, man has interfered with practically every sphere in natural ecosystem. The man-made pollutants that greatly influence the quality of environment are – metals, petroleum products, volatile industrial chemicals, heat and exhausts generated due to the burning of fossil fuels, radioactive species from reactors and nuclear reactors, organic and domestic wastes – as most of these are discharged untreated into the environment. Pollution is thus a kind of interference to the environment degradation. The problems of such environmental degradation – air, water, noise pollution, solid wastes, radiation hazards, thermal pollution, are threats to wildlife, depletion and destruction of natural resources, etc. are all environmental crisis and threats affecting the delicate balance of natural ecosystem. Pollution can be described in the following ranges -

(i) Pollution as any alteration of the environment.

(ii) Pollution as the right of the territorial sovereign (it indicates the limit of pollution allowed within geographical borders of a state).

(iii) Pollution as a damage to man and to the environment.

(iv) Pollution as interference with other uses of the environment

(v) Pollution as exceeding the assimilative capacity of the environment.

6.3.2 The level of pollution varies with the density of population and per capita income and inversely with the extent of recycling, technology and waste treatment. The different types, cause and effects of environmental pollution may be as follows -

(a) Air pollution:

Air pollution is the human introduction into the atmosphere of chemicals, particulates or biological materials that cause harm or discomfort to humans or other living organisms or damage the environment. Air pollution is caused by burning coal or crude oil like naptha in power stations, smoke from factories, exhaust fumes from automobiles, solvent losses and agricultural chemicals, etc. Air pollution leads to deaths and respiratory diseases.

(b) Water pollution :

Water pollution is the contamination of water bodies such as lakes, rivers and/or oceans caused by effluents from breweries and tanneries, coal washeries, chemical plants, discharge of coolants from nuclear power plants, pesticides and agricultural chemicals. Water pollution affects public health and safety, causes damage to property and leads to many economic losses.

(c) Noise pollution:

Noise pollution is a type of energy pollution in which distracting, irritating or damaging sounds are freely audible and is caused by noise due to running of heavy machines, big aircrafts, aircraft, drilling machines, etc. Noise pollution may lead to loss of efficiency at work, loss of hearing and causes psychological disorders, even insanity.

(d) Smell pollution:

Discharge of industrial products, unclear garbage dumps, open sewers, etc. It affects physical well-being and even causes psychological disorders.

(e) Thermal pollution:

Large inputs of heated water from a single plant or a number of plants using the same lake or slow-moving stream can have harmful effects on aquatic life. Thermal pollution is radiation of heat generated by plants in industries. Warmer temperatures lower dissolved oxygen content and cause aquatic organisms to increase their respiration rates consume oxygen faster and increases their susceptibility to disease, parasites, and toxic chemicals. Thermal pollution affects ecological balance and thereby the inhabitants.

(f) Visual pollution :

Effluents from chemical plants and washeries are discharged into the waterways causing reduced visibility. Industrial fumes and dust causing loss of landscape attractiveness and strain to vision of pedestrians and motorists, may cause more road accidents and traffic deaths.

(g) Climate pollution:

Radiation of heat in highly industrial centres leading to "micro climate zones" causing deforestation, shortening plants growth and affecting surroundings. It affects ecological balance and causes damages to plant and surroundings.

(h) Radiation pollution :

Radioactive fallouts, leakage from nuclear reactors and prolonged exposures to small doses of radiation results in a bio-accumulative process, causes a significant chronic affect by increasing the rate of genetic mutation.

(i) Soil/land pollution:

Indiscriminate use of fertilizers and pesticides, pollution of soil with man-made chemicals, indiscriminate disposal of solid use etc. Due to pollution the quality of soil deteriorates to the extent that they fail to support vegetation. It affects the global climate also.

6.4 Audit Checks of Different Functions

6.4.1 General

A management and administration auditor operating the following series of checks must remember that many of them are complementary. A correct picture of the effectiveness of any single function may not be completely obtainable from a review of checks in that area alone. Each function must be seen as a balanced part of a whole organization.

6.4.2 Directorial Checks

(a) What routine reports are considered as directors' meetings and do these *prima facie* provide information for effective and efficient control of the business?

(b) Do the directors receive projected information covering the various functions of the business, in addition to any figures which they receive to enable them to review the present performance of the business?

(c) Is there evidence that directors established their control primarily on such projections secondarily on past records?

(d) "Whether the Director review and approve the strategic and financial plans for achieving long-term success of the company.

(e) What is the directors' policy for ensuring that the right kind of senior managers including CEO are engaged?

(f) What interest do directors take in R&D? In particulars, if formal R&D facilities are available, what significant efforts are made to relate these to market research?

(g) Have the directors set out the objects of the organization in writing?

(h) Are all activities of the organization within the scope of its objectives?

(i) Whether they have been briefed about major risks faced by the business and strategies for addressing these risks.

(j) Do these include the ratio of capital aimed to be employed in the business, the objectives earning per share, the planned growth of the latter and the control of the former?

(k) What control do directors exercise on the cash flow?

(l) What is the method of determining budgets and the reporting system in connection therewith?

(m) What steps have the directors taken to see that the objectives of the business are effectively communicated to their managers?

(n) Have the directors defined the responsibilities of their various senior manages? Within such responsibilities have they set such senior managers defined objectives and established procedures for measuring the managers' performance against such objectives?

(o) Do up-to-date organization structure exist? If so, do they show lateral as well as vertical relationships?

(p) What control do directors exercise over senior management training?

(q) What steps have been taken to compare the results of the various units of the organization with each other?

(r) What control is exercised on transfer prices within the group organisation?

(s) How do the directors discharge their responsibilities for the certification of the stock for balance sheet purposes?

(t) Are special efforts made to control the management of technical and administrative service, as well as the management of operating departments?

(u) If the articles of association require a directors' share qualifications, do the various members of the board hold the number of shares required?

(v) Is the Register of Directors' shareholding maintained correctly?

(w) Have the annual returns of the Register of Companies been made in accordance with statutory requirements?

(x) Is the register of charges correctly maintained?

(y) Has the statutory AGM (where applicable) been held, and has not more than the statutory allowable time elapsed since the last AGM?

(z) Have extraordinary general meetings been called when required, and the requisite extraordinary land/or special resolution been passed where applicable?

(aa) Check there are no loans to directors except those which are statutory allowable?

(ab) Is the register of Directors and Securities correctly maintained?

(ac) What is the attendance record of directors at directors' meeting?

(ad) Are minutes of such meetings and of all general meting carefully kept?

(ae) Does a scrutiny of the directors' meetings minutes reveal that all necessary authorities and actions are obtained or taken, in accordance with statutory requirements, and the Articles of Association?

(af) What efforts do the directors make to coordinate the activities of the various departments of the company, and to avoid duplication?

(ag) What have the directors done to ensure the provisions of adequate management information and its dissemination?

(ah) Whether the details of management reports structured according to the levels to be informed?

(ai) Are the principles of management by exception applied to management information?

(aj) How do the directors exercise functional control of the business?

(ak) For function specific function is each director responsible?

(al) What arrangement have the directors made for effective internal communication?

(am) What arrangements have the directors made for effective external communication?

(an) Do such arrangements made adequate provision for the upward flow of information.

(ao) Are communications with customers and the general market satisfactory?

6.4.3 Managerial Checks

(a) Are all level of managers competent in their functions?

(b) What evidence is there that managers are up-to-date in their particular function?

(c) Do all managers sufficiently and efficiently delegate their function?

(d) Are there any example of delegation to the point where control is lost?

(e) Are there adequately defined communication procedures?

(f) Is it possible to identify the management styles of the senior managers and assess their effectiveness?

(g) Is there adequate definition of stuff responsibilities?

(h) Is there a precise organizational structure?

(i) Is there a system of management by objectives?

(j) Are job specifications available for each or the majority of positions?

(k) Are job specification/staff responsibilities revised as circumstances change?

(l) Are methods of work defined, or partly defined in writing?

(m) Whether or not they are in witting, how are they communicated to the staff?

(n) What arrangements are there for keeping such instructions up-to-date?

(o) Is there evidence of the enforcement of any authorizations required by such instructions, for example, for transactions that only transactions so authorized are allowed?

(p) What training facilities or arrangements are there for:

i. Managers?

ii. Staff generally?

iii. Newly joined staff?

iv. Trainees?

(q) Are career paths developed wherever possible?

(r) Who is responsible for training?

(s) Are the training tailored to the differing needs of the staff?

(t) Have the possibilities of the various tutorial devices been investigated or exploited?

(u) Are the efficient management for the recoupment of Training Board levies for all training carried out?

(v) What means of measurement of staff performance exists?

(w) How do managers plan the staff work load and control its flow?

(x) Is there evidence that the generally recognized management techniques are used as appropriate?

(y) Is there evidence of coordinated planning?

(z) How effective are managers in their use of computer facilities? Is there evidence of action other than the passive receipt of computer processed statistics?

(aa) How effective are the managers generally?

(ab) Do managers use their time effectively?

6.4.4 Organisational Checks

(a) How effective is the coordination and integration of the various departments?

(b) Is there any evidence of duplication of function as between one department and another?

(c) What is the management information system and who is responsible for it?

(d) Is the information supplied well and logically presented in the various reports?

(e) Is the information structured in such a way that the information given in the highest level reports is analysed in detail in the next level reports, and the information given in the second level reports analysed in the third level reports, etc.? If not, what is the detailed information retrieval system?

(f) What strengths and weaknesses of the organisation are revealed by the scrutiny of the special reports?

(g) Do special reports in general evidence of critical appraisal?

(h) How is the budget structure related to operational responsibilities and how are expenditure controlled within the budget and remedial actions taken?

(i) How is inflation catered for in budgets?

(j) Is reporting based on the exception principle, or what other methods are used to highlight information areas requiring investigation?

(k) Has each manager defined the responsibilities of his staff?

(l) What forms do such definitions take? Are they available to other members of the staff so that they can see their relationship to each other?

(m) Are common data files established for the use of several departments, particularly if the data processing is carried by computer?

(n) What checks are there on the accuracy of the information in such files? Are there strict controls on their amendments?

(o) Who has authority to amend such file information?

(p) What security controls are there on the various levels of management information?

(q) Is there evidence of good vertical information flow?

(r) Is there also evidence of satisfactory lateral information flow?

(s) Does the typical manager consult his subordinates as well as his superiors?

(t) What opportunities do subordinates have for brining their knowledge of detail to bear upon their superiors problems?

(u) Is there evidence of an external communication policy?

(v) Who has responsibilities for market communication? What are the principal policies and types in this respect?

(w) What is the quality of trade communication? Does this extend to inter-firm comparisons?

(x) Has management, generally a good credibility rating?

(y) How is the business controlled in general?

(z) Who is responsible for cash flow control? Is such control obviously effective?

(aa) Especially in a vertically structured organisation what kind of planning takes place to synchronize the timings and capacities of the various units?

(ab) What part does transport play in point (aa) and who controls this?

(ac) In horizontally structured organizations, is sufficient advantage taken of comparative statistics and the promotion of health being made to standardize procedure in the same type of unit?

(ad) In a conglomerate organisation, what financial controls are employed, in addition to those usual in other organisation, to take into account of the diverse production controls and market conditions?

(ae) What degree of interchangeability of staff is possible? Do interchanges take place where economically viable?

(af) In case of centralized organisation, is the response time to stimuli from the units adequate?

(ag) What are the pros and cons for centralization in the organisation being studied?

(ah) Is operational control of the various units largely decentralized? If so, what degree of central control is there and how is it organized?

(ai) Is the central control adequate?

(aj) Is the reporting structure from the operating units good?

(ak) In a largely decentralized business, are services which would otherwise be uneconomically duplicated, provided at the center?

6.4.5 Capital Checks

(a) Given that the directors ultimately control the cash flow in the sense of receiving reports and acting thereon, who actually controls the cash flow on a day to day basis?

(b) How effective is the control of cash flow? Does the cash flow plan include control of important liquid assets other than cash? Is there evidence that temporary cash surpluses are used to gain short term interest, if necessary on a day-to-day basis?

(c) Is the cash flow plan adequately linked to the sales budget finished goods, inventory budget and raw materials procurement, e.g. to reflect the cash requirements for inflation, a sudden demand for raw materials or extra labour, or to meet an unexpected sales upsurge? Is the control system capable of quick response to the mix and quantity of transactions affecting cash?

(d) Is the working capital adequate?

(e) Is the capital employed the optimum for the business?

(f) Are the fixed assets valued carefully, especially in the sense that land and buildings can be substantially under valued in an inflationary environment and result in unrealistic business decisions?

(g) What authorizations are required for the purchase of fixed assets and are they effective?

(h) Is there an up-to-date asset register, and how are the assets physically identifiable?

(i) How often is the asset register compared with the actual fixed assets position?

(j) Where asset purchase control is exercised by value, is there evidence of any circumvention of the controls by splitting orders, or by rental or lease arrangements, for instance?

(k) Is the right amount of technical appraisal being made before the purchase of fixed assets?

(l) Is there a similar commercial appraisal relating to the acquisition of capital assets in each case to suit the business or the type of asset acquired, e.g. by purchase, lease or rental alternatives?

(m) Is there continual appraisal of the fixed assets of the company? In certain circumstances, might it not be advantageous to sell property and lease it back from the purchaser?

(n) Is the equity and loan capital adequate of the business?

(o) How do the ratio of such capital compare with other business audited?

(p) What is the earnings ratio of such capital employed in the business?

(q) How do the earnings ratios compare with the business of the same type, in the same trade federation, etc.?

(r) What is the capital structure in relation to ordinary and preference share and between equity and loan capital, and how does this gearing affect the business?

6.4.6 Data Processing Systems Checks

(a) What are the main categories of data processing system? How are they divided between manual, mechanical and computer methods?

(b) Has the right balance between such methods being achieved over all?

(c) Are there adequate controls on the accuracy of all systems?

(d) Is efficient use made in manual systems of aids such as add-listing machine, to check, for example, that the positing made to individual accounts total to the posting of a control account?

(e) Are similar methods used in mechanical systems, e.g. to check that an accounting machine total agrees with a pre listed total of items posted on accounting machine?

(f) Is use made of appropriate office techniques, such as photocopying, duplicating etc?

(g) Is such equipment the best of the particular purpose for which it is being used?

(h) Are the systems the best that can be devised?

(i) Are computer systems used where appropriate, for example, a mini computer instead of a small selection of accounting machines?

(j) Is the computer installation appropriate in size and staffing?

(k) Is the computer process and its peripherals correctly balanced to the work load?

(l) What control is exercised on input to an output from the computer installation, and if by a control system is this sufficiently independent?

(m) Who has access to the computer installations?

(n) Do programmers or system have any direct control of the data preparation unit?

(o) Who has access to the computer installations?

(p) How is the amendment of such programmes controlled?

(q) What arrangements are there for the testing programmes before operational use?

(r) Is there evidence of specific testing material rather than random selection of data from files?

(s) How is systems testing organized?

(t) Does the systems testing cover operating systems, files management, operation messages, data management, job control routines and fault detection?

(u) Are recovery procedures featured in systems testing?

(v) Does the systems testing cover throughout and response time under actual operating conditions and stimulated faults, with all possible volumes, types and combination of transactions?

(w) What is the utilization of the various pieces of computer equipment?

(x) What is the percentage of down time or misuse time, due to programming error, data error, or bad instructions,

(y) How is data processing work scheduled through the computer?

(z) If data transmission methods are used, are they necessary and do they justify their cost?

(aa) What evidence is there of the economic use of computer?

(ab) Is input editing by computer methods at the data preparation stage?

(ac) Is the editing carried out on a special purpose data preparation computer?

(ad) If so, is the cost justified by the extent of the utilization of the main computer on other data processing?

(ae) Is the maximum use made of such methods as spoiling, multiprogramming and 24 hour shifts rather than extending the size of the computer?

(af) Is there full documentation of all programs and systems?

(ag) What controls are there on the magnetic base library?

(ah) Are correct records kept of all program amendments?

(ai) Have all such amendments since the last audit been checked?

(aj) What methods of input to the computer are used?

(ak) Are they the most efficient and economical for the installation in question?

(al) Has the same method of input been considered from even remote locations?

(am) If such methods of input are used, is the quicker processing really economically justified?

(an) Are there adequate methods for 'capturing' all relevant data?

(ao) Are the computer output methods efficient?

(ap) What controls are there on the number of copies produced?

(aq) Has careful consideration been given to the economy and effectiveness of exception reporting?

(ar) Is output only actually printed where necessary, e.g. other output stored on magnetic media for random retrieval?

(as) Has enough consideration given to graphical output methods and whether they would be a possible alternative method of information processing?

(at) Are there satisfactory procedures for monitoring capital work flow?

(au) Is there evidence for the continuance of 'private' manual system after computer systems covering the same ground have been introduced?

(av) Is there difficulty in measuring data processing effectiveness against management plans?

(aw) Is there adequate communication between the data processing section and user departments, and do liaison personnel change too frequently?

(ax) Are data processing personnel inefficiently employed by staffing for peak levels, or arising from bad organisation or administration?

(ay) Is there evidence of the general achievement of system development estimated times, bearing in mind that such times are often grossly under estimated and that development times tend to be much too long, leading among other things, to difficulties through changes of environment?

(az) Are the computer systems designs generally too complex (efficient) at the expense of practical applications (effectiveness)?

(ba) Is there evidence of adequate testing of programs and systems?

(bb) Are problems being encountered with the manufacturer's software?

(bc) Is staff turnover too high, even allowing for the traditional mobility of computer staff?

(bd) Are report late, hard to understand, inaccurate or too voluminous?

(be) Do programme changes take too long to implement?

(bf) Are there adequate security, back up and recovery procedures?

6.4.7 Standard Procedures Checks

(a) Do standard procedures exist and are they in writing?

(b) Who is responsible for keeping them up-to-date and are they in fact, so kept?

(c) Do they adequately reflect changes in organization or responsibilities that have occurred since the date they were originated?

(d) To whom are they circulated?

(e) Are any checks carried out on behalf of general management to verify that the procedures are being adhered to?

(f) If so, who is responsible for carrying out such checks and to whom does he report?

(g) What determines whether it is the organization's policy in any set of circumstances to cover them by a standard procedure, e.g. are standard procedures indicated if coordinated action is required by more than one department, or may they be confined to one department only?

(h) Are the standard procedures written as general instructions, leaving the details to be determined by individual department heads, or is veery detail intended to be covered?

6.4.8 Planning Function Organisation Checks

(a) Who is responsible for overall planning within the organisation?

(b) If detailed planning is a staff function, what arrangements are there for making sure the planning does not get out of step with the planning policy makers?

(c) What arrangements are there for information feedback from the operating units to the planners?

(d) Is there a corporate planning unit ?

(e) Is there a corporate stimulation model?

(f) If not, how far is stimulation used in the planning function?

(g) How accurate are the models?

(h) How are the various models kept up-to-date?

(i) To what use are the models put?

(j) If the stimulation models are processed on a computer, is the terminal operated by a responsible person proficient in the function which is the subject of the model?

(k) Are environmental surveys carried out, and how is such information is used?

(l) Do the computer facilities provide an effective medium for interactive operation?

(m) Are there adequate computer formula subordinates on call to the terminal operator?

(n) Can backwards iteration be used on the computer model as a provided function, so enabling a planner to choose a required result and iterate to the elements that builds up to the final result?

(o) Are there reasons of divergences from plans analyzed and the lessons learned used to modify later projection?

6.4.9 Purchasing Function Checks

(a) Are there effective arrangements for minimizing the price of purchases, e.g. total purchases for multi location organizations, contract pricing, forward purchasing, quantity controls and correct timing?

(b) What arrangement are there for controlling stock investment, in particular for controlling deliveries of raw materials, perhaps as a result of contracts placed for raw materials to be called off as required?

(c) Is there evidence that the purchasing budget is developing on sound lines?

(d) Is the budget, once prepared, used as an effective control on the purchasing function?

(e) Are 'make-or-buy' proposals made to ensure optimum supply arrangements?

(f) What is the system for synchronizing deliveries with the scheduled production requirements?

(g) What follow-up is there on scheduled deliveries?

(h) Is the receipt of goods adequately controlled?

(i) What procedures are there for dealing with over-deliveries and under-deliveries?

(j) Is there an effective system of inspection of materials received?

(k) Are 100 percent of the goods received inspected, or are they sampled, or what other inspection method is used?

(l) What accounting procedures are there for ensuring that rejected goods are debited to the supplier, either on return, or when scrapped, and for charging the supplier for any re-work done to make the goods acceptable?

(m) Are there any statistical routines to determine the quality standards of suppliers and the rejection rates of goods supplied by them?

(n) Are there similar routines to determine the supplier's relative ability to deliver on time?

(o) Are standards conditions printed on the order forms, and do they adequately cover the purchaser for the commercial and business hazards applying to the purchase of goods? For example, do the conditions make clear whether the carrier is to be construed the agent of the seller or the buyer?

(p) What system is used for validating incoming invoices for goods?

(q) What method of control prevents duplicate payment for goods?

(r) What purchasing measuring are taken to rationalize cash flow and the amount of capital locked up in stocks?

(s) Are there means for assessing buyers' workloads?

6.4.10 Inventory Control Function Checks

(a) How are maximum and minimum stock controlled?

(b) What customer service level is required?

(c) How are these limits determined?

(d) Within the permitted overall value coverage of stocks, how are permitted quantities of each stock item determined?

(e) Is the stock of each item definitely related to the production program and the forecasted sales?

(f) Is stock control also a function of the economic batch quantities?

(g) How is raw material stock valued for production purposes and for balance sheet purposes?

(h) How is the issue of stock controlled?

(i) What are the systems of stock security?

(j) What are the procedures to be followed when stock is found to be defective in store?

(k) Who has authority to scrap the stock?

(l) Who has authority to issue stock at other than the normal prices to production or to customers?

(m) What control is there on samples?

(n) Are all stock movements accounted for by any paper work?

(o) Is there any security check that goods leaving the premises are covered by one or other of the permitted authorizing documents?

(p) What system is in force for counting the stock to reconcile it with the book values, e.g. continuous stock checking?

(q) What is the procedure for investigating any discrepancies in stock? Who has authority to consider any investigation closed?

(r) In the case of discrepancies caused by system deficiencies, what follow up is there to ensure that the systems re improved?

(s) What procedure is there for writing down the value of stock, say, for obsolescence?

(t) If material has been issued to the shop floor as work in progress, what facilities are there in the production control system for establishing the point at which any stock deficiencies occur?

(u) What controls are there on the over looking or work done by operators?

6.4.11 Production Function Checks

(a) How are the production requirements for raw materials communicated to the purchasing function?

(b) How is the production scheduled and controlled against the schedule?

(c) Are these methods suitable for the type, size and complexity of the production processes?

(d) What is the system for amendments to the production schedule?

(e) How is rescheduling carried out when production is not to schedule, or there are machinery or labour troubles?

(f) What methods are used to control the supply of raw materials for production?

(g) How are labour requirement determined?

(h) What system is there for ensuring good utilisation for machinery and what statistics on the subject are available?

(i) Similarly, what is the system for ensuring good utilisation of labour and what statistics on this subject are available?

(j) What is the inspection system during production and at the final product stage?

(k) How are scrap items to be re-worked and controlled?

(l) What methods are used for forecasting the production levels that will be required for the future months/years?

(m) How is scheduled production broken down into its constituent items, to be produced at times which will make them available when required to merge with the part forming the finished product?

(n) Are there efficient preventive maintenance programs for production equipment and machinery?

(o) Is replacement cost information readily available for major items of plant?

6.4.12 Marketing Function Checks

(a) Have clear marketing objectives been set? What are they?

(b) What plans have been developed to attain those objectives?

(c) What is the extent and nature of market research?

(d) What principles apply to product planning?

(e) What arrangements are therefore the planning and control of packaging?

(f) How is the effectiveness of special sales promotions and advertising analysed?

(g) Is the selling administration adequate for the type of market served?

(h) Are transport arrangements suitable for the average size of order, the type of customer served and the pattern of distribution?

(i) Are there economically satisfactory arrangements for such matters as minimum order, minimum quantities and particular item and packing carton quantities?

(j) How is the sales force divided geographically, by specialization, according to category of customer, or by any other method?

(k) How is the performance of salesman measured? Are short falls against targets identifiable to salesmen and specific customer?

(l) What special incentives are there for salesmen?

(m) How are customers' orders received?

(n) Has a standard order form been considered?

(o) Are any special support services given to customers, e.g. in the counting and replacement of stock, extended credit?

(p) Are there routine facilities for collecting information from salesmen on competitors and the reaction of customers?

(q) In the case of suppliers not dealing directly with the ultimate customer, e.g. suppliers who service wholesaler only, what arrangements are there for appraising the requirements of the ultimate customer?

(r) Is there a meaningful analysis of customers' complaints and is such analysis effectively used in the engineering and product development branches of the business?

(s) What is the coverage of the sales statistics? Are market forecasts compared with actual results in sufficient detail to identify the reason for discrepancies?

(t) Are there comparative elements in such statistics with the budget, with the previous year with other representatives and with the other locations?

(u) What are the systems for controlling the amount and rate of credit to customers?

6.4.13 Distribution Function Checks

(a) Are there arrangements for deciding the most viable means of transport of finished goods?

(b) What are these arrangements? Are they well known by the transport staff?

(c) Did the arrangements result from some kind of the study of the transport problem and, if not, how were they developed?

(d) Has the limit of liability for claims on the various carriers in relation to the need of customers been considered in the choice of carriers?

(e) Have the economics of employing the company's own transport fleet been examined, particularly for high density and local deliveries?

(f) Has an attempt been made to compound claims with the carriers, so avoiding administrative expense in dealing with abortive paperwork and lengthy investigatory procedures?

(g) If the organisation uses its own transport fleet, have the pros and cons of contract hire or contract maintenance been considered?

(h) Are decentralized warehouses part of the distribution system? If not, have the possible benefits of such an arrangement been considered?

(i) Particularly where the organization's own transport and computer facilities are involved, has there been any attempt to optimize distribution patterns?

6.4.14 Financial Function Checks

Note : This check list assumes that a normal financial audit is also carried out.

(a) Is there an internal audit department? If so, is it responsible to a person independent of the accounts department?

(b) Does the internal audit department make regular reports and do these show a satisfactory position?

(c) Are control checks made of the agreement of the financial records with the control records of other departments? For example, do the wages 'books' for the appropriate period agree with standards wages plus or minus variances of the operations processed during the period?

(d) What are the checks on non-row materials expenditure, e.g. capital expenditure, rental and lease of equipment expenditure, personnel expenditure? Are personnel authorized to approve such expenditure listed, together with the appropriate limits, and does the accounts departments edit the paper work to ensure that proper approval has been obtained in each case?

(e) Is there an appropriate system of approval for the engagement of labour, and do the accounts department check that this has been carried out before entering a person on the pay roll?

(f) Is there a budgetary control system and what is the level of control exercised?

(g) Is there evidence that management and supervisory personnel have been personally involved when their particular budget was fixed?

(h) How effective is the budget system?

(i) What is the method for presenting management and supervision with the actual results against the budgets? Is this effective?

(j) Are the reasons for the discrepancies carefully ascertained and noted in the records?

(k) How are especially serious discrepancies and the discrepancies which recur without apparent reconciliation brought to the attention of senior management?

(l) Are the financial records so organized that the performance of senior managers can be measured?

(m) Are the organizational relationships of the finance and accounts departments clearly documented, e.g. in organizational charts?

(n) Are the duties of various posts within the above departments also documented, e.g. in job specifications?

(o) In such specifications are the holders of the posts given all the authority they require to fulfill the responsibilities of the posts and are the lines of communication and liaison clearly laid down.

(p) What are the credit control rules and are they being adhered to?

(q) Do the staff understand their service role to operational departments and also their own rules within the overall service function?

(r) What is the organization's policy on the acquisition and replacement of assets and the provision of funds for their replacement?

(s) How are fixed and movable machinery, etc. assets physically controlled?

(t) What evidence is there of effective security of accounting information, particularly that relating to personnel?

(u) How is the personnel expenditure authorized?

(v) How is the material expenditure authorized?

(w) How is fixed asset expenditure authorized?

(x) What controls are there on expenditure for labour?

(y) Are the method of payment for goods economical and adequately controlled?

6.4.15 Personal Function Checks

(a) Is there a manpower specification of the establishment of the organisation?

(b) To what is the specification related e.g. level of sales, production?

(c) Who has the authority to amend the manpower specification, other than in accordance with established rules, e.g. in proportion to sales?

(d) How do staff measure up to this manpower specification?

(e) Has job evaluation been carried out throughout the organisation and what are the arrangements for evaluating new jobs as they occur?

(f) Do job specifications exist for all jobs in the organisation?

(g) At what intervals is the structure, age, profession, grade, etc. of employees reviewed in relation to the manpower specification?

(h) Are adequate personnel records properly maintained at all times?

(i) If such records are kept centrally, what arrangements are there for access to them by remote managers and supervisors?

(j) Whether they personnel records kept in such a way that selection by employee characteristic can be made therefrom?

(k) Is there an active training programme?

(l) Who is responsible for training managers

(m) What arrangements are there for the management development?

(n) Are adequate training records kept?

(o) Are personnel records kept in such a way that trainable employees and the progress of those employees already being trained, can be monitored?

(p) Are there definite career paths within the organisation?

(q) How is basic training carried out?

(r) Is this carried out "in-house", "externally" or a mixture of both?

(s) Are promotable employees readily identifiable?

(t) Are forecasts prepared of the numbers and structure of personnel that will be required to man the organisation at future dates?

(u) Is there a definite personnel procurement program related to such forecasts showing how the difference between present and future structure is to be reconciled?

(v) Is the case of direct operators; is there some definite relationship within the production schedules?

(w) Is there a regular system of individual employee appraisal?

(x) In the absence of a full employee appraisal system, is there some form of periodic review of employees?

(y) Are employee made aware of the management's view of their performance, and given the opportunity to discuss the ways in which improvement can be made?

(z) Is there a formal management by objective scheme?

(aa) What controls are there on the hours of work completed, and the starting and finishing time of employees?

(ab) Is the maximum use being made of "local" labour, e.g. by flexible shifts times to suit married women?

(ac) Is absenteeism a serious factor in the organisation?

(ad) How is absenteeism identified?

(ae) Have any serious attempts been made to reduce absenteeism?

(af) What is the employee turnover ratio?

(ag) If high, what attempts have been made to reduce it?

(ah) How the absenteeism and employee turnover ratio compare with other organizations in the same class of business?

(ai) What security systems are there to safeguard the personnel records?

(aj) Are the security systems effective?

(ak) What controls are exercised over individual remuneration and its relationship to employees carrying out similar work in other departments?

(al) If agreed sales are used which allowed some latitude to individual managers, what efforts are made to ensure a uniform approach to such matters?

(am) Is there insufficient staff involvement due to inadequate means of disseminating information?

(an) Is the organisation able to obtain and hold competent personnel?

6.4.16 Management Service Function and Data Processing Security Checks

(a) What services are covered by the department?

(b) Are the roles of the various specialists, their responsibilities, authorities and relationship adequately defined?

(c) To whom does the head of the management services report?

(d) To whom does the head of the computer department report?

(e) Are the computer data preparation, operation, control programming and systems sections of the computer department independent of each other, reporting separately to the head of the computer department?

(f) Are the duties of each section clearly defined?

(g) Are there any opportunities for staff to carry out duties in a section other than their own?

(h) Does the operational head being serviced by a computer system have the opportunity to approve the sample output as part of the testing facilities?

(i) Is an operational log kept on the computer console typewriter or otherwise of all work processed on the computer and of the incidents that arise during the processing?

(j) Who receives copies of such logs and are they carefully filled for future reference?

(k) Are operation research techniques practiced?

(l) Who controls operational research projects?

(m) Are the regular process reviews of the operation research projects?

(n) Are managers generally aware of the type of problem amenable to an operations research approach?

(o) Who controls the work study department?

(p) Under what circumstances are work studies carried out?

(q) Is there a definite link between work study times and system of standard costs?

(r) Are work study made as soon as possible to replace temporary times?

(s) Are work study techniques used to assess job timings in the offices and administrative services as well as the production floor?

(t) What other forms of work measurement or control are employed in the clerical and administrative section of the business?

(u) Are systems, particularly computer system, audited in the design stage?

(v) Are systems and procedures continuously checked to ensure that unauthorized modifications are now made?

(w) How are projects controlled?

(x) Are projects selected as a result of cost-benefit studies?

(y) Is a project team leader always appointed?

(z) Are the objectives of a project always specifically stated?

(aa) What measurement of project progress are used?

(ab) What arrangements are there for the periodical review of the progress of project?

(ac) Who decides that projects have been completed to requirements?

(ad) Are appropriate terms of reference established for all organisation projects?

(ae) In the case of new organisation projects, is a "before" and "after" appraisal made to verify to what extent anticipated benefits or improvements have been achieved in practice? And by whom?

(af) How is data collection and analysis carried out?

(ag) What methods of investigations are used?

(ah) Are tentative solutions to organizational problems tested against the experience of the managers directly concerned?

(ai) How are new systems "sold" to operating management?

(aj) How are operating staff trained in new methods and parallel run operation controlled?

(ak) How effective in office management?

(al) Is there evidence of the planning of office activities, as distinct from dealing with crises as they arise?

(am) Is there evidence of coordination of the efforts of various elements of the office staff?

(an) How good is the document flow between offices, for the various sections of a large office?

(ao) Has general documentation between examined for readability, distribution and frequency?

(ap) Are office services centralized where this is appropriate and economic?

(aq) How efficient are the company's communication facilities?

(ar) Are there written standard procedures?

(as) How extensive are they, and to what distribution are they issued?

(at) Is there an index?

(au) What arrangements are there for keeping such procedures up-to-date?

(av) Who issued standard procedures?

(aw) What positive arrangements are there for the prosecution of work simplification programmes?

(ax) In such programmes, are such aids as work distribution and process charts employed?

6.4.17 Equipment Checks

(a) Who authorizes the purchase or rental capital equipment.

(b) What are the procedures for specifying equipment required in potential suppliers and for obtaining competitive quotations?

(c) Is recently obtained equipment in accordance with the specification, and what are the reasons for differences if there are any? Is inability to rectify difference due to failure to state the standards of performance required to fulfill the contract?

(d) How does capital equipment generally relate to the needs of the business? For example, in the case of a computer installation, is the equipment of the right capacity and balance? Is the input and output equipment of the right kind and speed to suit the organization's requirements? Are the backup store facilities too large or too small?

(e) In the case of equipment which have been replaced recently, or is about to be replaced relatively soon after acquisition, is there evidence that the original specification bore in mind reasonable development?

(f) In related equipment in different parts of or locations of the organisation compatible either for mutual standby purposes or to facilitate the interchange of matter processed?

(g) Is the existing equipment compatible with likely or possible development of the concern?

(h) In large organisation, have special purpose or minicomputers been considered as viable as alternatives to the further use of a central computer?

(i) In particular, where large data inputs are considered, has a separate small computer been considered as a part of the data entry, editing and validating procedures, prior to data entry to a large processor?

(j) Is equipment being utilised adequately, e.g. by shifts covering 24 hours a day, or by multiprogramming, spooling and/or virtual storage techniques?

(k) Are data collection systems too sophisticated for the needs of the business?

(l) Is the most efficient copying equipment for the particular needs and volumes of the business being used?

(m) What several types reprographic equipment are available, is each being correctly used in relation to such things as the number of copies required of the original, the intended recipients and the possibility of alternations and reruns etc.?

(n) Is there the proper balance of office equipment and facilities, e.g. between manual, electric and automatic typewriters, and between secretarial services, copy typing and individual and central typing facilities, also, between the various types of calculators – adding machines, add listing machines and calculating machines with memories?

(o) Is there the correct balance between computer programmes written in-house, obtained as packages, the use of standard modules in programmes written in-house, the utilization of the organization's own programming staff in relation to, say, obtaining a contract programme for a peak programming requirement not likely or recur, etc.?

(p) Where a large number of copies of computer output are required, have the merits of producing an offset master and/or the use of micro film considered?

(q) Have the alternative of rent, lease, or purchase various equipments been considered in relation to such factors as cash flow, capital employed in the business, rate of technological development and the break-even point of the replacement of old equipment by new, or in place of manual systems?

(r) In relation to the foregoing, has the other major alternative of buying time on other organization's equipment or at service bureaux been considered?

(s) In the case of lease equipment, are the precise terms specified under which upgrades, downgrades and termination of the use of the equipment are to be allowed?

(t) Have advantages of using a relatively large computer by means of terminals and time sharing been considered, particularly by a relatively small organisation, or by a large organisation with special requirements?

(u) Finally, in relation to points q, r and t, has the facilities management concept been considered, particularly in the case of a fairly young organisation that wishes to concentrate its own effort to pursing its basic functions?

(v) What methods are used for the efficient scheduling of the use of machinery?

(w) What evidence is there of smoothing and accelerating the work flow through the business and the rationalization of the location of machinery, departments and personnel in relation to the work flow?

(x) What transport methods are used – own, common carriers, couriers, the post office? Is this the most effective mix of such facilities?

(y) What consideration has been given to alternative methods of data transmission, if datapost, fascsimile transmission, digital transmission by use of the switched network and/private line? The company's own transport, etc., and is their the most effective and optimum mix of such facilities.

(z) Have agreed maximum response times been embodies in any maintenance service agreement for critical equipment?

6.4.18 Methods and Systems Audit Checks

(a) What general control is there on methods and systems?

(b) How efficiently is this exercised?

(c) How are methods and systems knitted into the organizations?

(d) What detailed control is there on the implementation of a system?

(e) If the stages of implementation of a system are sufficiently critical and/or important, is advantage taken of such techniques as network analysis as one of the means of control?

(f) How are methods and systems maintained and documented?

(g) How are systems evaluated? In particular, if a new system has been introduced, is there a post-evaluation and is this compared with expectations which were put forward at the time permission to introduce the new system was sought?

(h) Assuming that a system service is supplied to operating managers, in what form do the operating managers present their requirements to the departments supplying the system service?

(i) Do such specifications clearly bring out the objects of the procedures required?

(j) What is the method of development of a system from the point of the specification of his requirements by the operating managers?

(k) Is it part of the introduction of methods and systems procedures to evaluate the degree of efficiency with which the objects of the present procedure are achieved, before drawing a comparison with proposed system?

(l) When new systems and procedures are being contemplated, is specific provision made for the manner in which the changeover from the old system to the new is to be carried out, and in particular, how are phasing out stages of the old system dealt with?

(m) How are systems depicted in discussion and subsequently communicated to the staff who will be required to operate them?

(n) Are flow charts used as part of (m) above?

(o) Are written standard procedures used as part of (m) above?

(p) How is the documentation used in a new procedure explained to the users?

(q) How effective are any written standard procedures issued as a means of communication of systems requirements?

(r) Are they written in such a manner that rapid reference can be made to the parts that affect any particular employee in detail? At the same time, do they give an over all picture of the system of general management and facilitate initial reading of the procedures?

(s) Where procedures require that authorization should be obtained at certain point before continuing with the system flow, are such authorizing signatories and the limits of their authority clearly set out or referenced in the procedure?

(t) Most systems, require the initial setting up or taking over of files or records. What evidence is there that there has been adequate provision of the setting-up of such files and there is sufficient check on their accuracy before the new system commences?

(u) What standard arrangements are there for the testing and parallel running of systems before passing them for operational use?

(v) What evidence is there that new systems are generally implemented on schedule, and with the minimum of dislocation?

(w) Are systems as a whole well integrated in relation to the business?

(x) Do they use common data wherever this is practicable?

(y) Do they supplement rather than oppose each other?

(z) Is there an overall plan into which developing systems are fitted?

(aa) Is there evidence that systems are being kept administratively up-to-date? Have they been modified to reflect changes which have taken place in the organisation or personnel?

(ab) Is there evidence that systems are amended only in accordance with some authorized procedure?

(ac) What arrangements are there for monitoring the work flow from the systems point of view of day-to-day control and also from the stand point of required reviews of appropriateness of method or managing in the light of new volumes, work peaks, or other aspects of work flow?

(ad) What evidence is there that the social aspects of new systems have due attention?

6.4.19 Security Audit Checks

(a) What security precautions are taken against leakage of those aspects of the organization's policy and planning, which are desired to be kept secret?

(b) In particular, what security precautions are taken at boardroom level and in respect of secretarial facilities used by the board? Do this extend to carbon paper, plastic type writers ribbons and the magnetic media of automatic typewriters?

(c) Is assess to research and development areas controlled?

(d) Are the controls efficient and likely to be effective?

(e) In particular, is special attention given to the security risks involved in the entry of service personnel to research and development areas?

(f) What are the documentary and drawings security controls?

(g) Who is responsible for the security of the company assets?

(h) What measures are taken for the security of cash?

(i) How is cash transferred to the bank and how are collections of cash/bank handled?

(j) Who decides the actual route from the organization's premises to the bank?

(k) What systems are there for identifying and controlling movable tools and other assets?

(l) Is there a fixed asset register and who is responsible for maintaining it?

(m) How effective is the control of receipts and issues of stock-in-trade and raw materials and the custody of such assets?

(n) How often are stock-in-trade and raw materials items physically counted?

(o) What action is taken when physically counted stock varies significantly from the book stock?

(p) Who is able to authorize correction to the recorded book stock of an item?

(q) What are the procedures for writing off damaged stock and revaluing obsolescent stock?

(r) Is there an organized method of computer file preservation so that operator errors or equipment malfunctions causing loss of current file information can be rectified by reconstruction from preserved files?

(s) Additionally, are important files copied at intervals suitable to their rate of change and stored remotely, so as to provide a backup in the event of major catastrophe such as fire, flood or explosion destroying current records?

(t) Are magnetic file media stored away from the computer room in fire-resistant conditions when not in actual use?

(u) Is the "no smoking" rule strictly observed in the computer room and the computer strong areas?

(v) Are automatic fire detectors located in the computer room?

(w) Are doctors also installed in such danger areas as underfloor cavities, ceiling, voids and air-conditioning ducts associated with the computer room and computer files strong areas?

(x) Do such detection systems automatically trigger a fire brigade alarm?

(y) Do they trigger an immediate discharge of extinguishing gas?

(z) Does the fire detection system automatically switch off the air-conditioning installation in the event of fire, to avoid oxygen being unnecessarily fed into the flames?

(aa) Is the computer installation located close to the hazardous areas such as those with a high fire risk of from which the public could throw missiles or bombs?

(ab) Are there written instructions covering the action of computer operator staff in the event of major catastrophes such as fire, flood or explosion?

(ac) Are the computer operator staff aware of the action they have to take in the event of a major catastrophe?

(ad) Are the computer room walls and ceiling fire-resistant and water proof?

(ae) Is suitable drainage provided in such locations as underflow cavities to disperse water which would otherwise flood the building?

(af) Are hand fire-extinguishers readily available to computer room staff and do they know how to operate them?

(ag) Do waste bins in the computer installation areas has self closing lids?

(ah) Are adequate operating instructions available for all computer applications?

(ai) Are computer legs maintained and carefully preserved?

(aj) Are definite checks built into the application programmes to prevent miss operation and/or to assist the operator at appropriate stages of the processing?

(ak) Are computer operators encouraged to report any unusual occurrences or unusual equipment operating characteristic?

(al) Is access to the computer room and storage areas restricted?

(am) Are the restrictions effective.

(an) Are there a minimum of two computer operators on duty at any one time?

(ao) Is there a preventive maintenance schedule in operation and is it being adhered to?

(ap) How important is the uninterrupted provisions of computer services?

(aq) If is important that there should be no interruption, say, in the case of on-line facilities for a bank net work, are duplicate facilities provided?

(ar) In circumstances where an interruption is not critical, but continued provision of the service as soon as possible is essential, have reciprocal standby arrangements been made with a similar local installation?

(as) Are standby arrangements reviewed frequently to ensure that alterations in any of the installations have not invalidated the arrangements?

(at) Is any necessary standby software that will be required if standby facilities are to be used, prepared and available for immediate use and transit?

(au) Do catastrophe contingency plans exist?

(av) What arrangements have been made to cover an interruption in the supply of electricity?

(aw) Do these include protection against minute interruptions of the period of time required, say, to stand by generator?

(ax) If the computer protected against uneven power supply?

(ay) Are there large window areas unprotected from shattering?

(az) Are all computer files, programs, etc. under the control of a librarian even if the size of the installation does not justify a full-time officer?

(ba) Are issues and receipts into such library carefully recorded and the library otherwise kept locked?

(bb) On a surprise basis, has a request for a computer printout of certain records been made and checked off by reference to recent transactions?

(bc) Has selected specimen input data been processed by the computer against current programmes and records and the output checked for validity and accuracy?

(bd) Are remote enquiry stations and local terminals kept securely locked when not in use?

(be) Are the keys to such facilities strictly controlled?

(bf) Are code words needed to gain access to the central computer, and are these changed from time to time?

(bg) Has the efficiency of the security arrangements in connection with remote terminals been checked by an auditor trying to access the computer in an unpermitted manner?

(bh) Are there standard instructions specifying the individuals who are authorized to amend or otherwise have access to computer information?

(bi) Apart from the instructions given to staff covering immediate action in the event of a catastrophe, are plans laid for continuing operations after such a catastrophe?

6.5 Corporate Divisions/departments/functions

6.5.1 Evaluation of Purchase Management

The primary objective of purchase management is to procure raw materials, packing material etc. of the requisite quantity of required quality at reasonable cost at the right time. A management accountant may make a model questionnaire for evaluation of purchase management :-

(a) What is the organisation for purchase function?

(b) Whether the purchase policy is realistic?

(c) Whether the purchase requirements are related to production schedules and dependent upon the level of invention?

(d) How are suppliers selected and eliminated?

(e) Whether regular and dependable suppliers are ensured?

(f) Is there any system of purchase authorization?

(g) Whether latest market information automatically collected regarding new spares, etc.?

(h) Whether proper information is kept about price trends?

(i) Whether regular comparison is made between average price paid and the corresponding average market price?

(j) What are built-in-controls against misutilisation of purchasing powers?

(k) How effective is the system of follow-up?

(l) What is the system of executing emergency purchase?

(m) What is the procedure followed for impact of raw materials?

(n) Is there any proper coordination between purchase, stores and production?

6.5.2 Evaluation of Personal Management

The main objective of personnel function is to create such conditions in the organisation that the employees can put to best performances. The personnel manager has to assess manpower replacements, select, recruit, train and develop persons, ensure industrial peace, redress grievances of the workers, maintain discipline, keep various personal records and negotiate wage settlements. The performance of the personnel function policies may broadly be reviewed by asking the following questions :-

(a) What is the organisation of the Personal Department?

(b) Is the personnel department adequately staffed?

(c) What is the status of personnel manager in the organizational hierarchy?

(d) What is personnel policy? Is the organisation production-oriented or people-oriented? How does the top management look at its employees?

(e) How are the manpower requirements assessed? Are manpower requirements defined clearly according to the degree of skills required?

(f) What is the requirement policy? Are qualifications for each job specified clearly? Is the requirement procedure well designed?

(g) What is the internal promotion policy? Are the employees given a chance to grow in the organisation itself through the objective tests to their qualifications and performances?

(h) Are training programmes conducted regularly? Are they effective in updating the knowledge and skills of the employees? Are the opportunities for training adequate?

(i) Are the training methods modern or scientific? Are they suited to the needs of the organisation?

(j) Are proper records maintained for all workers? Is time keeping effective?

(k) What is the procedure for dealing with the grievances of the employees? Are they encouraged to speak to the personnel manager?

(l) How is the discipline maintained? How are the erring workers dealt with? Is there a uniform and stable policy of dealing with indiscipline and misconduct on the part of all the employees?

(m) Are the various human cost properly analysed? Is the cost of labour turnover and absenteeism worked out periodically? Are attempts made to reduce labour turnover to optimum levels?

(n) What effectively are labour welfare organized in the organisation?

(o) Is there a machinery for dealing with the demands of the workers? Is legitimate union activities encouraged?

(p) What is the extent of man-hours lost due to strike or lock out?

(q) How these losses compare with the man-hours lost by similar organisation in the area?

6.5.3 Evaluation of Production Management

The main objective of production management is to turn out finished goods of requisite quality by making an optimum use of men, machine, and services. The productivity of such factors must satisfy the standards or norms set for the industry. The following check list will help the management auditor in evaluating production management :-

(a) Is there an adequate system of production planning? Are production schedules drawn up to optimize various factors like plant capacity, raw materials, skilled labour, availability of funds, machine hours, availability of power, etc.?

(b) Is there close coordination with sales department to ensure acceptability of the finished products by customers? How effective is the quality of finished products by customers? How effective is the quality control system?

(c) How quickly are the customers' complaints dealt with ?

(d) Is the production design properly worked out? Is there a constant review of the production design to improve the cost-benefit ratio?

(e) Are the inputs and outputs of each process, operation or department linked up periodically?

(f) Does the input-output ratio conform with the standard ratio?

(g) What is the system of reviewing delays in production?

(h) What is the frequency of accidents? Are safety measures adequate?

(i) Is there a system of incentive scheme linked with the output of various production departments?

(j) Have the incentive systems been designed on the basis of scientific studies?

(k) How effective is control over idle time?

(l) Is the production process review done periodically to explore the possibility of having more efficient production method?

(m) Are the performances of service departments appraised periodically? Have standard efficiency factor worked out? Are they compared with actual efficiency ratios?

(n) How effective is the management information regarding production function as a whole?

6.5.4 Evaluation of Research and Development Activities

With the evaluation of management practice, it is realized that somewhat different techniques and approaches are required for management audit to research and development activity as a separate area as it involves dealing with creative people not falling into a predictable pattern of accomplishment. Moreover, it requires operations and development efforts in a relatively unknown era. A management auditor of a company can appraise and evaluate the activities of research and development on the basis of the following checklist:-

(a) What are the major achievements of the R&D?

(b) What is the input-output ratio?

(c) Whether the R&D scientist have actual operating experience in industry in order to visualize what they are developing?

(d) What are strategic issues formulated at the Board level relating to industrial research?

(e) How does the company formulate its approach on the annual outlay on research and development?

(f) Whether the outlay on R&D is a fixed sum, a percentage of turnover, of profits, or capital investment, or on industry average?

(g) Whether the Board of Directors identify or endorse the broad "types of research" to be undertaken to order to ensure that the efforts are concentrated in line with the defined goals?

(h) Whether the R&D is considered as an independent department in the company?

(i) Whether the R&D is viewed as a separate profit centre?

(j) What is the level and extent of contribution of the company's profit through sale of technologies?

(k) Whether there is proper coordination between the R&D cell and corporate planning cell?

(l) Are the guidelines from the Board clear and workable?

(m) How is the R&D budget formulated?

(n) Whether the R&D results are properly recorded, classified and analysed?

(o) How are the following areas of activity accomplished –

(i) Monitoring the existing projects?

(ii) Review of viability of projects in order to assign priorities?

(iii) Transfer of technology to project and operations sections?

(iv) Liaison with other departments and with outside agencies?

(p) Whether the control scheme for a particular R&D programme realistic and effective in relation to –

(i) Long-term programme?

(ii) Short-term programme?

(iii) Periodical assessment of results with the predetermined budgets and correlated ideas?

(iv) Authorization of expenditure?

(v) Analysis of cost-effectiveness?

(q) What successes and failures occurred in the past?

(r) From commercial view point –

(i) Where savings were brought in by improved process?

(ii) What were R&D costs on new products developed as compared with sales and profits arising from these products?

(iii) What was the cost of R&D on improvement of existing products and resultant increase in sales and profits?

6.5.5 Marketing Audit and its Areas

Marketing audit is an independent examination of the entire marketing effort of a company, or some specific marketing activities covering objectives, programme implementation, and organisation for purposes of determining what is being done, appraising which is being done, and recommending what should be done in future.

The essential feature of marketing audit is that marketing audit is carried out periodically at regular intervals and not only when the company is facing marketing problems and difficulties. Such audit covers both marketing place and control and evaluate the basic framework for marketing action as also the performance within the framework. It covers the appraisal of the entire system and process of marketing taking into account all the elements of the marketing operations.

Marketing audit may be horizontal or vertical. Horizontal audit (also known as system level audit) covers a major part of marketing audit and evaluates a total appraisal of the marketing efforts of a company. Vertical audit (also known as activity level of audit) concentrates on single item of functions of marketing operation of a company identified by horizontal audit or otherwise and which becomes the subject of through examination and evaluation. The marketing audit covers the following areas –

(a) Objectives : Marketing objectives should be clearly established. Majority of companies do not have clearly defined objectives except that achieving high sales volume or making high profit on the sales is the target. The search in audit of a clear objective will make the management aware of the gap in its operational policy if a well defined goal has not been already set up by the company.

(b) Programme : The auditor should carry out an appraisal for the programme which the company has laid down for achieving the objective.

(c) Implementation : The auditor will take up the examination of the company's implementation of the marketing programme.

(d) Organisation : A suitable organisation assists in a success of a marketing plan. The audit should appraise the marketing organisation by reviewing the formal lines of authority and responsibility, delegation of authority, status of marketing head and his staff, adequacy of the personnel, proper manning of key tasks and assignments thereof.

6.5.6 Evaluation of Sales Management

The main objective of function of sales management is to create and develop customers and retain the position of the organisation in the market.

The following questionnaire will help in evaluating sales management –

(a) How is the sales department organisation? Is it adequately staffed?

(b) How specific responsibilities fixed for development of products in various areas?

(c) What market forecasts are developed regularly? Are they reliable?

(d) How does the growth in sales during the last five years compare with that of the industry as a whole?

(e) What steps have been taken to increase the market share of the company?

(f) Whether the system of appraising performance of sales division and salesmen objectives fair?

(g) (i) Whether the salesmen's performance are linked with rewards?

(ii) Does the system motivate salesmen to give their best performances?

(h) Are the sales budget realistic? Do they show detailed physical targets for each sales office?

(i) What controls exist on the expenses incurred by salesmen?

(j) (i) What is the percentage of sales returns and allowances?

(ii) Whether the percentage of sales returns declined over the year?

(k) How does marketing manager keep in touch with the changing conditions in market? Are consumer surveys conducted regularly?

(l) Is there a constant review of the order book?

(m) (i) Does a proper control over stocks of finished goods exist?

(ii) Are the slow moving stocks reviewed periodically?

(n) Is there a proper and realistic budget for advertising and sales promotion?

(o) (i) Does a proper control over stocks of finished goods exist?

(ii) Is it reviewed periodically?

(p) (i) What are the overall controls on outstanding?

(ii) Are they analyzed periodically?

(q) (i) Are the ageing schedules prepared regularly?

(ii) What is the procedure of writing off bad debts?

(r) (i) Are the distribution channels properly selected?

(ii) Whether operations research techniques have been applied in distributing products to minimize costs?

(s) Is the system of after-sales services efficient?

(t) What is the frequency of customer complains?

(u) How frequently customer complaints are dealt with?

6.5.7 Evaluation of Distribution Function

For evaluation of distribution function a management auditor should consider the following points –

(a) Customer service goals and objectives.

(b) Integrated material management.

(c) Physical distribution network and operating plan.

(d) Management information system.

(e) Allocation of work activities and effectiveness in discharging the function.

The management auditor in order to carry out the review of "distribution policies" may design the following questionnaire –

A. Levels of customer service -

(a) Are the levels of customer service realistic and competitive?

(b) Does the management review –

(i) Customers' real service needs i.e. existing service levels?

(ii) Competitors abilities v. own abilities.

(c) What is the step wise approach to survey and determine the customer service requirements?

B. Capacity configuration -

(a) Whether the production, marketing and distribution capacities provide an economical means of meeting the necessary customer serviced criteria?

(b) How are the capacity costs considered with respect to –

(i) Physical distribution operating costs?

(ii) Inventory levels?

(iii) Investment in distribution activities?

C. Staging of inventory -

(a) What is the volume of each product at each stage?

(b) Whether the flow of finished goods inventory through the distribution process reasonable within the acceptable service limits?

D. Transportation mode mix -

(a) How is each transportation route in the distribution network identified?

(b) How are the characteristics of traffic movement in the key routes determined?

(c) Whether the present mode has been selected considering cost and service capabilities?

(d) Does the distribution policy indicate integrated character in respect of :-

(i) the needs of the key group customers?

(ii) the requirements of key product market segments?

(iii) the market policy?

6.6 Corporate Governance and Audit Committee

6.6.1 Introduction to Corporate Governance

6.6.1.1 During the initial years of corporate growth, buyers and sellers of corporate equities were individual investors such as wealthy businessmen or families. However, equity market has now become largely institutionalized i.e. both buyers and sellers are large institutions (pension funds, insurance companies, mutual funds, hedge funds, banks, investor groups etc.). These institutions on many occasions, a short term investors only or casual participants. This rise of the institutional investor has brought the need for professional diligence due to separation of ownership from control. This highlights the need for "Corporate Governance". The key elements of good corporate governance includes honesty, trust, integrity, transparency, responsibility accountability and commitment to the organization.

6.6.1.2 There is considerable variations in different definitions in the usage of term. The term refers to formal system of accountability to shareholders in its narrowest sense and the term is defined to include in its widest scope, the entire network of formal and informal relations involving the corporate sector and their consequences for society in general.

6.6.1.3 The term 'Corporate governance' has been about ethical conduct in business. These ethical dilemmas arise from conflicting interests of the parties involved. It has been defined narrowly as the relationship of a company to its shareholders or, more broadly, as its relationship to society. It has also been defined as the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance". In other words, corporate governance is all about "promoting corporate fairness, transparency and accountability."

6.6.1.4 OECD has defined it as "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." In other words, corporate governance is needed to create a corporate culture of consciousness, transparency and openness. It refers to combination of laws, rules, regulations, procedures and voluntary practices to enable companies to maximize shareholders' long-term value. It should lead to increasing customer satisfaction, shareholder value and wealth.

6.6.1.5 Kumar Mangalam Birla Report on Corporate Governance (January, 2000) has referred the fundamental objective of corporate governance as the "enhancement of the long-term shareholder value while at the same time protecting the interests of other stakeholders." It is clear from above that the Corporate governance primarily means transparency, full disclosure, fairness to all stakeholders and effective monitoring of the state of corporate affairs. The term corporate governance aims at achieving business excellence and enhanced shareholder value, while keeping in view the need to protect the interests of all stakeholders.

6.6.2 Evolution of Corporate Governance

6.6.2.1 The real origin of the corporate governance lies in the repeated business scams and failures. The junk bond fiasco in USA and the failure of Maxwell, BCCI and Polypeck in UK resulted in the Treadway Committee in USA and the Cadbury Committee in UK on corporate governance. A number of other committees were also set up to look into various aspects of corporate governance, which included Sir Adrain Cadbury Committee (1992), Greenbury Committee (1995), Hampel Committee (1998), Blue Ribbon Committee (1999), OECD Principles of Corporate Governance (1999) etc. The report of Cadbury Committee was published in December 1992 and from July 1993 all U.K. companies listed in London Stock Exchange were required to state in their the extent of their compliance with the Code of Best Practices and the reasons for non-compliance in their annual report.

6.6.2.2 The issue of Corporate Governance is particularly important for developing countries like India since it is central to financial and economic development. The Asian financial crisis brought the subject of corporate governance to the surface in Asia. However, corporate governance initiative in India was not triggered by any serious nationwide financial, banking and economic collapse One of the first among such endeavours was the CII Code for Desirable Corporate Governance developed by a task force set up in December 1995 and chaired by Rahul Bajaj. The task force submitted its voluntary code of corporate governance called 'Desirable Corporate Governance: A Code' in April 1998.

6.6.2.3 SEBI had initially constituted a committee on May 7, 1999 under the chairmanship of Shri Kumarmangalam Birla, then Member of SEBI Board "to promote and raise the standards of corporate governance". This committee submitted its report in early 2000. The mandate of a committee under the chairmanship of Kumar Mangalam Birla was to design a mandatory cum recommendatory code for listed companies. The Birla Committee Report was approved by SEBI in December 2000. The Kumar Mangalam Committee made certain mandatory and non-mandatory recommendations. Based on the recommendations of this Committee, a new clause 49 was incorporated in the Stock Exchange Listing Agreements ("Listing Agreements"). The important elements, in brief, are:

(a) Board of Directors are accountable to shareholders.

(b) Board controls are laid down code of conduct and accountable to shareholders for creating, protecting and enhancing wealth and resources of the Company, reporting promptly in transparent manner while not involving in day to day management.

(c) Classification of non-executive directors into those who are independent and those who are not.

(d) Independent directors not to have material or pecuniary relations with the Company/ subsidiaries and if they had, those to be disclosed in Annual Report.

(e) Laying emphasis on calibre of non-executive directors especially independent directors.

(f) Sufficient compensation package to attract talented non-executive directors.

(g) Optimum combination of not less than 50% of non-executive directors and of which companies with non-executive Chairman to have atleast one third of independent directors and under executive Chairman atleast one half of independent directors.

(h) Nominee directors to be treated on par with any other director,

(i) Qualified independent Audit committee to be setup with minimum of three directors, all being non-executive directors with atleast one having financial and accounting knowledge.

(j) Corporate governance report to be part of Annual Report and disclosure on directors' remuneration etc., to be included.

The Companies Act, 1956 was accordingly modified in the year 2001-02 to incorporate specific Corporate Governance provisions regarding Independent Directors and Audit Committees based on the recommendations of CII and SEBI. Later SEBI constituted one more committee after three years under the chairmanship of Shri Narayanamurthy.

6.6.2.4 The Enron debacle of 2001 followed by corporate collapses of Worldcom and Xerox led to the enactment of the stringent Sarbanes Oxley Act in the US in July 2002 in an attempt to restore trust in the public securities market by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. This led the Indian Government to appoint the Naresh Chandra Committee (2002) to examine and recommend amendments to the law involving the statutory auditor-client relationship and the role of independent directors. The Companies Amendment Bill of 2005 included many of the recommendations of the Naresh Chandra Committee.

6.6.2.5 The Companies Amendment Act 2000 had introduced a new Section 292A regarding constitution of Audit Committees. The new provision covers every public company having a paid-up capital of Rs 5 crore and above. The board of directors is required to constitute an audit committee consisting of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors. The annual report should disclose the composition of the audit committee, which should have the authority to investigate in to any matter, in relation to the items specified in Section 292A.

6.6.2.6 SEBI also constituted N.R. Narayanamurthy Committee in the year 2002 to further review the clause 49 of the standard listing agreement and suggest measures to improve corporate governance standards. The committee gave its report in February, 2003. The clause 49 has since been amended with the recommendations of the committee's report. Report of the SEBI Committee recommended that the mandatory recommendations on matters of disclosure of contingent liabilities, CEO/ CFO Certification, definition of Independent Director, independence of Audit Committee and independent director exemptions in the report of the Naresh Chandra Committee, relating to corporate governance, be implemented by SEBI. Narayana Murthy Committee recommendations included role of Audit Committee, Related party transactions, Risk management, compensation to Non- Executive Directors, Whistle Blower Policy, Affairs of Subsidiary Companies, Analyst Reports and other non-mandatory recommendations. Significant amendments to Clause 49:

- Sea Change in the definition of Independent Director.
- Non-executive / Independent directors fees require approval of shareholders.
- Board shall be responsible for compliance with laws and regulations.
- Code of conduct to be laid for Board and senior management – declaration signed by CEO affirming compliance to be incorporated in the Annual report.
- 2/3rd of the members of Audit Committee to be independent Directors.
- Audit Committee meetings – every quarter within a gap of 4 months between two meetings.
- Members of audit committee to be financially literate and at least one member shall have accounting or financial management expertise.
- Review of quarterly financial statements before submission to the Board for approval by Audit Committee.
- Reviewing performance of statutory and internal auditors.
- Mandatory review of certain information by the Audit Committee.
- Independent Director to be on Board of material non-listed Indian subsidiary and additional role of Audit Committee and Board.
- Increased disclosures for related party transactions.

- Disclosures of proceeds from public, rights, preferential etc. issues – annual statement of funds utilized other than stated in offer document / prospectus / notice to be certified by the statutory auditor.
- Disclosures on Risk Management Framework.
- The CEO / CFO of every applicable company would be required to certify the financial statements on true and fair view of the company's affairs, compliance with applicable laws and regulations, fraudulent, illegal or violation of company's code of conduct transactions, responsibility for establishing and maintaining internal controls and evaluation of the effectiveness of the internal control systems of the company.

6.6.2.7 Meanwhile, the Ministry of Company Affairs also constituted an Expert Committee on Company Law to advise the Government on the new Company Law under the Chairmanship of Dr. Jamshed J. Irani. The Expert Committee released the report in May 2005.

6.6.2.8 The Ministry of Company Affairs has also set-up the National Foundation for Corporate Governance (NFCG) to promote better corporate governance practices in India in partnership with:

- Confederation of Indian Industry (CII)
- Institute of Company Secretaries of India (ICSI)
- Institute of Chartered Accountants of India (ICAI)

The Mission of NFCG are:

- To foster a culture for promoting good governance, voluntary compliance and facilitate effective participation of different stakeholders;
- To create a framework of best practices, structure, processes and ethics;
- To make significant difference to Indian Corporate Sector by raising the standard of corporate governance in India towards achieving stability and growth.

6.6.2.9 On 30 July, 2002 U.S. Congress enacted the Sarbanes – Oxley Act of 2002 (SOX) to improve the accuracy and transparency of financial reports and corporate disclosures, as well as to reinforce the importance of corporate ethical standards. As a result the Securities and Exchange Commission (SEC) issued rules outlining the provisions of the Act. The Act is the most significant legislation impacting the accounting profession since the Securities Acts of 1933 and 1934, which it amends. It applies to all securities and Exchange Commission (SEC) registered organizations, irrespective of where their trading activities are geographically based. This Act has transformed corporate governance practices in the United States and has strongly influenced the development of corporate governance in other parts of the world. This Act mainly provides :-

(a) Creates new structure to regulate both the audit process and profession.

(b) Increases the responsibilities and liabilities of corporate boards for failure to insure against future malfunction;

(c) Provides protection for internal whistle blowers;

(d) Enhances the authority of the SEC to police the market.

6.6.2.10 Internationally different reports were published on corporate governance notably among them are the Report of the Cadbury Committee, the Report of the Greenbury Committee, the Report of the Blue Ribbon Committee in the U.S., the OECD code on corporate governance. The primary objective of the committee was to view corporate governance for the benefit of the investors.

6.6.2.11 Studies of corporate governance practices across several countries conducted by the Asian Development Bank (2000), International Monetary Fund (1999), Organization for Economic Cooperation and Development ("OECD") (1999) and the World Bank (1999) reveal that there is no single model to good corporate governance. This is recognized by OECD code.

6.6.2.12 The need for good corporate governance practices has been felt in the management systems of Central Public Sector Enterprises (CPSEs) also to ensure that ethics and probity are maintained in the functioning of CPSEs. Therefore, Government has issued Guidelines on Corporate Governance for Central Public Sector Enterprises (CPSEs) Dated the 22nd June, 2007 for an experimental phase of one year. These guidelines datd 22nd June 2007 have been formulated through a consultation process with various stakeholders and keeping in view the relevant laws, rules and instructions. These guidelines cover issues like composition of Board of Directors, setting up of Audit Committees, role and powers of Audit Committees, issues relating to subsidiary companies, disclosures, accounting standards, risk management, compliance and schedule of implementation, etc. These guidelines though voluntary in nature are envisaged to be followed by all CPSEs as proper implementation of these guidelines would protect the interests of shareholders and relevant stakeholders. The compliance with these guidelines is required to be reflected in the Directors' report, Annual Report and Chairman's speech in the Annual General Meeting. Suitable improvements would thereafter be made after one year in these guidelines in the light of experience gained.

6.7 Audit Committees and Corporate Governance

6.7.1 Introduction

6.7.1.1 Accurate and reliable financial reporting is very critical to the development of corporate sector in free market based economies. Investors need accurate and reliable financial information to make informed investment decisions. In fact investors confidence in the reliability of corporate financial information is fundamental to the liquidity and vibrancy of markets in free economies. Therefore effective oversight of the financial reporting process is fundamental to preserving the integrity of the stock market. The Audit Committee seeks to provide an independent review and oversight of a company's financial reporting process, internal controls and independent auditors. Therefore significant emphasis is being placed on the importance of audit committees to the principles of sound governance in public companies. It may be clarified here that the Audit Committee has an oversight responsibility only and not an "audit of the auditor" responsibility.

6.7.1.2 Audit Committees provide a forum separate from management in which auditors and other interested stakeholders can candidly discuss concerns. Even though, the corporate financial reporting and regulatory requirements, corporate culture and market place factors vary from country to country, all market based economies are ultimately driven by two critical factors namely integrity of financial reporting and investor's confidence. Therefore the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls.

The existence of independent audit committee assures the shareholders that the procedures that promote accountability are integrated into the respective roles within the organization. These requirements have brought the focus on audit committees around the world.

6.7.2 Audit Committee Statute in India

6.7.2.1 The Companies Amendment Act, 2000 had introduced a new section 292A regarding constitution of Audit Committees. The new provision covers every public company having a paid-up capital of Rs. 5 crore and above. The Board of Directors is required to constitute an audit committee consisting of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole time directors. Similarly, Clause 49 of the uniform listing agreement prescribed by Securities and Exchange Board of India (SEBI), which is applicable to all companies listed in India, requires the setting up of a qualified and independent Audit Committee.

6.7.2.2 Sub-section (6) of Section 292A requires that the Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.

6.7.2.3 Sub-section (7) of Section 292A provides that the Audit Committee shall have authority to investigate into any matter inter-alia in relation to these matters and shall have full access to the information contained in the records of the company and external professional advice, if necessary.

6.7.2.4 The clause 49 of the listing agreement provides that the audit committee shall have powers which should include the following :

(a) to investigate any activity within its terms of reference;

(b) to seek information from any employee;

(c) to obtain outside legal or other professional advice; and

(d) to secure attendance of outsiders with relevant expertise, if it considers necessary.

This clause further provides that the role of the audit committee shall inter-alia include the following :

(a) Oversight of the company's financial reporting process and the disclosure of its financial information;

(b) Recommending the appointment and removal of external auditor, fixation of audit fee and also approval for payment for any other services;

(c) Reviewing the annual financial statements with management before submission to the board;

(d) Reviewing external and internal auditors with the management and the adequacy of internal control systems;

(e) Reviewing the adequacy of internal audit system;

(f) Discussion with Internal Auditors of any significant findings and follow-up action thereon;

(g) Discussion with External Auditors; and

(h) Reviewing the company's financial and risk-management policies.

6.7.2.5 Sub-section (8) and sub-section (9) of Section 292A provides that the recommendations of the Audit Committee will be binding on the Board. In case the Board does not accept the recommendations of the Audit Committee, it will have to record the reasons and communicate the same to the shareholders. In short, the provisions related to Audit Committees can be summarized as under :

» All public limited companies having paid up capital of Rs. 5 crores or more are required to establish a committee of the Board known as Audit Committee.

» The Committee shall have at least three directors as members.

» Two-third of the total number of members shall be non-executive directors.

» The Audit Committee shall act in accordance with terms of reference to be specified in writing by the Board.

» The Statutory Auditors, the Internal Auditor, if any and director in-charge of finance shall attend and participate the meetings of Audit Committee but shall not have the right to vote.

» The Audit Committee should have discussions with the auditors periodically about internal control system, the scope of audit and review of the half yearly and annual financial statements before presenting the same to the Board.

» The Audit Committee shall have right to investigate any matter covered under the broad terms of reference.

» In case of any default, the company and every officer who is in default shall be punishable with imprisonment for a term which may extend to one year, or with fine, which may extend to fifty thousand rupees or with both.

6.7.3 Types of Committees Under Clause 49

6.7.3.1 **The clause 49 of the listing agreement prescribes two committees as mandatory committees namely :**

(a) Audit Committee; and

(b) Shareholder's Grievance Committee.

In addition to above, the Board of Directors may set up a remuneration committee also, which is a non-mandatory requirement.

6.7.3.2 **Functions of Audit Committee under Section 292A:**

Sub-section (2) of Section 292A provides that every Audit Committee constituted shall act in accordance with terms of reference to be specified in writing by the Board. Sub section (6) provides that the Audit Committee should have periodic discussions with the auditors on the following matters :

(a) Internal control systems;

(b) The scope of audit including the observations of the auditors;

(c) Review of the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems; and

(d) Compliance of Internal Control Systems.

Sub-section (7) of Section 292A further provides that the Audit Committee shall have the authority to investigate into any matter :

(a) In relation to the items specified in section 292A; and

(b) In relation to the items referred to it by the Board of Directors.

Sub-section (7) further provides that the Audit Committee shall have full access to information contained in the records of the company and external professional advice if necessary.

Sub-section (8) provides that the recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board. Sub-section (9) provides that in case, the Board does not accept the recommendations of the Audit Committee, it shall record the reasons for non-acceptance and communicate such reasons to the shareholders.

6.7.3.3 **Penalty for Contravention of Section 292A:**

Sub-section (11) of Section 292A provides that the company and every officer who is in default in complying with the provisions of this section shall be punishable with imprisonment for a term which may extend to one year or with fine which may extend to fifty thousand rupees or with both.

6.7.3.4 **Meetings of the Audit Committee:**

Clause 49 to the listing agreement provides that the Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one-third of the members of Audit Committee whichever is greater. However, there should be a minimum of two independent members present. In view of quarterly results, it becomes otherwise also essential to meet at least once in a quarter. However, there is no bar on the maximum number of sittings by an Audit Committee. The Companies Act, 1956 has assigned a role to these committees and does not provide anything about the minimum numbers of meetings.

6.8 Confederation of Indian Industries (CII) Code for Desirable Corporate Governance

6.8.1 The CII code has recommended the following 14 key aspects which should be shared with the board :

» Annual operating plans and budgets together with updated long-term plans.

» Capital budgets, manpower and overhead budgets.

» Quarterly results for the company as a whole and its operating divisions for business segments.

» Show cause, demand and prosecution notices received from the revenue authorities which are considered to be materially important.

» Internal audit reports, including cases of theft and dishonesty of a material nature.

» Fatal or serious accidents, dangerous occurrences, and any affluent or pollution problems.

» Default in payment of interest or nonpayment of the principal on any public deposit, and/or to any secured creditors or financial institutions.

- Defaults such as nonpayment of inter-corporate deposits by or to the company, or materially substantial non-payments for goods sold by the company.
- Any issue which involves possible public or product liability claims of a substantial nature, including any judgment or order which may have either passed, strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.
- Details of my joint venture or collaboration agreement.
- Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
- Recruitment and remuneration of senior officers just below the board level, including appointment or removal of the Chief Financial Officer and the Company Secretary.
- Labour problems and their proposed solutions.
- Quarterly details of foreign exchange exposure and the steps taken by management to limit the risk of adverse exchange rate movement, if material.

These issues can be classified into financial issues and non-financial issues which are not required to be presented to the Board statutorily

Explaining the nature of key information that should reach board as per CII Code.

Financial Issues :

- Operating plans and budgets
- Capital budgets
- Quarterly results as a whole and by business segment
- Joint venture and collaboration
- Foreign exchange exposures
- Defaults in payments
- Failure in collection

Non-Financial Issues :

- Internal audit report
- Fatal accidents
- Show causes, contingencies, claims, Labour problems
- Important recruitments.

6.8.2 Extracts of Clause 49 of Listing Agreement and Section 292A of the Companies Act, 1956

The extracts of clause 49 are as follows :

Annexure I

Clause 49 - Corporate Governance

The company agrees to comply with the following provisions:

I. Board of Directors

(A) Composition of Board

(i) The Board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors.

(ii) Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors.

(iii) For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who:

- (a) apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;
- (b) is not related to promoters or persons occupying management positions at the board level or at one level below the board;
- (c) has not been an executive of the company in the immediately preceding three financial years;
- (d) is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
  - (i) The statutory audit firm or the internal audit firm that is associated with the company, and
  - (ii) The legal firm(s) and consulting firm(s) that have a material association with the company.
- (e) is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and
- (f) is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares.

Explanation — For the purposes of the sub-clause (iii):

(a) Associate shall mean a company which is an "associate" as defined in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India.

(b) "Senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

(c) "Relative" shall mean "relative" as defined in section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956.

(iv) Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors.

Explanation:

"Institution' for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a "corresponding new bank" as defined in section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts]."

(B) Non executive directors' compensation and disclosures

All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

(C) Other provisions as to Board and Committees

(i) The board shall meet at least four times a year, with a maximum time gap of three months between any two meetings. The minimum information to be made available to the board is given in **Annexure– I A.**

(ii) A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

Explanation:

1. For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.

2. For the purpose of reckoning the limit under this sub-clause, Chairmanship/ membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered.

(iii) The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

(D) Code of Conduct

(i) The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.

(ii) All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

II Audit Committee

(A) Qualified and Independent Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

(i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

(ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Explanation 1: The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation 2: A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(iii) The Chairman of the Audit Committee shall be an independent director;

(iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;

(v) The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;

(vi) The Company Secretary shall act as the secretary to the committee.

(B) Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

(C) Powers of Audit Committee

The audit committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

(D) Role of Audit Committee

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:
   (a) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956
   (b) Changes, if any, in accounting policies and practices and reasons for the same
   (c) Major accounting entries involving estimates based on the exercise of judgment by management
   (d) Significant adjustments made in the financial statements arising out of audit findings
   (e) Compliance with listing and other legal requirements relating to financial statements
   (f) Disclosure of any related party transactions
   (g) Qualifications in the draft audit report.
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval
6. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.

8. Discussion with internal auditors any significant findings and follow up there on.

9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.

10. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.

11. To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.

12. To review the functioning of the Whistle Blower mechanism, in case the same is existing.

13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

    Explanation (i): The term "related party transactions" shall have the same meaning as contained in the Accounting Standard 18, Related Party Transactions, issued by The Institute of Chartered Accountants of India.

    Explanation (ii): If the company has set up an audit committee pursuant to provision of the Companies Act, the said audit committee shall have such additional functions/features as is contained in this clause.

(E) Review of information by Audit Committee

The Audit Committee shall mandatorily review the following information:

1. Management discussion and analysis of financial condition and results of operations;

2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;

3. Management letters / letters of internal control weaknesses issued by the statutory auditors;

4. Internal audit reports relating to internal control weaknesses; and

5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee

III. Subsidiary Companies

(i) At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non listed Indian subsidiary company.

(ii) The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

(iii) The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

Explanation 1: The term "material non-listed Indian subsidiary" shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

Explanation 2: The term "significant transaction or arrangement" shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.

Explanation 3: Where a listed holding company has a listed subsidiary which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.

IV. Disclosures

(A) Basis of related party transactions

(i) A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.

(ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.

(iii) Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same.

(B) Disclosure of Accounting Treatment

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

(C) Board Disclosures – Risk management

The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

(D) Proceeds from public issues, rights issues, preferential issues etc.

When money is raised through an issue (public issues, rights issues, preferential issues etc.), it shall disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

(E) Remuneration of Directors

(i) All pecuniary relationship or transactions of the non-executive directors vis-à-vis the company shall be disclosed in the Annual Report.

(ii) Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report:

(a) All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.

(b) Details of fixed component and performance linked incentives, along with the performance criteria.

(c) Service contracts, notice period, severance fees.

(d) Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.

(iii) The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.

(iv) The company shall disclose the number of shares and convertible instruments held by non-executive directors in the annual report.

(v) Non-executive directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

(F) Management

(i) As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

(a) Industry structure and developments.

(b) Opportunities and Threats.

(c) Segment–wise or product-wise performance.

(d) Outlook

(e) Risks and concerns.

(f) Internal control systems and their adequacy.

(g) Discussion on financial performance with respect to operational performance.

(h) Material developments in Human Resources / Industrial Relations front, including number of people employed.

(ii) Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its. core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.

(G) Shareholders

(i) In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:

(a) A brief resume of the director;

(b) Nature of his expertise in specific functional areas;

(c) Names of companies in which the person also holds the directorship and the membership of Committees of the Board; and

(d) Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above

(ii) Quarterly results and presentations made by the company to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.

(iii) A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as 'Shareholders/Investors Grievance Committee'.

(iv) To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

V. CEO/CFO certification

The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

(a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief :

(i) these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

(ii) these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

(b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

(c) They accept responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal control systems of the company and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

(d) They have indicated to the auditors and the Audit committee

(i) significant changes in internal control during the year;

(ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

(iii) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system.

VI. Report on Corporate Governance

(i) There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in **Annexure- I C** and list of non-mandatory requirements is given in **Annexure – I D**.

(ii) The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in **Annexure I B**. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

VII. Compliance

(1) The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

(2) The non-mandatory requirements given in Annexure – I D may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / nonadoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

Annexure I A

INFORMATION TO BE PLACED BEFORE BOARD OF DIRECTORS

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.
3. Quarterly results for the company and its operating divisions or business segments.
4. Minutes of meetings of audit committee and other committees of the board.
5. The information of recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and Company Secretary.
6. Show cause, demand, prosecution notices and penalty notices which are materially important.
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.

8. Any material default in financial obligations to and by the company, or substantial non-payment for goods sold by the company.
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgment or order which may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
12. Significant labour problems and their proposed solutions. Any significant development in Human Resources/Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc.
13. Sale of material nature of investments, subsidiaries, assets, which is not in normal course of business.
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
15. Noncompliance of any regulatory, statutory nature or listing requirements and shareholders service such as nonpayment of dividend, delay in share transfer etc.

Annexure I B

Format of Quarterly Compliance Report on Corporate Governance

Name of the Company:

Quarter ending on:

Particulars	Clause of Listing agreement	Compliance Status Yes/No	Remarks
I. Board of Directors	49 I		
(A) Composition of Board	49(IA)		
(B) Non-executive Directors' compensation & disclosures	49 (IB)		
(C) Other provisions as to Board and Committees	49 (IC)		
(D) Code of Conduct	49 (ID)		
II. Audit Committee	49 (II)		
(A) Qualified & Independent Audit Committee	49 (IIA)		
(B) Meeting of Audit Committee	49 **(IIB)**		
(C) Powers of Audit Committee	49 (IIC)		
(D) Role of Audit Committee	49 II(D)		
(E) Review of Information by Audit Committee	49 (IIE)		
III. Subsidiary Companies	49 (III)		

Particulars	Clause of Listing agreement	Compliance Status Yes/No	Remarks
IV Disclosures	49 (IV)		
(A) Basis of related party transactions	49 (IV A)		
(B) Board Disclosures	49 (IV B)		
(C) Proceeds from public issues, rights issues, preferential issues etc.	49 (IV C)		
(D) Remuneration of Directors	49 (IV D)		
(E) Management	49 (IV E)		
(F) Shareholders	49 (IV F)		
V. CEO/CFO Certification	49 (V)		
VI. Report on Corporate Governance	49 (VI)		
VII. Compliance	49 (VII)		

Note:

1) The details under each head shall be provided to incorporate all the information required as per the provisions of the Clause 49 of the Listing Agreement.

2) In the column No.3, compliance or non-compliance may be indicated by Yes/No/N.A. For example, if the Board has been composed in accordance with the Clause 49 I of the Listing Agreement, "Yes" may be indicated. Similarly, in case the company has no related party transactions, the words "N.A." may be indicated against 49 (IV A).

3) In the remarks column, reasons for non-compliance may be indicated, for example, in case of requirement related to circulation of information to the shareholders, which would be done only in the AGM/EGM, it might be indicated in the "Remarks" column as – "will be complied with at the AGM". Similarly, in respect of matters which can be complied with only where the situation arises, for example, "Report on Corporate Governance" is to be a part of Annual Report only, the words "will be complied in the next Annual Report" may be indicated.

Annexure I C

Suggested List of Items to Be Included In the Report on Corporate Governance in the Annual Report of Companies

1. A brief statement on company's philosophy on code of governance.

2. Board of Directors:

   i. Composition and category of directors, for example, promoter, executive, non- executive, independent non-executive, nominee director, which institution represented as lender or as equity investor.

   ii. Attendance of each director at the Board meetings and the last AGM.

   iii. Number of other Boards or Board Committees in which he/she is a member or Chairperson

   iv. Number of Board meetings held, dates on which held.

3. Audit Committee:
    i. Brief description of terms of reference
    ii. Composition, name of members and Chairperson
    iii. Meetings and attendance during the year
4. Remuneration Committee:
    i. Brief description of terms of reference
    ii. Composition, name of members and Chairperson
    iii. Attendance during the year
    iv. Remuneration policy
    v. Details of remuneration to all the directors, as per format in main report.
5. Shareholders Committee:
    i. Name of non-executive director heading the committee
    ii. Name and designation of compliance officer
    iii. Number of shareholders' complaints received so far
    iv. Number not solved to the satisfaction of shareholders
    v. Number of pending complaints
6. General Body meetings:
    i. Location and time, where last three AGMs held.
    ii. Whether any special resolutions passed in the previous 3 AGMs
    iii. Whether any special resolution passed last year through postal ballot – details of voting pattern
    iv. Person who conducted the postal ballot exercise
    v. Whether any special resolution is proposed to be conducted through postal ballot
    vi. Procedure for postal ballot
7. Disclosures:
    i. Disclosures on materially significant related party transactions that may have potential conflict with the interests of company at large.
    ii. Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.
    iii. Whistle Blower policy and affirmation that no personnel has been denied access to the audit committee.
    iv. Details of compliance with mandatory requirements and adoption of the non-mandatory requirements of this clause.

8. Means of communication.
   i. Quarterly results
   ii. Newspapers wherein results normally published
   iii. Any website, where displayed
   iv. Whether it also displays official news releases; and
   v. The presentations made to institutional investors or to the analysts.
9. General Shareholder information:
   i. AGM : Date, time and venue
   ii. Financial year
   iii. Date of Book closure
   iv. Dividend Payment Date
   v. Listing on Stock Exchanges
   vi. Stock Code
   vii. Market Price Data : High., Low during each month in last financial year
   viii. Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.
   ix. Registrar and Transfer Agents
   x. Share Transfer System
   xi. Distribution of shareholding
   xii. Dematerialization of shares and liquidity
   xiii. Outstanding GDRs/ADRs/Warrants or any Convertible instruments, conversion date and likely impact on equity
   xiv. Plant Locations
   xv. Address for correspondence

Annexure I D

Non-Mandatory Requirements

(1) The Board

A non-executive Chairman may be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties. Independent Directors may have a tenure not exceeding, in the aggregate, a period of nine years, on the Board of a company.

(2) Remuneration Committee

i. The board may set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.

ii. To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director.

iii. All the members of the remuneration committee could be present at the meeting.

iv. The Chairman of the remuneration committee could be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

(3) Shareholder Rights

A half-yearly declaration of financial performance including summary of the significant events in last six-months, may be sent to each household of shareholders.

(4) Audit qualifications

Company may move towards a regime of unqualified financial statements.

(5) Training of Board Members

A company may train its Board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

(6) Mechanism for evaluating non-executive Board Members

The performance evaluation of non-executive directors could be done by a peer group comprising the entire Board of Directors, excluding the director being evaluated; and Peer Group evaluation could be the mechanism to determine whether to extend / continue the terms of appointment of non-executive directors.

(7) Whistle Blower Policy

The company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization.

EXTRACT OF SECTION 292A OF THE COMPANIES ACT, 1956

292A. Audit Committee

(1) Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board knows as "Audit Committee" which shall consist of not less than three directors and such number of other directors as the Board may determine of which two thirds of the total number of members shall be directors, other than managing or whole-time directors.

(2) Every Audit Committee constituted under sub-section (1) shall act in accordance with terms of reference to be specified in writing by the Board.

(3) The members of the Audit Committee shall elect a chairman from amongst themselves.

(4) The annual report of the company shall disclose the composition of the Audit Committee.

(5) The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

(6) The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.

(7) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.

(8) The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.

(9) If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders.

(10) The chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.

(11) If a default is made in complying with the provisions of this section, the company, and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees, or with both.]

6.8.3 OECD (Organisation for Economic Corporation and Development) – Principles on Corporate Governance

The OECD Council meeting at Ministerial level on 27-28 April 1998, called upon the OECD to develop, in conjunction with national governments, a set of corporate governance standards and guidelines. In order to fulfill this objective, the OECD established the Ad-hoc Task Force on Corporate Governance to develop a set of non-bonding principles that embody the views of Member countries on this issue.

The principles contained in this document are built upon experiences from national initiatives in Member countries and previous work carried out within the OECD, including that of the OECD Business Sector Advisory Group on Corporate Governance.

I. The rights of shareholders

The corporate governance framework should protect shareholders' rights.

A. Basic shareholder rights include the right to :

- » secure methods of ownership registration?
- » convey or transfer shares;
- » obtain relevant information on the corporation on a timely and regular basis;

» participate and vote in general shareholder meetings;

» elect members of the board; and

» share in the profit of the corporation

B. Shareholders have the right to participate in, and to be sufficiently informed on, divisions concerning fundamental corporate changes such as :

» amendments to the statues, or articles of incorporation or similar governing document of the company;

» the authorization of additional shares; and

» extraordinary transactions that in effect result in the sale of the company.

C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings :

» Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meetings.

» Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to some limitations.

» Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

E. Markets for corporate control should be allowed to function in an efficient and transparent manner.

» The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholder according to their class.

» Anti-take-over devices should not be used to shield management from accountability.

F. Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

II. The equitable treatment of shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A. All shareholders of the same class should be treated equally.

- » Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote.
- » Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
- » Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

B. Insider trading and abusive self-dealing should be prohibited.

C. Members of the board and managers should be required to disclose any material interests in transactions.

III. The role of stakeholders in Corporate Governance

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A. The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

C. The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant information.

IV. Disclosure and transparency

The corporate governance frameworks should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on :

- » The financial and operating results of the company.
- » Company objectives.
- » Major share ownership and voting rights.
- » Members of the broad and key executives, and their remuneration.
- » Material foreseeable factors.
- » Material issues regarding employees and other stakeholders.
- » Governance structures and policies.

B. Information should be prepared, audited and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure and audit.

C. An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

D. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

V. The responsibility of the board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

A. Board members should act on a fully informed basis, on good faith, with due diligence and care, and in the best interest of the company and shareholders.

B. Where board decisions may affect different shareholders groups differently, the board should treat all shareholders fairly.

C. The board should ensure compliance with applicable law and take into account the interests of stakeholders.

D. The board should fulfill certain key functions, including :

» Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance; objectives; monitoring implementation and corporate performance and overseeing major capital expenditures, acquisitions and divestitures.

» Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

» Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.

» Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets.

» Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.

» Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.

» Overseeing the process of disclosure and communications.

E. The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.

» Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.

» Board members should devote sufficient time to their responsibilities.

F. In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

6.9 Self-examination Questions

1 What do you understand by “corporate services audit”? Mention the areas covered by such audit.

2 Explain the term “consumer service audit”. Prepare a questionnaire for evaluation of “consumer services”.

3 What do you understand by the corporate development audit? Prepare checklist in some areas of corporate development such as corporate planning, corporate objectives etc.

4 What is “personnel development”? Explain how would you evaluate it.

5 Briefly mention the scope of personnel function of an organization.

6 What are the causes of environmental pollution? Discuss the impact of such pollution.

7 What do you understand by social cost and social benefit?

8 What is social accounting? Mention two approaches practiced by corporate bodies in relation to social responsibility and disclosure.

9 What is social audit? What should be the area to be covered in social audit report? Suggest whether social audit should be conducted for employees, society and customers.

10 Discuss in brief the special responsibilities of management auditors.

11 As a management auditor of a manufacturing concern, draft a model questionnaire for evaluation of purchase management.

12 As a management auditor, you are requested to carry out the review of personnel policies in an organization. Prepare a suitable questionnaire which will be helpful for carrying out such a review.

13 You as a management auditor, have been asked to conduct a review of a function of the personnel department of a company. State the various points which will be covered in the review.

14 Evaluation of the personnel function of an organization by the management auditor is by no means an easy task. In your view what are the areas to be covered and points to be kept in mind while assessing the personnel function of an organization?

15 You are required to look into, as a management auditor, the production functions of a manufacturing unit. How would you proceed and what areas would you look into?

16 As a management auditor, draft a model questionnaire for evaluation of production management.

17 What are special features of research and development activities as compared with common production and selling activities? As a management auditor, how will you appraise and evaluate these activities?

18 (a) What is marketing audit? What are its essential features?

(b) Marketing audit is to be successful has to be done in certain specific areas. What are they?

19 As the management auditor of a manufacturing company, draft model questionnaire for evaluation of sales management.

20 As a management auditor draft a suitable questionnaire for evaluation of distribution function of an organization.

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STUDY NOTE - 7

Various Types of Audit and Their Process

This Study Note includes:

- Due Diligence Audit
- Sox Audit
- Energy Audit
- Productivity Audit
- Inventory Audit
- VAT Audit
- Special Audit of Excise and Custom Records
- Environment Audit
- Audit under ERP environment
- Bank Audit
- Concurrent Audit

7.1 Due Diligence Audit

7.1.1 The term 'Due Diligence' is generally used for a number of concepts involving the performance of an act with a certain standard of care and caution. At its simplest, due diligence means care and precaution. In this sense, due diligence in work place means taking every precaution to protect the health, safety and welfare of all workers and staff.

7.1.2 Due Diligence primarily means 'background checking' or the intense examination of a target asset for an acquisition by a prospective buyer. It is done to ensure that the buyer has all the information to take the necessary decision. It can therefore, be described as a fact-finding to assist in taking the final decision i.e., whether to buy the target asset or how much offer to pay for the acquisition or how to structure the acquisition. The main objective of Due Diligence is to verify the assertions made by the Seller and to identify caveats, if any that may not have been disclosed by the Seller. It can also be described as the task of carefully confirming all critical assumptions and facts presented by a buyer or borrower and to ensure that no material facts are omitted. In other words, it is a reasonable investigation about the state of affairs of the business to be acquired, especially focusing on matters which may have a critical bearing on the future of the business. In short, the Buyer determines through Due Diligence that the proposed bought out acquisition contains all the assets and liabilities that have been paid for.

7.1.3 The origin of term 'Due Diligence' owes to US Securities Act of 1933. This Act contained a "Due Diligence" clause which could be used as defence by the broker-dealer, if accused of inadequate disclosure of material information to investor with respect to purchase of securities. This term was subsequently institutionalized by the broker-dealer community as a standard practice over a period of time by conducting due diligence investigations of any stock offerings by them. However, it has now been associated with investigations of private mergers and acquisitions etc. as well. The aim is to ensure that there is nothing which contradicts the financier's or buyer's understanding of the current state of affairs and potentials of the business proposed to be acquired.

7.1.4 The due diligence process varies in each case based on its own merits. The broad areas of investigation include finance, legal, personnel, taxation, environmental and other market/ commercial considerations. Luis F Gillman has suggested that a comprehensive Due Diligence ought to investigate the following nine fields:

(a) Compatibility audit

(b) Financial audit

(c) Macro-environmental audit

(d) Legal - environmental audit

(e) Marketing audit

(f) Production audit

(g) Management audit

(h) Information systems audit

(i) Reconciliation audit

7.1.5 A recent survey had revealed that most of the mergers and acquisitions have subsequently failed to add to the shareholder value. This high failure rate can be very easily reduced with proper and efficient due diligence in each case. It may be clarified here that Due Diligence is not a process of valuation of a business. In short, a due diligence audit is performed to understand the details of the development process, degree of regulatory compliance, etc. of a target asset sought to be acquired.

7.2 SOX Audit

7.2.1 Sarbanes-Oxley Act of 2002 is also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox. This is a United States federal law enacted on July 30, 2002 in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom.

7.2.2 U.S. Congress enacted the Sarbanes – Oxley Act of 2002 (SOX) on 30 July, 2002 to improve the accuracy and transparency of financial reports and corporate disclosures as well as to reinforce the importance of corporate ethical standards. The Act is the most significant legislation impacting the accounting profession since the Securities Acts of 1933 and 1934, which it amends. It applies to all Securities and Exchange Commission (SEC) registered organizations irrespective of where their trading activities are geographically based. This Act has transformed corporate governance practices in the United States and has strongly influenced the development of corporate governance in other parts of the world.

7.2.3 The legislation establishes new or enhanced standards for all U.S. public company boards, management and public accounting firms. However, it does not apply to privately held companies. The Act contains 11 titles or sections ranging from additional Corporate Board responsibilities to criminal penalties. The Act also establishes a new quasi-public agency, the Public Company Accounting Oversight Board, or PCAOB, which is charged with overseeing, regulating, inspecting, and disciplining accounting firms in their roles as auditors of public companies. The Act also covers issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure. Each title consists of several sections summarized as under:

(a) Public Company Accounting Oversight Board (PCAOB)

Title I establishes the Public Company Accounting Oversight Board to provide independent oversight of public accounting firms providing audit services. It also creates a central oversight board with responsibility for registering auditors, defining the specific processes and procedures for compliance audits, inspecting and policing conduct and quality control, and enforcing compliance with the specific mandates of SOX.

(b) Auditor Independence

Title II establishes standards for external auditor independence aimed at limiting conflicts of interest. It also addresses the issues like approval requirements for new auditor, policy for audit partner rotation, conflict of interest issues and auditor reporting requirements. Section 201 of this title prohibits any public accounting firm from providing non-audit services to a firm while auditing the same firm. These services include book-keeping, appraisal, and others (excludes tax preparation).Section 203 of this title mandates that the lead auditor and reviewing partner must rotate off the audit every 5 years. Section 204 of this title further requires that Auditors must report all critical accounting policies and practices to the firm's audit committee.

(c) Corporate Responsibility

Title III mandates that senior executives shall be individually responsible for the accuracy and completeness of corporate financial reports. It provides for the interaction of external auditors and corporate audit committees and the responsibility of corporate officers for the accuracy and validity of corporate financial reports. It enumerates specific limits on the behaviours of corporate officers and penalties for non-compliance. For example, Section 301 calls for the formation of an independent and competent audit committee. The audit committee is responsible for hiring, setting compensation and supervising the auditor's activities. SOX requires that each member of a firm's audit committee be a member of the board of directors and be "independent". The term "independent" means the members are neither part of the management team nor do they perform any consulting or professional services for the firm. Moreover, it is also recommended that each audit committee have a "financial expert" as part of the committee. Section 302 requires the CEO and chief financial officers to certify that the financial statements accurately and fairly represent the financial condition and operations of the company. There are criminal sanctions for intentional false certification. The signing officers must certify that they are "responsible for establishing and maintaining internal controls" and "have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared."

(d) Enhanced Financial Disclosures

Title IV provides for the enhanced reporting requirements for financial transactions including off-balance-sheet transactions, pro-forma figures and stock transactions of corporate officers. It requires internal controls for ensuring the accuracy of financial reports and disclosures and mandates both audits and reports on those controls. The most contentious aspect of SOX is Section 404, which requires management and the external auditor to report on the adequacy of the company's internal control over financial reporting (ICFR). This is the most costly aspect of the legislation for companies to implement, as documenting and testing important financial manual and automated controls requires enormous effort. Section 404 requires that each annual report should contain an internal control report. This report provides for the responsibility of management to establish and implement adequate procedures for financial reporting. This report must include the assessment of effectiveness of internal control structure and procedures, any code of ethics and contents of that code.

(e) Analyst Conflicts of Interest

Title V includes measures, which are aimed at restoring investor confidence in the reporting of securities analysts. It defines the codes of conduct for securities analysts and requires disclosure of knowable conflicts of interest.

(f) Commission Resources and Authority

Title VI defines practices to restore investor confidence in securities analysts. It also defines the SEC's authority to censure or bar securities professionals from practice and defines conditions under which a person can be barred from practicing as a broker, adviser or dealer.

(g) Studies and Reports

Title VII is concerned with conducting research for enforcing actions against violations by the SEC registrants (companies) and auditors. Studies and reports include the effects of consolidation of public accounting firms, the role of credit rating agencies in the operation of securities markets, securities violations and enforcement actions.

(h) Corporate and Criminal Fraud Accountability

Title VIII is also referred to as the "Corporate and Criminal Fraud Act of 2002". SOX provide new protection for whistle blowers and mandates criminal penalties for actions taken against whistle-blowers. It is now illegal for any (includes private firms) firm to punish whistle-blowers in any way. This portion of the SOX is especially important for co-op boards to follow as a best practice. All organizations should implement procedures for handling employee complaints referring to accounting or financial management practices. It is recommended that organizations should establish an anonymous complaint process to encourage employees to report any inappropriate financial management practices.

(i) White Collar Crime Penalty Enhancement

Title IX is also called the "White Collar Crime Penalty Enhancement Act of 2002." This section increases the criminal penalties associated with white-collar crimes and conspiracies. It recommends stronger sentencing guidelines and specifically adds failure to certify corporate financial reports as a criminal offense.

(j) Corporate Tax Returns

Title X includes Section 1001, which provides that the Chief Executive Officer should sign the company tax return.

(k) Corporate Fraud Accountability

Title XI includes Section 1101, which recommends a name for this title as "Corporate Fraud Accountability Act of 2002". It identifies corporate fraud and records tampering as criminal offenses and joins those offenses to specific penalties. It also revises sentencing guidelines and strengthens their penalties. This enables the SEC to temporarily freeze large or unusual payments.

7.3 Energy Audit

7.3.1 An Energy Audit has been defined as an inspection, survey and analysis of energy flows in a building, process or system with the objective of instituting energy efficiency programs in an establishment. It consists of activities that seek to identify conservation opportunities preliminary to the development of an energy savings program. In other words, an energy audit is conducted to seek opportunities to reduce the amount of energy input into the system without negatively affecting the output(s). An energy audit also seeks to prioritize the energy uses according to the greatest to least cost effective opportunities for energy savings. In simple words, Energy audit means monitoring the energy efficiency of different equipment and process in a plant and looking into way by which the total sum of energy consumed can be cut down without affecting production or its efficiency.

7.3.2 In view of above, an energy audit is a fundamental step of the energy conservation programme in any industrial plant or energy consuming facility. Energy utilization and conservation play an important role in an industry in the current scenario of rapidly diminishing fossil fuels, explosive rise in the prices of crude oil and other energy sources and a possible switch over to alternative source of energy both for conserving energy costs and towards attempt for alternative sources of energy.

7.3.3 Energy audit and environment audit sometimes done together as both involve measurement of same parameters i.e., which are common to both. Thus for a boiler, for example, both would require measurement of fuel flow and air flow, CO_2 in the flue gas, etc. The energy-cum-environment audit allows a simultaneous consideration of energy and environmental aspects. As a result, it is possible to identify options to reduce the overall cost of energy as well as pollution control. Moreover, some of the principles of energy cost reduction and pollution control are also identical. Thus, an energy-cum-environment audit would eliminate the repetitive measurement of these common parameters. An energy-cum-environment audit is an analogous step of a programme aimed at conserving energy in an energy consuming facility and keeping its impacts on the environment within acceptable limits.

7.3.4 A few illustrations of possible sources for conserving energy are given below–

(A) **Steam Generation:**

(i) Selection of boilers to achieve fuel economy

(ii) Consider multiple or modular boiler units instead of one or two large boilers.

(iii) Check against infiltration of air in furnace. Use doors or air curtains.

(iv) Improve burner design, combustion control and instrumentation.

(v) Use ceramic fibres in the case of batch operations.

(vi) Match the load to the furnace capacity.

(vii) Retrofit with heat recovery device.

(viii) Investigate cycle times and reduce.

(ix) Techno-economics of fuel substitution

(x) Burn wastes if permitted.

(xi) Improving the combustion efficienct

(xii) Design of low temperature heat recovery system from the exhaust flue gas.

(xiii) Use variable speed drives on large boiler combustion air fans with variable flows.

(xiv) Increasing the generation to rated capacity

(xv) Evaluating the efficiency of steam generation, fixing up the cost of steam generation and improving the efficiency

(xvi) Design of monitoring system to effect economy

(xvii) Preheat combustion air with waste heat

(xviii) Use boiler blow down to help warm the back-up boiler.

(xix) Recycle steam condensate.

(xx) Optimize boiler water treatment.

(xxi) Add an economizer to preheat boiler feed water using exhaust heat.

(xxii) Incremental loading of boilers

(xxiii) Establish a boiler efficiency-maintenance program.

(B) **Steam distribution:**

(i) Design of steam distribution system to augment the needs of process house.

(ii) Redesign the existing steam distribution system to increase the production rate.

(iii) Fix steam leaks and condensate leaks.

(iv) Use back pressure steam turbines to produce lower steam pressures.

(v) Use more-efficient steam desuperheating methods.

(vi) Ensure process temperatures are correctly controlled.

(vii) Maintain lowest acceptable process steam pressures.

(viii) Reduce hot water wastage to drain.

(ix) Use waste steam for water heating.

(x) Use an absorption chiller to condense exhaust steam before returning the condensate to the boiler.

(xi) Use electric pumps instead of steam ejectors when cost benefits permit

(xii) Repair damaged insulation. Insulate all flanges, valves and couplings

(xiii) Insulate any hot or cold metal or insulation.

(xiv) Establish a steam efficiency-maintenance program.

(C) **Steam utilization:**

(i) Estimation of steam requirements, compare them with standard norms and suggest ways and means to reduce steam consumption.

(ii) Selection and maintenance of steam traps.

(iii) Insulate open tanks.

(iv) Design of condensate recovery system.

(v) Optimization of various process parameters to achieve steam economy in process equipment like stentors, evaporators, dryers, etc.

(vi) Selection of proper vacuum system to effect economy.

(vii) Scheduling of process operations to achieve fuel economy.

(D) **Electrical energy utilization:**

(i) Shift loads to off-peak times if possible.

(ii) Minimise maximum demand by tripping loads through a demand controller

(iii) Stagger start-up times for equipment with large starting currents to minimize load peaking.

(iv) Use standby electric generation equipment for on-peak high load periods.

(v) Relocate transformers close to main loads.

(vi) Disconnect primary power to transformers that do not serve any active loads

(vii) Export power to grid if you have any surplus in your captive generation

(viii) Check utility electric meter with your own meter.

(ix) Shut off unnecessary computers, printers, and copiers at night.

(x) Improving load factor

(xi) Improving power factor

(xii) Use water-cooled condensers rather than air-cooled condensers

(xiii) To study the matching of motors and driven equipments and suggest modifications

(xiv) To assist in selection of high efficiency motors

(xv) To suggest better variable speed drivers

(xvi) Better operation, maintenance of compressed air system

(xvii) To study and suggest measures for improving the system, the system efficiencies of refrigeration and air-conditioning system.

(E) **Total energy system:**

(i) Shut down spare, idling, or unneeded equipment.

(ii) Make sure that all of the utilities to redundant areas are turned off – including utilities like compressed air and cooling water.

(iii) Install automatic control to efficiently coordinate multiple air compressors, chillers, cooling tower cells, boilers, etc.

(iv) Use the lowest possible hot water temperature.

(v) Do not use a central heating system hot water boiler to provide service hot water during the cooling season – install a smaller, more-efficient system for the cooling season service hot water.

(vi) Consider the installation of a thermal solar system for warm water.

(vii) Use multiple, distributed, small water heaters to minimize thermal losses in large piping systems.

(viii) Use freeze protection valves rather than manual bleeding of lines.

(ix) Consider alternatives to high pressure drops across valves.

(x) Assess the heat and power requirements and study the feasibility of incorporating cogeneration system to affect higher thermal efficiency of the system and give specifications of boilers, turbines and the related auxiliaries.

(F) **Diesel exhaust recovery:**

(i) Study the techno-economic feasibility of recovering heat from diesel exhaust and assist in implementation.

(ii) Turning up diesel generating sets for highest efficiency.

7.4 Productivity Audit

7.4.1 The Productivity audit is basically an analysis of the productivity of the resources deployed by any organization. It is generally done to generate information about the status of productivity in the organization for the purpose of determining the scale of efficiency and effectiveness of 'resource utilization'. The term 'resources' here would include not only "money" but also "men", "machines", "materials" and "methods". In other words, the objectives of productivity audit is –

(a) to attain optimum result, and

(b) to improve on the benchmarks.

7.4.2 This audit would generally comprise –

(a) comparison of expected returns on utilization of the resources vis-à-vis the actual returns;

(b) comparison of optimum returns on utilization of the resources vis-à-vis the actual returns; and

(c) the steps taken to improve benchmarks of returns and the utilization.

7.4.3 The term 'Productivity' is normally attributed only to the "productivity of labour" or "efficiency of labour" alone. But productivity audit is actually "productivity of every resource employed". Productivity audit is done by –

(a) Ratio analysis

– Return on capital employed

– Return on sales

– Turnover ratios of fixed assets, current assets, inventories, category-wise debtors etc.

(b) Capacity utilization of plant, machinery and equipments against available capacity.

(c) Productivity analysis of man (labour) hours in time and cost.

(d) Material consumption against norms and benchmarks.

7.4.4 The following ratios are generally used in measuring productive efficiency of the resources deployed and utilized:

Resources Deployment

(i) Capital employed per capita

(ii) Capital employed per unit of product

(iii) Gross profit to capital employed

(iv) Net profit to capital employed

(v) Debt equity ratio

(vi) Net worth and long-term debts to gross fixed assets

(vii) Net worth and long-term debts to net fixed assets

(viii) Debts to fixed loans

(ix) Debts to floating loans

(x) Current assets to current liabilities

(xi) Net working capital

(xii) Total inventory to capital employed.

Resource Utilisation

(i) Capacity utilisation –

Installed capacity: Utilised capacity of machines (by units)

(ii) Capacity utilisation –

Installed capacity: Utilised capacity of machines (by machine hours)

(iii) Machine time available : Machine time utilised

(iv) Machine time consumed : Per unit of product (individually)

(v) Machine time consumed : Per capita

(vi) Gross fixed assets : Turnover

(vii) Net fixed assets : Turnover

(viii) Inventories : Turnover (inventory turnover)

(ix) Raw materials : Turnover (No. of days of stock)

(x) Work in process : Turnover (No. of days of stock v. cycle time)

(xi) Finished goods : Turnover (No. of days of stock v. lead time)

(xii) Labour time consumed : Division-wise

(xiii) Labour time consumed : Product-wise

(xiv) Labour time consumed : Product group-wise

(xv) Turnover per capita

(xvi) Value added : per capita

(xvii) Indirect labour : Direct labour number

(xviii) Indirect labour costs : Direct labour costs

(xix) Levels of management.

7.5 Inventory Audit

7.5.1 All organizations involved in the production of goods or services for sale, hold inventory stocks of different types at any particular time. These stocks include raw materials, which are procured in advance to avoid production stoppages; goods in process not yet fully finished; the materials fully processed and finished which are packed and kept in the godown ready for delivery and the consumable stores and spare parts. The criteria for deciding whether it is an inventory item is that it should have been held in the ordinary course of business. The inventories can thus be grouped into following categories:

(a) Raw materials including process materials like dyes, chemicals, sizing materials, packing materials, etc.

(b) Work-in process

(c) Maintenance supplies, consumable stores, spare parts and loose tools.

(d) Scraps – usable /saleable.

(e) Finished goods.

7.5.2 It is generally observed that inventory value as a percentage of total current assets varies from 55% to 65% and inventory value as percentage of production value varies from 32% to 35%. Thus from the point of view of lenders who keep their basis of lending on the values of current assets and current liabilities, any change in the inventory valuation has got a tremendous bearing on the lending levels.

7.5.3 The value of inventories is one of the most important figures appearing in the financial statements, which has a direct bearing on the profit/loss of an organization. Increase in the value of inventory will increase the profit figure directly and by the same amount. Increase/decrease in the inventory valuation has a multiplier effect on the profit/loss of an organization. It has been seen that a 5% change in the inventory value resulted in changing the profit figure by 10% to 130%. Thus the importance of correct, fair and reasonable inventory valuation for determining the true and fair profit cannot be overemphasized.

7.5.4 Though theoretically anyone with accounting background can conduct Inventory Audit, the most suited would be the Cost Accountant. The Financial Auditor is not expected to make detailed examination of cost records while conducting the statutory audit. He usually takes certificate from the management about the inventory valuation. The dangers of relying on the certificate from the management are quite obvious. Moreover, it may not be the totally correct policy under the corporate governance. Therefore, such self proclaimed inventory values need to be scrutinized and certified by an independent non-biased professional, who has thorough knowledge of costing.

7.5.5 Usually banks extend loans by way of cash credits based on the inventories and book debts. Thus banks and any other lenders or financial institutions shall be interested in Inventory Audits. Income-tax authorities are also interested in getting the inventory audit done by an independent professional. In addition, such necessity arises at the time of takeovers, mergers, etc. Thus the emphasis of the person conducting the inventory audit in certain items of inventory, etc. varies depending upon the person, who wants the Audit to be conducted. For example, in case of Banks, the Auditor has not only to deal with the stocks but also scrutinize the sundry debtors and sundry creditors. He may also verify the extent to which the stocks have been insured.

7.5.6 Before starting the Inventory Audit, the Auditors should have the following attended to:

(a) Exact objective and scope of the audit: A written letter from the authority who wants the Inventory Audit to be conducted delineating the area to be covered, the time frame and the exact scope of work, etc.

(b) Audit Plan: Meet the concerned officials of the organization and discuss the plan for conducting the audit.

(c) Prepare a Questionnaire and distribute the same to all the concerned departments in the organization so that required data is ready at the appropriate time.

(d) Prepare a checklist of the time to be covered in each department/section.

(e) Prepare a manpower requirement as audit staff.

7.5.7 Before verifying the accuracy of the valuation of the inventories, the following items are inter-alia required to be covered –

(a) Study of existing internal control system in order to identify the weaknesses in the existing system.

(b) Periodicity of physical inventory verification – whether representatives of the statutory auditors or internal auditors or cost auditors are present during physical stocktaking.

(c) Existence of records / reports of verification.

(d) Perusal of accounting policy of the organization in regard to inventory valuation i.e., whether as per Accounting Standards.

(e) Profit and Loss and Balance Sheet for the period under review and last audited records.

(f) Collection of duly valued and authenticated Stock Sheets and verification with departmental records.

(g) Quantity reconciliation for "A" category items of physical inventory.

(h) Study of system booking purchases and sales.

(i) Verifications of confirmations from the parties for company's stock lying with them.

(j) Verification of stocks lying at outside godowns, bonded warehouses, depots and retail shops.

(k) Verification of stocks of others lying at company's premises to see that these are not included in the inventory valuation.

(l) Verification of stage of completion of process in regard to various work-in-process.

7.5.8 The main thrust of the Inventory Auditor is to check the accuracy of the costs, to verify the market rates and to see that the values adopted for stock valuation are cost price or net realizable value whichever is lower. For verifying the inventory values it would be better to do so for each type of inventory viz. raw materials, work-in-process, finished goods etc. as enumerated below:

I. Raw materials, stores, spares, etc.:

The raw material cost in some of the industries constitutes almost up to 80% of the total cost of the product. Therefore, proper care should be taken to see that the values adopted are correct. The following guidelines will be helpful:

(a) Get a detailed statement of physical inventory giving the age-wise break up.

(b) Scrutinize the G.R. Notes for verifying that the goods have actually been received.

(c) Verify the rates applied for valuation with the rates mentioned in the Purchase Bills.

(d) The value applied may include freight, octroi, loading and unloading and other incidental charges incurred which is applied as a percentage on the purchase price. In such cases, verification of the percentage applied should be done to see that it is accurate.

(e) Verify whether the rejected goods are not included in the inventory list.

(f) If bills have not been received, the rates as per contracts may be taken which should include excise, sales tax etc. as applicable.

(g) For imported items, the costs should include FOB, ocean/airfreight, insurance, customs duty, port dues and other clearing charges, surface transport charges to point of storage, transit insurance commission payable to Indian agents, and any other costs like loading, unloading, etc.

(h) Foreign exchange translation rate for conversion of FOB/CIF costs will be:

  (a) as per bank debits under LC, or

  (b) rate prevalent as evidenced by Bill of Entry (or Forward Rate if Forward Contract has been taken) for imports on D.A. terms or on account.

  Exchange rates difference between date of receipt and date of payment to be ignored. Similarly, forward contract charge and SWAP charges will not be allowed to affect material cost. These are to be treated as gains/losses arising out of foreign currency management.

(i) Excise Duty, Sales Tax, Octroi and other levies should be reduced from the material cost as and where applicable (CENVAT, Sales Tax set-off, etc.)

(j) Method of valuation can be FIFO, LIFO, but it should be verified whether it is consistently applied over successive periods.

(k) Items of slow-moving, non-moving and obsolete inventory not meant for sale but used in consumption should be written down as per laid down policy.

II. Work-in-progress:

In respect of semi-finished goods, the following guidelines will be of help:

(a) Verify that the physical stage of completion as shown in the inventory sheets reflects correct valuation.

(b) Verify that the costs up to the stage of completion have been properly determined.

(c) Scrutinize whether overhead allocation to cost centres is properly done and cost absorption has been correctly done.

(d) The costs should be related to production and credit for scraps, joint products and by-product should be taken care of.

(e) Costs shall include normal loss. Anything abnormal should be excluded.

(f) When comparing the actual costs with the net realizable, proper care should be taken to see that all the costs that have not been incurred for the unprocessed part should be deducted from the gross realizable value.

III. Finished goods:

While valuing the finished goods, the following points should be checked–

(a) Statement showing the finished goods stock giving age-wise details should be obtained.

(b) Marketing and selling costs are not to be included in cost of production.

(c) Excise duty paid on finished goods which have been cleared and stored at depot, etc. will be treated as part of its value.

(d) Cost of packing and freight paid on finished goods on movement to the point of storage will be included in inventory value.

(e) In respect of material that are got converted or sub-contracted, inventory value will include cost of material supplied including normal wastage or scrap conversion charge, excise duty, freight to and from subcontractor and any other directly identified charge.

IV. General:

The following point should be taken care of –

(a) Notional costs should not be considered.

(b) Cost items like interest if not incurred to bring the goods in the present location/stage should be excluded.

(c) Any costs of an abnormal nature should be excluded from costs.

(d) Fixed costs relatable to significant unutilized or under-utilized capacity should be excluded from costs.

7.5.9 Sometimes, certain clients like banks or financial institutions require the Auditor to scrutinize and verify the Sundry Debtors and Creditors and analyse the same age-wise as the lending may be based on the aggregate value of stocks and sundry debtors minus sundry creditors. Sundry debtors above a certain period say above 6 months, may not be considered for this purpose. In such cases, it should be shown separately. The Auditor has to focus his attention on these areas also. Similarly some organizations like banks have their own formats of Audit Report, which the Auditor is required to fill in with the required data. However, in many cases, the Auditor has to design his own Audit Report, which should conform to the requirements of the client. In any case, some items which need to be highlighted or drawn attention should be shown separately. The report should also contain the lacuna, if any, improvement required, his suggestions for improvement etc. Needless to say that the report should be useful not only for the client but also to the unit whose audit is carried out so as to enable them to improve their performance.

7.6 VAT Audit

7.6.1 India has introduced Value Added Tax (VAT) system of taxation w.e.f. 1st April, 2005 joining the globally recognized sales taxation system that has been adopted by more than 130 countries. This introduction of VAT in the country is considered as one the major reforms in the area of public finances since independence. The basic advantages of Value Added Tax can be stated as its neutrality, transparency, certainty and self policing mechanism. This is projected to make accounting more transparent, cut trade barriers, boost tax revenues and reduce tax evasion. VAT has replaced the single point sales tax system, which had number of disadvantages, primarily that of double taxation. VAT is a modern and progressive taxation multi point sales tax system that avoids double taxation, besides set off of tax paid on purchases. VAT has following advantages:-

(a) It is a self policing and self assessment taxation system, which puts more trust on dealers;

(b) It eliminates the cascading impact of double taxation and thus promotes economic efficiency;

(c) It is invoice based and thus offers a better financial system with less scope for error;

(d) It widens the tax base and promotes equity;

(e) It has an improved central mechanism resulting in better compliance.

7.6.2 VAT is levied on sale of goods including intangible goods. The term "Goods" including every kind of movable property including goods of incorporeal and intangible nature subject to certain exclusions. All business engaged in the buying and selling of goods within the scope of VAT laws are referred to as dealers. The VAT system embraces all the businesses in the production and supply chain, from manufacture through to retail. VAT is collected at each stage in the chain when value is added to goods. It applies to all business, including manufacturers, distributors, wholesalers, retailers, works, contractors and lessers. However, VAT law specifically excludes all importers, exports and inter-state transactions, which are covered by the CST Act.

7.6.3 Generally, most of the items are covered under two main tax rates of VAT i.e. 4% and 12.5%. However, there are other separate rates also for luxury items or essential items. Moreover actual rates of tax on each item may vary in each state. The VAT is levied as a percentage of the price of each taxable sale transaction by the sellers. These sellers or dealers in turn, are reimbursed the amount of VAT paid by them on their purchases at the time of their sales in such a way that the actual amount of VAT is payable only on the incremental value added to the goods at each stage of production. Therefore, it is basically a tax on the value addition on the product and ultimately the burden of tax is to be borne by the consumer of goods.

7.6.4 The following example will show how the VAT works through the chain from manufacturer to retailer. Company 'A' buys raw materials and other chemicals and manufactures different bulk drugs; Partnership firm 'B' buys the different bulk drugs from Company 'A' and makes formulations; shopkeeper 'C' buys some of the bulk formulations and purchases packing material from vendor 'D', packages them and sells the packed tablets to the retail public.

(The sale and purchase figures shown in the example are excluding tax)

PARTICULARS	AMOUNT (Rs.)	VAT @ 4% (Rs.)
Company 'A'		
Cost of raw materials and other chemicals	50,000	2,000
Sales of Bulk Drugs	1,50,000	
Value added	1,00,000	
Company A is liable to pay VAT on Rs. 1,50,000 @ 4%	6,000	
Less VAT paid on raw material set off	2,000	
Net VAT amount to pay		4,000
(Note: Tax invoice issued by Company 'A' will show sale price as Rs. 1,50,000, tax as Rs.6,000. Therefore the total invoice value will be Rs. 1,56,000)		
Partnership 'B'		
Purchases Bulk Drugs	1,50,000	6,000
Sales Bulk Formulations	1,80,000	
Value added	30,000	
Partnership 'B' is liable to pay VAT on Rs. 1,80,000 at 4%	7,200	
Set off of VAT paid on purchases	6,000	
Net VAT amount to pay		1,200
Shopkeeper 'C'		
Purchases formulations	1,80,000	7,200
Packing material	5,000	200
Total Purchases	1,85,000	
Sales	2,25,000	
Value added	40,000	
Shopkeeper 'C' is liable to pay VAT on Rs.2,25,000 @ 4%	9,000	
Set off of VAT paid on purchases		
(Rs.7,200 + Rs. 200 of packing material)	7,400	
Net VAT amount to pay		1,600
Vendor 'D' (For Packing Material)		
Tax paid costs	NIL	
Sales	5,000	

Value added	5,000	
Vendor 'D' is liable to pay VAT on Rs. 5,000 @ 4%		200
The VAT due on the value added through the chain, i.e., 4% on Rs. 2,25,000 is		9,000

7.6.5 The State Government received the amount of VAT tax in stages. The payments of VAT tax were as follows.

	Amount (Rs.)
Suppliers of Company 'A'	2,000
Company 'A'	4,000
Partnership 'B'	1,200
Shopkeeper 'C'	1,600
Vendor 'D'	200
Total	9,000

7.6.6 Thus, through a chain of tax on sale price and set off on purchase price, the cascading impact of tax is totally eliminated. However in practice, the tax is borne by the ultimate consumer, who will finally pay Rs. 2,34,000 consisting of Rs. 2,25,000 as sales price and Rs. 9,000 as VAT @ 4% of such sale.

7.7 Computation of Tax Liability Under VAT

7.7.1 The first step is to determine tax liability under VAT is to determine the amount of value addition and tax thereon i.e., – (a) the turnover of sales and the amount of VAT due on total turnover and (b) the turnover of purchases and the amount of VAT actually paid on total turnover. The second stage is to ascertain the actual amount of tax due for payment.

7.7.2 The turnover of sales is the sum total of the amounts received or receivable (excluding VAT charged separately) in respect of the sale of goods, less the amount refunded to a purchaser in respect of goods returned within six months of the date of the sale. However, the following amount should be deducted from the total sales turnover:

- The total of exports and inter-state sales;
- The total amount of sales of tax free goods; and
- Branch/consignment transfers.

7.7.3 The next step is to segregate the turnover of sales during the return period (net of the above deductions) according to the relevant rates of tax applicable i.e. amount of turnover liable for say 4% VAT and amount of turnover liable for 12.5% VAT etc. This gives the total amount of VAT tax due. Similarly, the turnover of purchases is the total of the amounts paid or payable (excluding VAT charged separately) in respect of the purchase of goods less the amounts received back in respect of goods returned, within six months from the date of purchase. From the total purchases turnover, the following amount should be deducted:

- Imports from out of India

- Inter-State purchases
- Purchases of tax free goods
- Direct purchases from exempted units under the Package Scheme of Incentives
- Consignment transfers, and
- Local purchases from unregistered dealers.
- Local purchases from registered dealers not supported by tax invoice.

The resulting figure represents purchases against tax invoices from registered dealers.

7.7.4 If the sale price or the purchase price of any goods is subsequently changed and either a credit note or a debit note is issued, then the amount credit note or the debit note, as the case may be, should separately show the amount of tax and the price. These should be accounted for in the period in which the appropriate entries are made in books of accounts. However, if purchases include goods used

- as fuel, or
- for the manufacture of any tax-free goods, or
- as packaging for tax-free goods sold

7.7.5 Then the value of those purchased items has to be deducted from the amount of total purchases and the amount of taxes paid as set off may not be available. Similarly, if the goods are stock transferred by way of branch/consignment transfer to a place outside the State, set off of tax period may not be available. Similar adjustments are also sometimes made towards works contracts, office equipments, furniture/fixtures or capital assets etc. Similarly set off is also generally not available on goods of incorporeal or 'intangible' nature, passenger motor vehicles, motor spirits, crude oil, building material used for construction etc. No set off is generally available on purchases remaining unsold on date of discontinue of business. Set off for VAT paid on purchase is available only if valid tax invoice for that transaction is available and account of purchases showing the specified details is maintained. The amount of set-off so worked out admissible can be adjusted against tax payable. The amount of net tax payable is the total of sales tax collected on sales minus the set-off available.

7.7.6 If the amount of set-off admissible during the period is more than the amount of tax payable, the periodic VAT return would reflect a balance refundable. The amount of set-off can be more than the tax payable for a variety of reasons, such as –

- Inputs are taxable at higher rate as compared with the rate of VAT tax on output.
- Outputs are tax-free goods while inputs carry tax.
- Outputs are export sales.
- Outputs are CST sales which are taxable at the concessional rate of CST.
- Manufactured goods or trading goods are transferred to branches outside the State or are sent on consignment transfers.

The excess credit can also be on account of:

- unutilized portion of tax deducted at source or
- refund payment order or
- ad-hoc payment made is more than tax payable.

7.7.7 VAT is a self-assessment system and each dealer is expected to make self-assessment for a given tax period and declare his VAT liability by filing returns. The returns have to be filed in the prescribed form and by the specified dates. Further, we are required to pay the tax due as per the return filed. Normally, VAT does not envisage any special records or books to be kept for VAT purposes. However, the records that are kept should have sufficient details to enable to correctly calculate the amount of VAT due for payment and file periodic return. The following records are generally required for VAT:

- to enable to identify the nature and value of goods purchased and sold;
- to distinguish between
  - o local sales, inter-State sales & exports
  - o local purchases, inter-State purchase & imports
- to indicate value of
  - o sale and purchase of tax free goods
  - o sales exempted from tax
  - o purchases from un-registered dealer
  - o rate-wise purchases & sales
  - o local purchases from registered dealer with VAT shown separately
- to record payments for the purchases and sale of goods in cash book/bank book.
- to include a summary of VAT paid separately on purchases, VAT charged on sales, VAT paid to the State treasury and VAT refundable/refunded.
- to contain adequate proof that goods have been exported or imported;
- to be supported by invoices for all goods purchased and copies of invoices, and bills or cash memoranda etc. issued for goods sold.

7.8.7 If annual turnover of sales of any dealer exceeds Rs. 40 lakh, or in case of some of the states, it satisfies other conditions like a license for the manufacture or sale of liquor is held etc. the VAT books of accounts audited are required to be by a practicing Chartered Accountant/Cost Accountant (in most of the States). The audit report is generally required to be made in the prescribed format.

7.8 Special Audit of Excise and Customs Records by Cost Accountant

7.8.1 Central Excise is the single largest source of revenue through indirect taxes for the Central Government of India. “The Central Excise and Salt Act, 1944” was notified in the year 1944 by combining the 11 different Acts existing for decades.

7.8.2 Excise duty is a tax levied on goods manufactured or produced in India. This duty is collected by the Central Excise Department under the authority of Central Excise Act, 1944 and Central Excise Rules, 1944. The term "manufacture" under the Central Excise requires the presence of following four characteristics:-

(a) A process must be carried out;

(b) The said process must result in the manufacture of a new product than what was originally before;

(c) The product so produced must have a marketability and commercially known and sold as such; and

(d) The product must be movable in nature.

7.8.3 In other words, the term "excisable goods" is referred to those goods which are mentioned in the Central Excise Tariff Act, 1944 and possessing the following characteristics:

(a) Goods must come out of MANUFACTURING PROCESS;

(b) Goods must be MOVABLE (No excise duty on immovable goods)

(c) Goods must be MARKETABLE (can be bought and sold)

(d) Goods must be MENITONED in the Central Excise Tariff Act.

7.8.4 The organisation structure of the Excise Department is almost similar to the organisation structure of the Income Tax Department. Central Board of Excise and Customs (CBEC) is the apex body for administration of both Central Excise duties and custom duties. This is a statutory board set up under the Central Boards of Revenue Act, 1963. Immediately below the CBEC are the Chief Commissioners, who are administratively in charge of several commissionerates, each of which is headed by a Commissioner. The organisation structure of a commissionerate is as under:

Commissioner

Additional Commissioner / Joint Commissioner

Deputy Commissioner

Assistant Commissioner (Divisions)

Superintendent (Ranges)

Field Officers (Inspectors)

7.8.5 There are various types of excise audits. In addition, a unit can have its own internal audit. Services of Cost Accountant can be availed by Excise and Customs Department for auditing Excise and Customs records of assesses in certain cases. The legal provisions in this regard explained below –

(a) Selective audit by Central Excise Department

An Audit section is attached to each Commissionerate. Some audit parties are functioning under Commissionerate headquarters, while some others may function at important industrial centres where Joint Commissioner or Addl. Commissioner has been posted. These Audit Parties usually consist of three to four inspectors, headed by a Superintendent. These audit parties visit factories periodically. Audit by these audit parties is called 'departmental audit'. Since audit of assessees is done on selective basis, the audit is also termed as 'selective audit'. Such audit parties check records, see the operations of factory and carry out test checks etc. Excise returns are checked with other records and returns like balance sheets, bank statements, stores ledger, buyer-wise ledger, return to department of industries and other Government authorities etc. These checks are done on selective basis. If their queries are not replied satisfactorily, show cause notices cum demands are issued and adjudicated as per Excise Rules.

(b) Excise Audit 2000 (EA-2000)

Central Excise Authorities have dispensed with all statutory records as a measure of simplification of procedures. Therefore assesses are not required to maintain the record of each receipt of raw material, production and clearance/sale of finished goods etc. in the registers/documents earlier prescribed by the Central Excise Department. Assesses are now allowed to maintain all their records in whichever from they like (including maintenance of the entire records in electronic form) provided the essential information required for calculation of central excise duty liability can be obtained from such records. Therefore, it becomes necessary for the auditors to look into the assesses records to verify whether the assessee is paying central excise duty correctly and following the laid down procedures.

So a need was felt for a change of approach in Excise Audit. Efforts should be to have a more effective system of audit to encourage greater compliance rate and more revenue. Moreover, it was also felt that Self Assessment has shifted the focus of departmental checks from pre-clearance to post clearance. Therefore, a strong and professional audit system based on basic accounting/auditing principles was envisaged to balance the twin objectives of safeguarding revenue and transparency.

In view of above, a new system of audit i.e. Excise Audit 2000 (EA 2000) was initiated from 1st December 1999. Excise Audit 2000 is the audit based on the scrutiny of business records of the assessee. This is a more systematic form of audit, wherein the auditors are required to gather basic information about the assessee and analyze them to find out vulnerable areas before conducting the actual audit. The audit is therefore more focused and in-depth as compared to the traditional audit. Further, at every stage of audit, the assessee is consulted. This makes EA 2000 audit user friendly.

The process of EA 2000 begins with identification of a unit to be audited. About 300 to 400 units are selected for conducting audit during a financial year based upon the manpower availability. The units were picked up for audit randomly under the conventional system without any scientific basis of selection. Under EA 2000, the selection of the unit is based on taking into account in the 'risk-factors'. The assesses, who have a bad track record (having past duty evasion cases, major audit objections, past duty dues etc.) are given priority for conducting audit over those having clean track record.

The auditors are required to gather as much information about the assessee as possible. They can gather information from the departmental records, published documents like balance sheets annual statements etc., and through market Enquirer. Since this can be done without interacting with the assessee, this step called as 'desk-review'. The department has now decided to use the expertise of Chartered/Cost Accountants during this process of desk review

(Circular No. 821/18/2005 dated 7.11.2005) and has issued guidelines for selection of cases for Desk review by Chartered Accountants/Cost Accountants. At this stage of 'Desk Review', the auditors may have already identified certain areas which warrant closer examination from the assessee to complete his preliminary investigation. For this he may write letter to the assessee or send him a questionnaire to obtain this information. This step is called 'gathering and documenting assessee information'. The auditor then visits the unit of the assessee to see the actual running of the unit, the systems that are followed for maintaining records in various sections and the system of movement of goods and the related documents within the unit. This step is called 'touring of the premises'.

The next step is the conduct of actual audit, which in technical parlance is called 'Verification'. The auditors visit the unit of the assessee on a scheduled date (informed to the assessee in advance) and carry out the scrutiny of the records of the assessee as per the audit plan. The auditor is required to compare the documentation of a fact from different documents. For example, the auditor may check the figures of clearance of finished goods showed by the assessee in central excise return with the sales figures of the said goods in Balance Sheet, Sales Tax Returns, Bank statements etc. The auditor may also enquire about the entries which appear vague (say an entry like 'Misc. Income') in various records and documents. The process of verification is always carried out in presence of the assessee so that he can clarify the doubts and provide required information to the auditor.

A 'Draft Audit Report' is prepared at the end of the verification stage. An audit report provides (issue or para wise) the issue in brief, the reply or the explanation of the assessee, the reason for the auditor not being satisfied with the reply, the amount of short payment (if tabulated) and the recoveries of the same (if could be made at the spot). The draft audit report is then reviewed by the senior officers to ensure the sustainability of the objections raised by the auditors. The audit report becomes final after such review and in cases where the disputed amounts have not already been paid by the assessee at the spot, demand notices are issued by the department for their recoveries.

(c) CERA – Audit of C and AG

Comptroller and Auditor General of India also carry out audits of all assessees. These are called 'CERA' i.e. Central Revenue Audit. These audit parties audit accounts of excise as well as customs assessees. C&AG Audit Report shall be submitted to President of India, who causes these to be laid before each House of Parliament. CERA audits are conducted as a part of audit of Government accounts. Thus, these audits are conducted under Constitutional authority and are in no way connected or related to internal audits carried out by the staff of excise department. Frequency of CERA Audits is as per the importance attached and availability of time to CERA audit parties.

(d) Self Audit (Internal Audit)

Each Company should conduct self audit of their excise operations for various purposes (a) to ensure that all excise rules and procedures are being scrupulously followed to avoid any penal consequences, (b) to ensure that duty is not paid in excess and classification and valuation is correct. All allowable deductions are claimed. (c) Cenvat is claimed on all inputs and inputs are procured from such sources that Cenvat credit on all inputs is available, (d) all export benefits are availed, (e) train people in excise law. Such audit can be conducted by expert employees of the company or outside experts. Such audits will be highly beneficial to industry.

(e) **Special Audit by Cost accountant**

In addition to departmental audit and audit by CERA, excise and customs authorities are empowered to order special audit by Cost Accountant. The audit can be in respect of Valuation under Central Excise or Cenvat credit. Customs department can order audit by cost accountant in respect of custom bonded warehouse.

Special audit of excise can be ordered in respect of *Excise valuation or Cenvat credit.*

(i) **Valuation Audit:** Valuation is one of the most vital and critical aspects of assessment of excise duty payable. In order to ensure that duty is being paid correct 'Assessable Value', a provision has been made to order a 'Special Audit' in some specified cases vide section 14A of CEA. The audit can be ordered only with prior approval of Chief Commissioner of Central Excise. Valuation Audit under section 14A can be ordered at any stage of enquiry, investigation or any proceedings before Assistant/Deputy Commissioner regarding assessable value of the goods manufactured by assessee, if the Assistant/Deputy Commissioner is of the opinion that the value has not been correctly declared by a manufacturer or any person. It may be noted that under rule 173C(3), 'enquiry' in respect of 'value' can be made as soon as Invoice is raised or 'Declaration regarding Assessable Value' is filed with Assistant/Deputy Commissioner. The special audit for valuation can be ordered by Dy./Asst. Commissioner with prior approval of Chief Commissioner.

(ii) **Cenvat credit audit**: As per section 14AA of CEA (added w.e.f. 14th May, 1977), special audit of Cenvat credit availed or utilized can be ordered by Commissioner of Central Excise. Such audit can be ordered if the Commissioner of CE has reasons to believe that (a) Cenvat credit availed or utilized is not within the normal limits, having regard to nature of final products and type of inputs, (b) Cenvat credit has been availed or utilized by reason of fraud, collusion or any willful misstatement or suppression facts. Such audit can be done by practicing 'Cost Accountant', to be appointed by Commissioner of CE. Expenses of and incidental to such audit, including the remuneration payable to the cost accountant shall be paid by Central Government (i.e. excise department). Audit of Cenvat credit availed or utilized by a manufacturer can be ordered under section 14AA if Commissioner has 'reason to believe' that Cenvat credit availed is not normal or the credit has been availed on account of fraud, willful misstatement, suppression of facts or collusion.

7.8.6 The Special Audit Order in case of valuation (Section 14A) can be issued by Assistant / Deputy Commissioner only with prior approval of Chief Commissioner of Central Excise. Audit order in case of Cenvat (Section 14AA) can be ordered by Commissioner. Such order can cover accounts of his factory, office, depots, distributors or any place, as may be specified in the order. Audit has to be done by a qualified Cost Accountant. The Cost Accountant has to be nominated by Chief Commissioner in case of valuation audit [Section 14A (1) of CEA] and by Commissioner of Central Excise in case of special audit of Cenvat credit [Section 14AA (1) of CEA]. Such audit is irrespective of any other audit that may be carried out under any other law [Section 14A (3) of CEA and section 14AA (3) of CEA]. The Cost Accountant must be a member of Institute of Cost and Works Accountants of India, holding Certificate of Practice.

7.8.7 The Cost Accountant has to submit his audit report within the time specified in the order with such other particulars as may be prescribed by the Central Excise Officer. The Special Audit Report has to be signed and certified [Section 14A (2) of CEA and Section 14AA(2) of CEA]. The report should be submitted within time prescribed by Central Excise Officer. In case of special audit for valuation. Such period can be extended at the request of manufacturer for material and sufficient reason. However, the maximum period for submission of audit report is 180 days from date of receipt of Special Audit order by the manufacturer. (Section 14A(2) of CEA). In case of special audit of Cenvat credit, the audit report has to be submitted within the period prescribed by the Commissioner [Section 14AA(2) of CEA]. The expenses of audit and audit fees shall be paid by excise department.

7.8.8 If the Central Excise officer proposes to utilize the information gathered on basis of the audit, the manufacturer shall be given opportunity of being heard [Section 14A(5) and Section 14AA(5) of CEA]. The Central Excise Act does not specifically grant any powers to Cost Auditor. However, it has been held that where an Act confers a jurisdiction, it impliedly also grants the power of doing all such acts, or employing such means, as are essentially necessary to its execution – M K Mohammed Kunhi – AIR 1969 SC 430 (1969) 71 ITR 815 (SC) Para 4 – quoting from 'Maxwell on Interpretations of Statutes' with Statutes' with approval. [For example, if a court is empowered to grant an injunction, the power to punishing disobedience is impliedly conveyed by the enactment, for the power would be useless if it could not be enforced.] Thus, powers to conduct Valuation Audit or Cenvat credit audit by a Cost Accountant include incidental and ancillary powers like calling for and examining records, calling persons for discussion and explanation, visiting places essential for carrying out Special Audit etc. Of course, the Cost Auditor has no powers to punish a person for not furnishing required information. In such cases, he may report the fact to Assistant/ Deputy Commissioner, who has powers to summon a person and call for records. If a party does not supply information which is in his possession, an adverse inference can be drawn.

7.8.9 Special Audit should be from point of view of purpose i.e. Valuation for Central Excise if order is under section 14A and Cenvat credit if order is under section 14AA. Thus, provisions and principles of Central Excise in respect of valuation / Cenvat credit should be kept in mind while presenting the data and figures so that adjudicating authority may take suitable action. The Cost Auditor should check the records from valuation / Cenvat point of view as per order. Similarly, in case of records of customs bonded warehouse, auditor should ensure that inputs imported free of duty are utilized for the purpose for which they were imported and any provisions in respect of such imports are not violated.

7.8.10 The Auditor may take following precautions during the special audits :

* He should refrain from offering his views on admissibility or otherwise of a particular expenditure or Cenvat credit. His duty is only to present figures in proper perspective – nothing more, nothing less.
* Auditor should remember the age old maxim: "Auditor is a watch dog, not a blood hound."

* He need not look at everything with jaundiced eye.

* He should look at the situation with a practical and pragmatic view.

7.8.11 Special audit for valuation may be ordered in following or similar situations : (a) where assessee is claiming deductions from the assessable value, which prima facie do not appear to be justified (b) department (during Internal audit check or otherwise) finds that some expenses are being recovered separately and would like to carry out detailed examination (c) Huge difference between turnover as declared in annual accounts and the total sales as per summary of monthly returns (d) Annual accounts showing large amounts as 'other income' which is not properly explained (e) The price as declared appears to be very low compared to price of comparable products (f) any other reason due to which there is suspicion that the value as declared is not the correct value. Audit of Cenvat credit availed may be ordered where prima facie, cost or quantity of inputs appears to be abnormally high compared to selling price and/ or quantity of final products.

7.8.12 The form of Special Audit report will vary depending on terms of reference and type of industry. Section 14A or section 14AA of Central Excise Act does not prescribe and specific form for this purpose. However, as a guideline, it is suggested that the report should contain following details :

(a) In case of valuation audit, following details may be given:

(i) *Basic Information about the manufacturer* : Basic information about manufacturer like management controlling the unit, capital structure, major products, major raw materials, location of registered office and factories (with address, phone numbers, FAX numbers, E-Mail number etc.), capital investment, number of employees, major machinery etc.

(ii) *Manufacturing process:* Brief outline of manufacturing processes and major capital equipment may be given.

(iii) *Marketing organization:* Information about marketing network, number of distributors, normal credit terms, discount structure, production distribution network may be given. If 'prima facie' it appears that dealers are 'related persons', this may be mentioned, but without expressing any opinion about the same.

(iv) *Accounting Policies:* Salient features of the accounting policies of the Company may be stated.

(v) *Cost Details:* Cost of major products in comparison with its Net Realisable Value and profit as percentage of total cost may be given. Basis of Cost allocation and apportionment may be mentioned. The costs should be preferably worked out on basis of normal production norms. Items like *Income unconnected with manufacturing activity * Abnormal Costs * Abnormal Receipts should be segregated and should not be considered. Basis of cost calculations should be disclosed. [It may be noted that legally, Assessable Value is based on selling price (transaction value). Thus, technically, no objection can be raised if a unit sells below its cost. However, it has to be seen that the decision to sale below total cost is taken on the basis of sound commercial considerations alone.]

(vi) *Expenditures claimed as deductions:* In respect of expenses claimed as deduction by manufacturer, (like freight, packing charges, taxes etc.) details of expenditure claimed and actual expenditure during the period may be given, Break up of 'Actual expenditure' like * Direct Expenditure *Overhead allocable to the activity (if applicable) *Normal profit on the activity (if applicable) may be given.

(vii) *Expenses charged separately:* The manufacturer may charge some expenses (like design charges, installation charges, packing charges, transport charges etc.) separately through debit notes/credit notes or other arrangements. Details of expenditure charged separately and actual expenditure incurred on that account during the year may be given. Breakup of 'Actual expenditure' like * Direct Expenditure * Overhead allocable to the activity (if applicable)* Normal profit on the activity (if applicable) may be given.

(viii) *Effect of other items on value :* Some items not directly related to costs and prices as reflected in accounts may have bearing on the 'Assessable value' of product e.g. (a) Some expenditure may be incurred by others on behalf of manufacturer e.g. dealer may incur advertisement expenses on behalf of manufacturer or buyer may supply dies and fixtures himself. It may be examined whether this had some effect on selling price. (b) Buyer may advance some interest free loans. It may be seen whether this has depressed the selling price. (c) Buyer may have supplied some raw materials. It should be seen whether its cost is includible. Special Audit Report should make mention of these and quantify them to the extent possible.

(ix) *Reconciliation with sales turnover shown in a balance sheet :* Sales turnover shown in Balance Sheet of the company should be reconciled with the total of Assessable Values of corresponding period of 12 months shown in excise records. This will ensure that only permissible deductions have been claimed.

(x) *Documents checked:* Auditor should give details about the list of account books and other documents examined. The Auditor may also mention whether he got all the information required by him and whether the figures given in his report, in his view, are 'true and fair'.

(xi) *Aspects to be covered in report :* Auditor should give his special attention and his comments and findings on the following : * Whether Net Realisable Value is fair and reasonable considering the total cost of product * Additional charges made over and above value shown in invoice * Debit notes and credit notes raised separately * Agreements with distributors/buyer with particular reference to clauses likely to affect valuation * Materials supplied by buyers if any * Reconciliation with turnover shown in annual accounts and the total of 12 months Assessable Values as shown in excise records.

(xii) *Specific Observations and comments:* The Cost Auditor may make some observations, which, in his opinion, may be relevant for valuation purposes. However, he should refrain from making any comment on admissibility or otherwise of a particular expense, as that is the function of adjudicating authority alone.

(b) In case of audit of Cenvat credit, following details may be given.

(i) *Basic Information about the manufacturer* – Basic information about manufacturer like management controlling the unit, capital structure, major products, major raw materials, location of registered office and factories (with address, phone numbers, FAX numbers, E-Mail number etc.), capital investment, number of employees, major machinery etc.

(ii) *Manufacturing process:* Brief outline of manufacturing processes and major capital equipment may be given.

(iii) *Material Purchase organization* – Information about major supplies of inputs, mode of ordering, receipt and accounting of inputs and capital goods etc. may be given. If 'prima facie' it appears that some purchases or Cenvat credit documents are doubtful, this may be mentioned, but without expressing any opinion about the same.

(iv) *Trend of availment of Cenvat credit:* Assessee pays part of duty in cash (i.e. PLA) and part through Cenvat credit. Broadly, % of Cenvat credit to total duty paid in last three years should be analysed and summarized. If there are major variations, these should be explained. Cenvat credit availed on capital goods should be separately indicated and analyzed, vis-à-vis the assets capitalized in the annual accounts of the company.

(v) *Input-output ratios:* Input output ratios of major raw materials and Cenvat credit on those raw materials should be indicated, preferably for last three years.

(vi) *Documents checked:* Auditor should give details about the list of account books and other documents examined. The Auditor may also mention whether he got all the information required by him and whether the figures given in his report, in his view, are 'true and fair'.

(vii) *Aspects to be covered in report :* Auditor should give his special attention and his comments and findings on the following - * Input-output norms and utilization of inputs vis-à-vis outputs * Correlation of Cenvat credit documents with financial accounts like creditor's ledger, material purchase account, transporter's documents etc. * Cross check of some Cenvatable invoices with Range Superintendent of the manufacturer / dealer from whom goods were received * Last three years' trend of 5% of Cenvat credit to total duty paid. If there is any significant variation, causes should be investigated.

(viii) *Specific Observations and comments:* The Cost Auditor may make some observations, which, in his opinion, may be relevant for purposes of Cenvat credit availed. However, he should refrain from making any comment on admissibility or otherwise of any Cenvat credit, as that is the function of adjudicating authority alone.

7.9 Audit When Goods are Manufacutred in Customs Bonded Warehouse

7.9.1 With the sanction of Assistant Commissioner, manufacturing or other operations can be carried out in the warehouse (Section 65 of Customs Act). The facility is useful if final products are to be exported after manufacture (though final products can be cleared for home consumption too). After manufacture, the produced goods may either be exported without payment of customs duty or cleared for home consumption on payment of duty. These provisions are applicable to EO, FTZ, STP or EHTP units who have to manufacture goods under customs bond.

7.9.2 Facility for manufacture in warehouse under bond is also available for goods imported for repairs, reconditioning, re-engineering etc. The goods can be imported without payment of customs duty and can be re-exported after repairs, reconditioning etc. Such re-export must be within three years from date of import. *[Notification No. 134/94 – Cus dated 22-6-94]*. Board has framed 'Manufacture and Other Operations in Warehouse Regulations, 1966' prescribing procedures. Procedures for manufacture under bond have not been considerably simplified. Physical control and supervision of customs officer on the bonded warehouse has already been done away since July 1998.

7.9.3 Owner has to make application giving full details regarding process to be carried out, imported and other goods used, plan and description of warehouse volume of manufacture anticipated. On obtaining permission, necessary bond has to be executed undertaking to observe all regulations and maintaining accounts etc. Manufacture will not be under supervision of Customs Officers. However, customs officers can visit warehouse and control and supervise manufacturing process or imported and other goods. Detailed accounts are required to be maintained of raw materials, stock, WIP and production. Input-output norms should be fixed wherever considered necessary.

7.9.4 There is no physical control of customs authorities over clearances of raw materials / components to job workers, clearances to other EOUs, export and sale to DTA etc. However, proper records should be maintained. Account of duty free goods can be kept on overall basis and not consignment wise. The rules require that the units should maintain following records : (i) Bond register showing receipt and issue of goods (ii) Issue Notes (iii) Manufacturing Register (iv) Finished product register (v) Reject / scrap register (vi) Export Register (vii) Sub-Contract Register (viii) DTA Sale register (ix) Indigenous goods register showing receipt and issue. [CCE, Indore TN 1/2001-Cus dated 12.2.2001]

7.9.5 Till 1998, manufacture in warehouse was required to be under physical supervision of customs authorities. The requirement of physical supervision has now been removed. However, to ensure proper control, provision of special audit has been made. Special audit of accounts of the warehouse can be ordered by Chief Commissioner of Customs. He can appoint a cost accountant to conduct audit of accounts of warehouse, office, stores, godowns, factory and depot of the manufacturer. In case of special audit of customs bonded warehouse, following details may be given.

(a) *Basic Information about the manufacturer :* Basic information about manufacturer like management controlling the unit, capital structure, major products, major raw materials, location of registered office and factory (with address, phone numbers, FAX numbers, E-Mail number etc.), capital investment, number of employees, major machinery etc.

(b) *Manufacturing process:* Brief outline of manufacturing processes and major capital equipment may be given.

(c) *Input-output ratios:* Input output ratios of major raw materials should be indicated, preferably for last three years.

(d) *Documents checked:* Auditor should give details about the list of account books and other documents examined. The Auditor may also mention whether he got all the information required by him and whether the figures given in his report, in his view, are 'true and fair'.

(e) *Aspects to be covered in report:* Auditor should give his special attention and his comments and findings on the following -

* Input-output norms and utilization of inputs vis-à-vis outputs
* Correlation of customs documents of import of inputs and export of final products with financial accounts like creditor's ledger, material purchase account, transporter's document etc.
* Last three years' trend of % of inputs to final products. If there is any significant variation, causes should be investigated.
* Scrap sale.
* Sale in domestic tariff area (DTA) – whether as per permissible norms.

(f) *Specific Observations and comments:* The Cost Auditor may make some observations, which, in his opinion, may be relevant for purposes of audit. However, he should refrain from making any comment on admissibility or otherwise of any Cenvat credit, as that is the function of adjudicating authority alone.

7.10 Legal Position of Special Audit Reports

7.10.1 Special Audit report is like an 'Expert Report' for legal purposes. Report of Cost Auditor in special audit is an 'expert opinion'. Section 45 of Evidence Act provides that opinion of an expert is a 'relevant fact'. Thus, opinion of Cost Accountant in his report can be considered while adjudicating an issue. In State of Himachal Pradesh v Jail Lal AIR 1999 SC 3318 = 1995(5) SCALE 445 (SC), it was held that it has to be shown that an expert has made a special study of the subject or acquired a special experience therein, or in other words that he is skilled and has adequate knowledge of the subject. - The credibility of expert depends on the reasons stated in support of his conclusion and the data and materials furnished which form the basis of his conclusion. - Expert has to be examined as a witness in Court and has to face cross-examination. - Court can decline to place reliance upon evidence of witness (expert) unsupported by any reason.

7.10.2 The reports should give the basis of all figures including assumptions, if any made. In case of costing report, basic costing method applied, method or overhead allocation, basic assumptions made, documents checked etc. must be disclosed in the Cost Audit report. Similarly, in case of chemical report, mode of testing should be given, if relevant. In *Skanan Hardware (P.) Ltd. V. CC* – 1992 (57) ELT 306 (CEGAT), it was observed : "A bald reference to the value in show cause notice (without showing the basis on which expert valued the goods) does not give any effective opportunity to assessee to rebut or challenge the same. This is in violation of principles of natural justice."

7.10.3 Expert should not give any opinion beyond his exact scope of work or assignment. Functions and duties of a Cost Auditor is to analyse the data in such a way that adjudicating authority can take a view about admissibility or otherwise of a particular head of expenditure. The Auditor is not expected to give his views on allowability or otherwise of a particular deduction or Cenvat credit, and such observation will be normally considered beyond his scope of authority. In *Novopan Indian Ltd. v. CCE* 1994 (73) ELT 769 (SC), it was held that expert opinion obtained to bolster party's case is not reliable especially when their opinion is not backed by any technical literature or authority – followed in *CCE* v. *Kedia Agglomerated Marbles Ltd*. – 1995 (77) ELT 710 (CEGAT).

7.10.4 The opinion of an expert has to be treated in law as evidence of any other witnesses and does not stand on any higher footing. Expert or no expert, the Court or Tribunal cannot shirk the responsibility in applying its mind before reaching a conclusion – *Rubicon v. CCE* – 1998 (38) ELT 353 (CEGAT). Expert opinion is only a relevant piece of evidence and ultimately, it is for quasi-judicial authorities to adjudge the correctness of same by applying their mind – *Kiran Overseas v. CC* – 1988 (38) ELT 362 (CEGAT). Giving opinion about eligibility of exemption of goods would be overstepping the jurisdiction of the expert – *CCE* v. *General Pharmaceuticals (P.) Ltd., Pune* – 1986 (26) ELT 1050 (CEGAT). An expert (chemical examiner in this case) has to furnish the result of his tests. It is not his province to give opinion on tariff classification – *N P Venkataraman Iyer* - 1986 (23) ELT 471 (CEGAT) * *Danmet Chemicals v. CC* 1999 (112) ELT 844 (CEGAT). Chemical examiner has only to state his expert opinion and not to suggest classification under any particular heading – *Triton Synthetic Fibres v.* CCE 1999 (106) ELT 557 (CEGAT) * *Warren Laboratories* v. *CCE* 1999 (114) ELT 447 (CEGAT). Chief Chemist cannot decide on classification of goods – *Oxide (I) P. Ltd. v. CCE* 2001 (128) ELT 513 (CEGAT).

7.10.5 When reliance is placed on the opinion of expert and a plea is made for cross-examination of the expert, the expert should be made available normally for cross-examination. - *Vijayalakshmi v. CCE* – 1993 (68) ELT 696 (CEGAT). In *Visalakshmi Mills v. CCE* 1998 (104) ELT 499 (CEGAT), it was held that if show cause notice is based on test report, opportunity to cross examine the Dy Chief justice Chemist should be given. Otherwise, it will amount to violation of principles of natural justice. – similar views in *Hindalco Industries Ltd. v. CCE* 1999 (114) ELT 297 (CEGAT) * ELT 607 (CEGAT) * *Triumph Leather v. CCE* 2001 (130) ELT 262 (CEGAT). In *Modipon Ltd. v. CCE* 1999 (114) ELT (1006) (CEGAT), it was held that cross examination of Chemical Examiner should be allowed if method adopted for testing, if relevant, is not mentioned in the report. – similar views in *A K Gupta v. CCE* 2000 (123) ELT 901 (CEGAT), in case of cross-examination of Director (Antiques) of Archaeological Survey of India, when his report formed foundation of the case.

7.10.6 In *Carrara Marble v. CCE* 2001 (129) ELT 654 (CEGAT), it was held that cross-examination cannot be denied only on the ground that the report is given by an ancient and reputed institution (Geological Survey of India in this case). Mere age and reputation of institution cannot justify refusal of cross-examination. It is not possible that all employees of the reputed organization are so perfect in their job that their word is to be accepted without question. Even eminent professional may make mistake in the opinion. In *Shalimar Agencies v. CC* 2000 (120) ELT 166 (CEGAT), it was held that if expert does not appear for cross-examination, either his appearance should be forced or evidence tendered by him should be discarded.

7.10.7 The Report of Cost Accountant is like any other report of expert. Any evidence to be used against the assessee had to be made known to him and his objections should be noted. If required, the assessee could adduce evidence as to why such a report should not be accepted or accepted in modified manner. If the assessee so desires, such an expert could be called for tendering evidence and could also be cross-examined, if the assessee so chooses. In any case, the adjudicating/appellate authority has to come to his own decision in consonance with principles of natural justice – *Sunder Singh and Co. (P) Ltd. v. CCE* – 1993(68) ELT 812 (CEGAT).

7.10.8 Annexure 27 of Cost Audit Report Rules, 2001 relating to Central Excise Reconciliation for the product under reference is reproduced below as the information will be useful for conducting valuation audit and Cenvat audit under Section 14A and 14AA of the CEA.

27. Central excise reconciliation for the product under reference:

Particulars	**Chapter Heading**	**Chapter Heading**	**Chapter Heading**
A. Quantitative Details :			
1. Opening Stock			
2. Add : Production			
3. Less : Closing Stock			
4. Total Sales / Clearance			

Particulars	**Assessable Value (Rs.)**	**Rate of Duty**	**Amount of Duty (Rs.)**
B. Details of Clearances :			
1. Total Clearance (Chapter heading wise)			
2. Less : Duty Free Clearances (factory)			
3. Excisable Clearances (factory)			
4. Penalty/Fine/Interest payable if any			
5. Total Duty Payable (total 3 & 4)			

Particulars	**Inputs**	**Capital Goods**	**Total**
C. Summary of Cenvat Credit :			
1. Opening Balance			
2. Add : Availed During the year			
3. Add : Refunds received during year			
4. Less : Closing Balance as per Excise Records			
5. Total Cenvat credit utilized during the year (1 + 2 + 3 – 4)			
6. Closing Balance as per Annual Accounts			
7. Difference between 4 – 6			
8. (State amount and reasons for difference)			

Particulars	**Amount (Rs.)**
D. Reconciliation of Duty Paid	
1. Excise Duty Payable as per 'B'	
2. Total Excise Duty paid through	
a) Cenvat Account – (Inputs)	
b) Cenvat Account – (Capital Goods)	
c) P.L.A.	
Total (a + b + c)	

Particulars	Amount (Rs.)
3. Difference between (1 – 2)	
4. (State amount and reasons for difference)	
5. Excise Duty as per RT–12	
6. Difference between (2 – 5)	
7. (State amount and reasons for difference)	
E. Reconciliation of Duty Paid and Recovered	
1. Excise Duty paid as per P & L A/c	
2. Excise Duty Recovered as per P & L A/c	
3. Difference between duty paid and recovered	
4. (State amount and reasons for difference)	
F. Reconciliation of Turnover :	
1. Turnover as per RT 12	
2. Turnover as per Annual Accounts (Net of Duties & Taxes)	
3. Difference between (1 – 2)	
4. State amount and reasons for difference	

7.11 Environment Audit

7.11.1 Environment is the surroundings in which a person, animal or plant lives. Environment Protection is the policies and procedures aimed at conserving the natural resources, pre-serving the current state of natural environment and if possible, reversing its degradation. In other words Environment Protection refers to any activity aimed to maintain or restore the quality of environmental media through preventing the emission of pollutants or reducing the presence of polluting substances in environmental media. Life and natural environment are closely interrelated. Without natural environment, the creation and survival of life are impossible. Man forgets his responsibility in maintaining ecological balance for personal pleasure. The mad-race after materialism compels man to exploit the natural resources thoughtlessly without taking into consideration of the inevitable consequences relating to the life of the human species on earth.

7.11.2 "Pollution of the environment" means pollution of the environment due to the release (into any environmental medium) from any process of substances which are capable of causing harm to man or any other living organisms supported by the environment.

7.11.3 The global concern and awareness for environmental issues has risen significantly during past two decades precipitated in past by the major incidents like Bhopal Chemical leak (1984), Exxon Valdez oil spill (1989) and accident at Chernobyl Nuclear Power Plant (1986). These incidents got international media attention and concerns in addition to other environmental damage/issues like global warming, depletion of non-renewable resources etc. Therefore corporates have become increasingly aware of the environmental implications of their operations, products and services. The awareness and the concerns raised by the society and strict deterrent penalties/fines have ensured that environmental risks cannot be ignored. In fact any deficiency in environmental behaviour may have adverse impact on business in addition to severe punishments including fine, increased liability for environmental taxes, adverse media publicity, law suits, contingent liabilities and harm to corporate image and brand value in addition to many potential hidden costs.

7.11.4 In view of huge costs attached to environmental factors like protection and safeguarding or environment, environment costs should be appropriately reflected in the financial disclosures. However, existing conventional accounting systems are unable to adequately and scientifically compute the environmental costs. Therefore general practice is to assign the apparent direct costs to the general overheads. Therefore most of the organizations are not aware of their actual costs and managers have no incentive to reduce these costs. Therefore existing accounting techniques sometimes, distort and misrepresent environmental issues leading to organizations making decisions, which are not only bad for organization but also worst for environment. The most glaring example is the accounting for energy costs. A recent UK government publicity campaign concluded that most of the companies are consuming 30% extra energy on an average through inefficient practices. In other words energy costs on an average can be reduced by 30%, which in turn will proportionately reduce the pollution caused by production and use of additional 30% energy. Therefore management accounting techniques need to be reformed to incorporate environmental concerns, risks and liabilities. In absence of these details, the companies are unable to identify cost reduction and other improvement opportunities. This also leads to incorrect product mix and incorrect pricing besides increasing the risks exposure and other decisions having long term implications.

7.11.5 Cost Accounting Records Rules have taken an important step towards this direction and require the separate collection of expenses incurred for pollution control. Para 16 of the Cost Audit Report Rules provide for audit of these costs especially costs incurred for environmental protection. However, rules do not provide for determining the impact of pollution control abatement measures on the cost of production and the necessary costs for environmental protection.

7.11.6 The 'environmental audit' is an initial step towards the pursuit of environmental quality management. This environment audit makes the organization self-regulating. Moreover undertaking of 'environmental audit' on regular basis provides a platform for improvement aiming at "zero spills, zero pollution, zero waste and zero accidents".

7.11.7 Environmental audit is nowadays absolutely necessary for the survival of the industry and the economy to serve the best interest of the society at large. It is a systematic, documented, periodic and objective review by regulated entitites, of facility operations and practice related to meeting environmental requirements. The objectives of an environment audit are –

(i) to ensure cost effectiveness compliance with the statutes and company policies

(ii) cost savings from improved practices

(iii) to prepare data-base relating to pollution potential of all facilities

(iv) to make a social cost-benefit analysis

(v) to develop social reputation, confidence of customers

(vi) to develop overall awareness, identifying problems and areas of risk

(vii) to encourage the use of low waste technologies and prudent use of resources and to identify potential hazards and risks.

7.11.8 Environment audit has the following aspects –

(i) Technological and operational aspect involving audit of the technology of environment management as well as the operation of environment management system.

(ii) Environment valuation and environment costing without which environment management plans and policy implementation becomes useless and non-viable. Thus in the absence of such environment valuation and environment costing, the cost of environment damage cannot be assessed for determination of compensation. In brief we can point out that no effective Environment Regulatory policies and measures can be formulated and implemented without proper environment valuation/costing.

7.11.9 It may be observed that environment valuation/costing mostly uses standard methodologies of costing and cost accounting applied on baseline date (based on technical/scientific parameters and estimates and survey statistics published by various authorities) and a wide variety of environment models. For this exercise a cost accountant is required to apply his knowledge, tools and techniques in a creative way depending on the situation which varies widely from case to case.

7.11.10 In India there is no specific provisions in any environment related Acts and Rules thereof for statutory Environment Audit by External Auditors. However, there exists Environmental Impact Assessments (EIA) and Annual Appraisal of environment related performances documented in the form of Environment Statements which require exercise in the nature of audit. As a matter of policy followed by the Pollution Control Board, FIA statements are submitted after a kind of assessment/ appraisal by external examiners i.e. Environmental Consultants with the State Pollution Control Boards.

7.11.11 Similar kind of audit of Environmental Statement (required under Environment Protection Rules, 1986) by Practicing Cost Accountants should also be given due consideration. This is particularly because the critical information contents of the Environment Statement Form relate to –

(a) consumption of raw materials and other resources – product-wise and per unit of output,

(b) discharge of pollutants and waste (which is relatable to material movement, consumption and wastage through various process of production),

(c) impact of pollution abatement measures on the cost of production, and

(d) investment proposals/measures for environmental protection.

7.11.12 Similarly, waste management records to be maintained and annual returns to be submitted under Hazardous Waste (Management and Handling) Rule, 1989 may also be audited by Practicing Cost Accountants.

7.12 Relevant Provision Under the Indian Constituion

7.12.1 The Government of India looks after the environment not only on the instance of the Courts when an individual is seeking the enforcement of his right, but also as per specific provisions contained in the Constitution of India, namely –

(i) **Article 42:** The State should make provisions for just and human conditions of work.

(ii) **Article 43:** Securing living wages is not enough; State should endeavour to ensure decent standard of life.

(iii) **Article 44:** State to raise the level of nutrition and standard of living and to improve proper health.

(iv) **Article 48-A:** State shall endeavour to protect and improve the environment and to safeguard the forests and wild-life of the country.

(v) **Article 51-A(g) :** It is fundamental duty of every citizen of India to protect and improve the natural environment.

7.12.2 It is unfortunate that there is a lack of awareness about pollution and environmental hazards among the general public in our country although there are several enactments in our country relating to environment protection, some of which are as follows:

(i) The Factories Act, 1948

(ii) Water (Prevention and Control of Pollution) Act, 1974

(iii) Water (Prevention and Control of Pollution) Cess Act, 1981

(iv) Forest Conservation Act, 1980

(v) Air (Prevention and Control of Pollution) Act, 1981

(vi) Environment Protection Act, 1986

(vii) Hazardous Waste (Management and Handling) Rules, 1989

(viii) Public Liability Insurance Act, 1991

(ix) Motor Vehicles Act, 1991.

7.12.3 Rule 14 of the Environment (Protection) Act, 1986 requires an industry to submit annual Environmental Statement by 30th September each year from 1993 onwards to the relevant State Pollution Control Board. Rule 14 is applicable to any industry which possesses or requires consent/authorization under Water (Prevention and Control of Pollution) Act, 1974, Air (Prevention and Control of Pollution) Act, 1981, and/or Hazardous Waste (Management and Handling) Rules, 1989.

7.13 Powers of Environment Control Authorities (Extracts From Environment (Protection) Act, 1986)

7.13.1 **Environment (Protection) Act, 1986:**

Section 3: Power of Central Government to take measures to protect and improve environment

The Central Government may, if it considers it necessary or expedient so to do for the purpose of this Act, by order, published in the Official Gazette, constitute an authority or authorities by such name or names as may be specified in the order for the purpose of exercising and performing such of the powers and functions (including the power to issue directions under Section 5) of the Central Government under this Act and for taking measures with respect to such of the matters referred to in Sub-section (2) as may be mentioned in the order and subject to the supervision and control of the Central Government and the provision of such order, such authority or authorities may exercise the powers or perform the functions or take the measures so mentioned in the order as if such authority or authorities had been empowered by this Act to exercise those powers or perform those functions or take such measures.

Section 5: Power to give directions

Notwithstanding anything contained in any other law but subject to the provisions of this Act, the Central Government may in the exercise of its powers and direct any person, officer or any authority and such person, officer or authority shall be bound to comply with such directions.

Explanation – For the avoidance of doubts, it is hereby declared that the power to issue directions under this Section includes the power to direct –

(a) the closure, prohibition or regulation of any industry, operation or process; or

(b) stoppage or regulation or the supply of electricity or water or any other service.

(*Note*: It may be mentioned that the Central Government has delegated the powers vested in it under 9.5 of the Act (as mentioned hereinbefore) to various state governments).

7.14 Audit Under ERP Environment

7.14.1 The companies earlier used to store important business records in respective departments. All these departments used different systems, techniques and softwares to manage that information. Some times, same information would be collected differently by different departments without being necessarily identical or up to date. Most of this information would be on paper with one person, making it difficult to access by others in the organisation.

7.14.2 For example, data related to a product in a manufacturing firm is usually kept by the respective departments detailed as under:

(a) Inventory record by the stores department.

(b) Estimated cost or detailed cost break-up by the Costing Department.

(c) Department-wise salary and wages by the Payroll Department.

(d) Status of production/batch production of an item by the Production Department.

(e) Details of pending sales order for a product with the sales department etc.

(f) Etc. etc.

7.14.3 Therefore, if a customer wants to know about the delivery status of his order, the sales rep would ask the production department to track down the order instead of referring to a shared database. Now, if the production is held up for want of any input, the sales rep would pursue with Purchase Department to know the tentative date of delivery of critical input.

7.14.4 Enterprise Resource Planning (ERP) is the term used to describe a broad set of activities supported by multi-module application software, which helps the business in its management. It is a business management system that integrates all facets of the business, including planning, purchasing, manufacturing, sales and marketing etc., which are sometimes located at different geographic locations.

7.14.5 ERP Systems aim at serving the information needs of an organization. This enables each department of an organization to know what is happening in each of the departments. They seek to combine the separate records relating to the same subject at one place making them completely reliable and comprehensive.

7.14.6 In other words, the integrated nature of ERP's can further add to the risks or challenges of an organisation related to :

(a) Industry and business environment.

(b) User or management behaviour;

(c) Business processes and procedures;

(d) System functionality;

(e) Application security;

(f) Underlying infrastructure;

(g) Data conversion and integrity; and

(h) Ongoing maintenance/business continuity.

7.14.7 As the ERP methodology has gained popularity, software applications have emerged to help business managers to manage their functions like inventory control, order tracking, customer service etc. more efficiently and more effectively. In other words, ERP is the software solution to address the enterprise needs taking the process view of an organisation by tightly integrating all functions of an enterprise into unified system. It facilitates the enterprise wide integrated information system covering all functional areas. A key ingredient of most ERP systems is the use of a unified database to store data for the various system modules. The common database allows every department to store and retrieve information in real time. It allows information to be more reliable, accessible and easily shared.

7.14.8 Another advantage of Integrated System is that there will be single input to the computer record instead of multi-recording of the same set of information in the respective departments. The risks associated with the ERP system can't be assessed through review of particular application or technical risks in isolation. These risks have to be assessed in conjunction with the business process control objectives. The auditor should therefore understand the business and regulatory environment of the organization.

7.14.9 The unified nature of ERP systems necessitate that a risk assessment be performed and audit approach be modified accordingly. Integrated audits covering business processes and security aspects are necessary in the ERP environment. Segregation of duties and security management are inter-linked for evaluation of risk management. Trade off in separation of duties are made and compensated by automated controls.

7.14.10 The major characteristics of ERP systems necessitating change in audit approach are :-

(i) On-line real time processing.

(ii) All transactions are stored in one common database.

(iii) System usually resides on multiple computers.

(iv) Optimum co-ordination is a challenge.

(v) Traditional "batch" controls and audit trails not available.

(vi) Data bases can be accessed by any module.

(vii) System modules are transparent to the users.

(viii) Significant increase in number of users.

(ix) Network and data base access security is critical.

7.14.11 The audit of an ERP system requires specific knowledge and an understanding of the integrated complex features required for the successful implementation. The auditors require not only specialized skills but also capability to use unique methodologies to deal with various risks involved. Audit and Review guidelines should also be developed providing management oriented framework and proactive control self-assessment.

7.15 Bank Audit

7.15.1 Bank Audit in banks traditionally implies transaction audit i.e. verification of accounts based on flow of accounting transactions over a specified period of time, generally a period of 12 months. Banking business has undergone complete transformation during last two decades. The bank branches are no longer there for intermediary role only to mobilize funds from "surplus clients" and deploying these funds with the "deficient clients" for their business purposes. Today most of the commercial banks have embraced multi faceted financial services business like investment banking, treasury functions, project consultancy services, executor – executrix business and insurance business etc.

7.15.2 The effective conduct of bank audit requires that a comprehensive audit programme be chalked out based on the size of the branch, volume of the transactions, status of computerization and the classification of the branch. The effective audit of banks require that the team members are familiar with the following :-

(a) Exact scope of work i.e. whether it is Concurrent Audit, Stock Audit, Revenue Audit, Credit Risk Audit or any other assignment etc.

(b) RBI circulars relating to income recognition, asset classification and provisioning norms;

(c) Accounts closing instructions issued to the branches by the Head Office of the concerned bank;

(d) Guidelines issued to the auditors by the banks regarding certificates to be issued by them;

(e) The accounting system of the bank and the relevant internal controls;

(f) Salient features of Long Form Audit Report (LFAR);

(g) Audit procedure to be adopted;

(h) ICAI Guidance Note on bank audit;

(i) Various checklists for audit of different operations.

(j) Understanding the business of the branch with specific reference to applicable laws like:

 (i) Banking Regulation Act, 1949;

 (ii) Relevant State Co-operative Act;

 (iii) Multi State Co-operative Act, 2002;

 (iv) Service Tax Provisions;

(v) TDS Provisions under Income Tax Act;

(vi) Bank Cash Transactions Tax;

(vii) Prevention of Money Laundering Act, 2002.

7.15.3 The following areas are the critical areas in any bank audit :-

(a) Verification of Balance Sheet and Profit and Loss Account with main and subsidiary ledgers.

(b) Verification of all closing returns with the ledgers and registers.

(c) Review of inter-branch items and clearing differences.

(d) Verification of all large NPA advances and the provisioning thereof.

(e) Verification of all large advances granted during the year with specific reference to terms of sanction and documents.

(f) Balancing of books.

(g) PMRY loans granted during the year.

7.16 Concurrent Audit

7.16.1 Concurrent audit is a systematic examination of financial transactions on a regular basis to ensure accuracy, authenticity and compliance with procedures and guidelines. It is an examination, which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. The main focus of this audit is to ensure that transactions adhere to the system and laid down procedures. It serves the purpose of effective internal control as it reduces the time gap between occurrence of a transaction and its overview or checking. The concurrent audit is similar in nature to internal audit as both are generally initiated by the management itself. However, there is basic difference between the two i.e. concurrent audit is regular audit of financial transactions whereas internal audit is a periodic audit.

7.16.2 Sound internal controls are essential to the prudent operation of banks and to promote stability in the financial system as a whole. Concurrent Audit ensures that adequate internal controls within banking organizations are supplemented by an effective internal audit function, which independently evaluates the control systems within the organization. Concurrent Audit of Bank Branches involves checking of all aspects of banking and other operations on an ongoing daily basis to ensure that the Branch is adhering to the Bank's laid down systems and procedures. The Concurrent Auditors are responsible to examine and comment on all the areas specified by the Bank/RBI from time to time in regard to concurrent audit of branches. A copy of guidelines on the manner of conduct of audit is also provided at the time of allotment of concurrent audit and from time to time thereafter. Therefore, it ensures that all errors and frauds, if any are generally detected immediately after their occurrence to control the damage, if any.

7.17 Central Excise Circular No. - 821/18/2005 Dated 07.11.2005

Guidelines for selection of cases for Desk review by Chartered/Cost Accountant

The Board has been examining various initiatives to enhance the effectiveness of EA 2000 Audit. It has been decided that the expertise of the Chartered/Cost Accountants can be availed in the process of Desk review being conducted by the Department. The services of Chartered/Cost Accountants would be paid at the rate of Rs. 5000/- per day with service tax and other Government dues being extra. Their services are to be used in an advisory capacity only for cases of audit of very large assessees having complicated accounting systems and voluminous transactions, e.g. audit of multi-location units. To facilitate the process of selection, both the Institute of Cost and Works Accountants of India & Institute of Chartered Accountants of India have identified a panel of their accountants whose services can be used. The services of accountants appearing in the panel alone should be used. Before appointing an accountant, the issue of conflict of interest should be kept in mind, i.e. the accountant who is in any way connected to the assessee or its group of companies should not be engaged.

2. The following guidelines can be used to select units for such Desk Review:
   (a) The assessees who have filed their ER 4 Return; or
   (b) The assessees who have submitted copies of their cost audit reports under Section 233B of the Companies Act, 1956; the Income Tax audit report under Section 44AB of the Income Tax Act, 1961, annual financial statements such as the Balance Sheet, Trial Balance, Profit and Loss Account etc., Form 3 CD, Internal Audit Report, Income Tax Return and the departmental auditors find it difficult to use the information contained in any of these statements. Assessees who have filed their ER 5 and ER 6 Returns; or
   (c) Two or more manufacturing units, which are related persons or interconnected units as per the Central Excise Act, 1944; or
   (d) Inter connected assessees who manufactures and supplies all or part inputs to inter connected unit who manufactures final products; or
   (e) Assessees selling goods through related/associated units; or
   (f) Assessees manufacturing goods on job work basis whose valuation may require examination; or
   (g) Assessees whose assessable values are showing a downtrend; or
   (h) The scrutiny of monthly returns by the Range Officers indicates repeated high risks as per the scrutiny guidelines.
3. The services of Chartered Accountants can be used in cases so selected for validating and interpreting the information contained in the ER 4 return and identifying issues for audit verification on this basis. They can also be used for scrutinizing the Balance Sheets, Profit & Loss A/c, Annual Report, Income Tax Audit Reports or any other return filed the other authorities in complicated cases for identifying issues for inclusion in the Audit Plan. Their services can also be used for derivation of unit-wise (i.e. factory wise) financial information from consolidated accounts in case of multi-location units in complicated cases.
4. The services of Cost Accountants can be used for validating, interpreting and analysing the information disclosed by the assessees in ER 5 & ER 6 returns (consumption of inputs) for identifying issues of CENVAT misuse, in the case of units filing these returns. They can also be used for identifying valuation issues during desk review stage in case of sales to related units and captive consumption.
5. The above guidelines are merely illustrative and not exhaustive. Commissioners are directed to report instances wherein selection of units using other criteria produces good results/detections. The Board

further desires that in the ensuing quarter of the current financial year, two units per Commissionerate should be picked up for such Desk Review. The result of the initiatives taken for the quarter ending December, 2005 may be forwarded to the DG(Audit) by 10.1.2006. The consolidated report to the Board may be forwarded by DG(Audit) by 10.1.2006.

6. Receipt of the circular may be acknowledged.

7. Hindi version will follow.

F.No. 224/22/2005-CX-6

(Hemambika R Priya)
Director to the Govt. of India

7.18 Extracts from Central Excise Act, 1944

14A. *Special audit in certain cases*.- (1) If at any stage of enquiry, investigation or any other proceedings before him, any Central Excise Officer not below the rank of an Assistant Commissioner of Central Excise or Deputy Commissioner of Central Excise, having regard to the nature and complexity of the case and the interest of revenue, is of the opinion that the value has not been correctly declared or determined by a manufacturer or any person, he may, with the previous approval of the Chief Commissioner of Central Excise, direct such manufacturer or such person to get the accounts of his factory, office, depots, distributors or any other place, as may be specified by the said Central Excise Officer, audited by a cost accountant, nominated by the Chief Commissioner of Central Excise in this behalf.

(2) The cost accountant, so nominated shall, within the period specified by the Central Excise Officer, submit a report of such audit duly signed and certified by him to the said Central Excise Officer mentioning therein such other particulars as may be specified: Provided that the Central Excise Officer may, on an application made to him in this behalf by the manufacturer or the person and for any material and sufficient reason, extend the said period by such further period or periods as he thinks fit; so, however, that the aggregate of the period originally fixed and the period or periods so extended shall not, in any case, exceed one hundred and eighty days from the date on which the direction under sub-section (1) is received by the manufacturer or the person.

(3) The provisions of sub-section (1) shall have effect notwithstanding that the accounts of the manufacturer or person aforesaid have been audited under any other law for the time being in force or otherwise.

(4) Omitted.

(5) The manufacturer or the person shall be given an opportunity of being heard in respect of any material gathered on the basis of audit under sub-section (1) and proposed to be utilised in any proceedings under this Act or rules made thereunder.

Explanation.—For the purpose of this Section, “cost accountant” shall have the meaning assigned to it in clause (b) of sub-section (1) of Section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959).

14 AA. Special audit in cases where credit of duty availed or utilised is not within the normal limits, etc.- (1) If the Commissioner of Central Excise has reason to believe that the credit of duty availed of or utilised under the rules made under this Act by a manufacturer of any excisable goods—

(b) is not within the normal limits having regard to the nature of the excisable goods produced or manufactured, the type of inputs used and other relevant factors, as he may deem appropriate;

(c) has been availed of or utilised by reason of fraud, collusion or any willful mis-statement or suppression of facts, he may direct such manufacturer to get the accounts of his factory, office, depot, distributor or any other place, as may be specified by him, audited by a cost accountant nominated by him.

(2) The cost accountant so nominated shall, within the period specified by the Commissioner of Central Excise, submit a report of such audit duly signed and certified by him to the said Commissioner mentioning therein such other particulars as may be specified.

(3) The provisions of sub-section (1) shall have effect notwithstanding that the accounts of the said manufacturer aforesaid have been audited under any other law for the time being in force or otherwise.

(4) Omitted.

(5) The manufacturer shall be given an opportunity of being heard in respect of any material gathered on the basis of audit under sub-section (1) and proposed to be utilised in any proceedings under this Act or rules made thereunder.

Explanation.– For the purpose of this Section, "cost accountant" shall have the meaning assigned to it in clause (b) of sub-section (1) of Section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959).]

7.19 Self Examination Questions

1. What is due diligence audit? Why is it undertaken?

2. What are the steps involved in any due diligence audit?

3. What is Sarbanes – Oxley Act of 2002 ? Explain the circumstances leading to its enactment.

4. Explain the major changes brought by Sarbanes – Oxley Act in the area of corporate governance.

5. What is energy audit? How is it linked to environment audit?

6. Explain major areas for possible source of conserving energy.

7. What is Productivity Audit? How is it different from the Management Audit?

8. What is Inventory Audit? Whether Cost Auditor can take up the job of Inventory Audit? Give reasons.

9. What is VAT? How is it different from Sales Tax?

10. EA 2000 is a modern, transparent and interactive method of audit. Do you agree?

11. What is the scope for Cost Accountant in EA 2000?

12. Explain special audit of excise by cost accountant. What are the different types of special audit of excise?

13. What is Environment Audit? How is it useful to the society?

14. What is ERP environment? How is the audit under ERP environment different from other audits?

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Fields for Practicing Cost Accountants

This Study Note includes:

- Evaluation-Cost and Management Accounting
- Fields for Practising Cost Accountants
- World Trade Organization

8.1 Evaluation Cost and Management Accounting

8.1.1 Globalization of business activities and intense world competition calls for astute handling of all aspects of business. The increased competition and consequent economic pressures have made the cost accounting most essential of the management services. Management Accounting is therefore mainly concerned with formulating strategies for optimal use of resources and help in taking decisions. It also aims at planning and constructing business activities and supporting financial reports preparation.

8.1.2 Management Accountant uses traditional cost accounting techniques in conjunction with innovative techniques like life cycle cost analysis, activity based costing and just-in-time costing concepts to make the organization competitive and efficient. Life cycle costing concept recognizes that the ability of the management to influence the ultimate product is at its greatest, when the product is still at the design stage of its product life cycle. This will help the management to produce only those products, which are cost effective and can face international competition. Activity based cost accounting, some times also known as "Cause and Effect Accounting" aims at optimizing the efficiency of the production activities in any organization. In other words, Management Accountants are the strategic partner and provider of decision based information in any organization. The scope of activities may include areas like forecasting and planning, risk and regulatory reporting, performing variance analysis, business driver metrics and profitability analysis.

8.1.3 There is a clear shift of emphasis today in the methods employed in financial management and cost and management accounting, a shift from controls to management:

"financial controls" to "management of finance";

"cost controls" to "cost management"; and

"cost analysis to "cost evaluation".

8.1.4 Norms of measurement and skills for management need to be sharpened towards this end. Critical approach of cost accounting not only ensures care during sickness but also helps maintain good health on a continuous basis – an attitude from "Patient care" to "Health care". Cost Accounting is not only a saviour in peril, but also an effective instrument in prosperity.

8.2 Fields for Practising Cost Accountants

8.2.1 A Cost Accountant may build up his own practice by obtaining a license from the institute, which would enable him to practice as a Cost Accountant, either individually or in partnership with one or more members of the institute in practice. The scope of practice for Cost Accountants has improved radically in the era of liberalization with the minimization of government control measures, because regulatory agencies have sprung up and professionals like Cost Accountants are essential aides to such regulatory functions. The types of service a Cost Accountant may offer his clients are varied.

8.2.2 The Cost Accountants are well conversant with the maintenance of records, verification/examination of correctness/rationality of the system followed for the purpose of adhering to the provisions under different Acts. Some of the audits undertaken by Cost Accountants give comprehensive expertise in auditing activities are as below:

(i) Cost Audit under Section 233B of the Companies Act, 1956.

(ii) Central Excise Audit under Section 14A of Central Excise Act, 1944.

(iii) Central Excise Special Audit under Section 14AA of the Central Excise Act, 1944

(iv) Internal Audit

(v) Inventory Audit

(vi) Concurrent Audits in Banks.

(vii) Sales Tax / VAT Audit.

(viii) Telecom Regulatory Authority of India (TRAI) Audit.

(ix) Special Audit under Customs Act.

(x) Management and Operational Audit etc.

(xi) Service Tax Audit

(xii) Anti-Dumping.

8.2.3 A Cost Accountant in practice has already been recognized under the various Statutes, Rules and Regulations to appear as authorized representative before several quasi-judicial bodies as mentioned herein below:

(a) Income Tax Appellate Tribunal under the Income Tax Act, 1961 and Income Tax Rules, 1962 [Section 288 (2) and Rule 50(3)];

(b) Company Law Board Regulations, 1991, Regulation 19(2);

(c) Customs, Excise and Service Tax Appellate Tribunal under Central Excise Act, 1944, Central Excise (Appeals) Rules, 1982 [Section 146A and Rule 9(b)];

(d) National Company Law Tribunal and National Company Law Appellate Tribunal (Section 10 GD (c) of Companies Act, 1956);

(e) Competition commission of India (Competition Act, 2002) (Section 35, Explanation (c));

(f) Telecom Disputes Settlement and Appellate Tribunal under Telecom Regulatory Authority of India Act, 1997 (Section 17 and Explanation (c));

(g) Securities Appellate Tribunal under Securities Contracts (Regulation) Act, 1956, Securities Contracts (Regulation) Rules, 1957 (Section 22C, Explanation (c)), Securities and Exchange Board of India Act, 1992 (Section 15V, Explanation (c)) and Depositories Act, 1996 (Section 23C, Explanation (c)).

(h) Monopolies & Restrictive Trade Practices Regulations, 1974 (Regulation 65, Explanation).

(i) Central Electricity Regulatory Commission under the Central Electricity Regulatory Commission (Misc. Provisions) Order, 1999.

Certifications: (a) Under Exim Policy

(b) Valuation of Assets

(c) Under Excise Act

(d) Under FEMA

(e) Under Companies Act

(f) Under Regulatory authorities

(g) Under Anti-Dumping regulations

(h) Certificates to the Banks and Financial Institutions etc.

8.2.4 Other Services: Further, as per the Cost and Works Accountants Regulations, 1959, a Cost Accountant in Practice may also act a s Trustee, Executor, Administrator, Arbitrator, Receiver, Appraiser, Valuer, Advisor, Secretary or as a secretarial consultant, or as a representative for financial matters including taxation and may take up appointment that may be made by the Central or State Governments, Courts of Law, Labour Tribunals or any other legal authority falling under the various corporate, economic and tax laws. A large number of our members are already practicing in the areas of Income Tax, Central Excise, Customs and Service Tax and are appearing before relevant Tax authorities such as ITAT, CESTAT etc.

8.2.5 Other areas of his specialization include :

- Designing and introduction of systems.
- Control functions, such as inventories, debtors, working capital management, etc.
- Capital projects – right from the state of feasibility studies upto preparation of project reports, recommendation as to choice among alternatives, profitability appraisals and execution of projects.
- Studies of problems in capacity utilisation, raw materials substitution, etc.
- Preparation of profitability forecasts for future periods for purposes of collaboration arrangements, financing arrangements and government assistance.
- Certification of consumption for import application.
- Deciding among alternative such as make or buy a part, hiring or buying an equipment, etc.
- Advising in the matter of purchasing a business or planning or mergers.
- Other consultancy assignments.

8.2.6 Based on above, the fields for practicing cost accountants can be categorized in following two broad categories:

I. Statutory and Specific Fields:

(a) Audit

(b) Taxation

(c) Corporate laws

(d) Certification

(e) Insurance

(f) Empanelment

II. Non-Statutory and General Fields:

(a) System design, Installation and Operation

(b) Techno-economic study

(c) Services to Banks, Insurance Companies and other Financial Institutions

(d) Financial Management

(e) Project Consultancy

(f) Materials Management

(g) Management Accountancy

(h) Tax Planning

(i) Diagnostic Accounting and Revival of Sick units

(j) Investment Counselling and Portfolio Management

(k) Internal Management and Operational Audit

(l) Organizations Structure Review

8.2.7 The aforesaid details can also be tabulated as under :

I. STATUTORY AND SPECIFIC FIELDS

Fields		*Purposes*	*Authority/Statute*
A. Audit			
(a)	Cost Audit	For conducting audit of Cost Accounts prescribed u/s 209(1)(d) of the Companies Act, 1956	U/s 233-B of the Companies Act, 1956 as amended by the Companies (Amendment) Act, 1974
(b)	Cost Audit Cooperative Sector	For conducting cost audit or performance audit or both of Cooperative Societies in the state of Maharashtra	U/s 81 (2A) & (2B) of the Amended Maharashtra Cooperative Societies, 1960
(c)	- do -	For conducting cost audit or performance audit or both of Cooperative Societies in the state of West Bengal	U/s 90 Sub-sec. (1A) and (1B) of West Bengal Cooperative Societies Act, 1983 (Amendment Act, 1990).
(d)	Internal Audit	To comply with the requirement of para 4(a) (xv) of MAOCARO regarding Internal Audit.	Qualification is not prescribed for this area. Hence, PCAs can undertake this assignment.
(e)	Internal Audit of State Public Sector Undertaking, Govt. of Punjab	Appointment of PCA as Internal Auditor of State Undertakings in Punjab.	Govt. of Punjab, Dept. of Finance (Finance Budget – II Branch) Cir. F. No. 10/64/92-CL.V. (M.A. April 93, page 303).

(f)	Internal Audit of State Public Sector Enterprises	Appointment of PCA as Internal Auditor of State Public Sector Enterprises in Tamil Nadu	Government of Tamil Nadu, Finacne (BPE) Dept. GO. MS. No. 705 dt. 3.9.1992. (M.A. Nov. 92 page 867).
(g)	Internal Audit of State level Public Sector Enterprises of Andhra Pradesh	Appointment of PCA as Internal Auditor of State Public Sector Enterprise in A.P.	Government of AP, Gen Admn. (PE II), Department letter No. G.O. M.S. No. 552 dt. 20.10.93. (MA. March '94 page 205).
(h)	Internal Audit of State Public Sector Enterprises, Orissa.	Appointment of PCA; as Internal Auditor of State Public Sector Enterprises in Orissa.	Government of Orissa, Public Enterprise Dept. Office Memo. No. COr. VII-34/9373 PE dt. 10.1.94
(i)	Stock Audit for Banks	Appointment of Cost Accountant for annual stock audit for large borrowers	Canara bank, Inspection Planning Sec. Central Office Bangalore Circular No. INSW/IPS/64/484/93 dt. 10.3.93
(j)	Stock Audit for Banks	Appointment of Cost Accountant for annual stock audit for large borrowers	Indian Bank Credit Policy and General Department Central Office Madras Circular No. CPGD/1197/95 dt. 25.2.1995
(k)	Concurrent Audit	Appointment as concurrent auditor by the various All India Financial Institutions	Letter No. BDP/Institute/84-1B 509 dt. 30.7.84 from the Manager (Tech.), IFCI, New Delhi.
(l)	Central Excise Valuation Audit	Appointment of Cost Accountants to conduct Excise Valuation Audit.	U/s 14A of the Central Excise Act, 1994.
(m)	Central Excise Special Audit	Appointment of Cost Accountant to conduct special audit and report.	U/s. 14AA of the Central Excise Act, 1944
B. TAXATION			
(a)	Income-tax	For appearing before I.T. Authority or Appellate Tribunal as authorized representatives of assesses.	Under Section 288(2) (V) of IT Act, 1961 and Rule 49 and 50(3) of I.T. Rules, 1962 (CBDT notification No. S.O. 719 dated 23.3.1970).
(b)	Wealth-tax	Recognised for registering as a valuer of stocks, shares debentures etc.	Wealth Tax (Second Amendment) Rules, 1988-Rules 8A(7).
(c)	Excise Duty	Appointment as Valuers in the category of "Accountants" under Section 4(3) of the Estate Duty Act, 1953, provided that the Cost Accountant is in practice for a minimum period of 7 years.	Notification No. 5/77/68-E.D. dtd. 20.2.69 issued by Ministry of Finance Dept. of Revenue and Insurance, New Delhi.
(d)	Sales Tax	To appear before the sales tax authorities of Tamil Nadu Commercial Taxes Department.	Government of Tamil Nadu, Notification No. SRQA 1007 dt. 9.10.91 (published in Tamil Nadu Government, Gazette Part V dt. 1.1.2.71)

(e)	Sales Tax	To appear before the Sales Tax authorities of the Government of Maharashtra	Bombay Sales Tax (Amendment) Act, 1983, Sec. 71(1) & 71(2).
(f)	Customs	To act as authorized representative before the Customs, Excise and Gold (Control) Appellate Tribunal and other authorities.	Customs Act, 1962 sec. 146A and Customs (Appellate) Rules 1982 Rule 9.
(g)	Excise	Certifying figures of production for goods used for captive consumption u/s 4 of the Centra Excises Act 1944 and Rules 6(b)(ii) of the Central Excise (Valuation Rules) 1975.	Madras Trade Notice No. 109/73 dt/ 13.7.73 (42/GI/73) & 153/75 dt. 26.9.76 – census 505/1975.
(h)	Excise	Guidance to Company in ascertaining the cost of production for the current year for goods used for the captive consumption	CBE & C letter F. No.6/32/87-ex dt. 31.3.88.
(i)	Excise	Certificate to deductions permitted from the invoice value to determine assessable value.	Excise authorities are generally insisting on Cost Accountant's certificate.
(j)	Excise	To Act as authorized representative before the Customs, Excise and Gold Control Appellate Tribunal and other authorities.	Central Excise and Salt Act, 1944 Sec. 35Q & Central Excise Rules, 1944 Rule 232B.
(k)	Excise	Certificate for deduction of eqalised Sales Tax, etc. for approval of price list.	Trade notice No. 225/90 dt. 27.11.90 (Madras Collectorate).
C.	**CORPORATE LAW**		
(a)	Company Law:		
	CLB Regulations	Appearing before Company Law Board Benches as Authorized representative of a party.	Rule 19 of the Company Law Board (Bench) Regulations, 1991.
D.	**CERTIFICATIONS**		
(a)	Rubber Board	Certifying half yearly return in Form "N" for quantity of rubber purchased and consumed by manufacturers under rule 33(f) of the Rubber Rules, 1955.	Letter No. 7/1/78 – ED/2185 dt. 2.4.79 from Secretary, the Rubber Board, Ministry of Commerce, Government of India, Shastri Road, Kottayam, Kerala, 686001
(b)	Duty Drawback on exports	Application for supplementary claim for drawback under Rule 15 of Customs and Central Excise Duties Drawback Rules, 1955. Certifying the amount of duty paid on the materials used for the manufacture of exported goods as indicated in Forms DBK-I, II, IIA, III, IIIA.	Letter F. No. 609/118/84-DBK dt. 29.6.84 from Director (Drawback), department of Revenue, Ministry of Finance, Government of India, New Delhi, Rules 6(1)(9) & 7(1) of Customs and Central Excise Duties Drawback Rules, 1971. (Copy of Forms DBK – I, II, IIA, III & IIIA in this study material.

(c)	Supplementary Cash Assistance in lieu of duty drawback claim.	Certifying data indicated in the drawback statement.	Circular No. 12(17) 78-EAC dt. 12.12.87 by Export Commissioner, Ministry of Commerce, Government of India, New Delhi
(d)	Cash Compensatory Support Scheme (CCS)	Certifying data in the Proforma prescribed by Government of India, Ministry of Commerce.	Proforma B Annexure I & II Circular No. 12/14/EAC dt. 29.9.88 from the Department of Commerce, Govt. of India, New Delhi.
(e)	Vanaspati Manufacturing Units	Certifying data of quantity of vegetable oils issued/received Annexure I, II and III.	Directorate of Vanaspati, Vegetable Oils & Fats, Ministry of Food & Civil Supplies.
(f)	Hotel Tariff	Certifying Calculation for approval of Hotel Tariff submitted to Department of Tourism, Government of India	Letter No. 11-TH 1(27)/87 dt. 21.9.87 from department of Tourism, government of India, C1Hutment, Dalhousie Road, New Delhi.
(g)	Fertilizer Industry	Certificate for monthly subsidy claim and reimbursement of Transport Cost.	Fertilizer Industry Coordination Committee, Ministry of Petroleum, Chemicals and Fertilizers, Govt. of India letter No. 4(42)/78FDA-1/ Vol. II dt. 26.8.81.
(h)	Fertilizer Industry	Certificate of product-wise position of production, dispatches, stock, etc. for the year (Annexure III-A)	Letter No. 4(27)80 – FDA-1 dt. 29.8.80
(i)	Textile Industry	Textile Committee Cess monthly Return in Form A	Textile Committee Act, 1973, Rule 4.
(j)	Drugs (Price Control) Order	Certify information required to be given in the Second Schedule – Form I: (Item No. 18) – Annexure Form of application of fixation or revision of prices of scheduled bulk drugs. Form II: Form of information: Nonscheduled bulk drugs. Form III: Form of application: Scheduled formulation. Form IV: Form of application – Scheduled formulation – imported. Form VI: Yearly Information.	Drugs (Price Control) Order, 1995.
(k)	Anti-Dumping Duty Questionnaire	Proforma C1 and C2	Proforma attached in this study note.

II NON-STATUTORY AND GENERAL FIELDS

	FIELDS		*WORK ACTIVITY*
A.	Systems		Design, installation and operation of systems and periodic review and modification of the existing systems and procedures in operation.
B.	Techno-economic study	(a)	Study of Problems in optimum capacity utilisation, raw material substitution and economic allocation and utilisation of input resources :
		(b)	Introducing techniques of Value Engineering, Cost Reduction and Profitability improvement;
		(c)	Attending to cost and price enquiries, representation to authorities on techno-economic, cost and financial matters and special areas of compliances with Government regulations;
		(d)	Design and operation of marginal costing system to ensure economic use and greater profitability of the available as well as scare resources, economic pricing policy for products and determination of balanced product-mix to secure optimum return on investment;
		(e)	Advising in the matter of taking over an existing business or planning of mergers;
		(f)	Advising on the cost of marketing and distribution function - analysing the relative merits and economies of different markets, methods of marketing and channels of distribution;
		(g)	Conducting cost studies for evaluating operating efficiency and suggestions measures for cost control and cost reduction;
		(h)	Designing and implementing profit improvement plan in the organization;
		(i)	Application of cost reduction tools in the fields of manufacturing, Marketing, Administration, Finance and Inventory Control for increasing efficiency and optimizing results;
		(j)	Designing standard costing and budgetary control manual specific to the requirements of individual units and prescribing management control systems as key tools for providing for free flow of vital information needed for decision making, according to responsibility accounting principles and implementation thereof;
		(k)	Certifying cost escalation claims;
		(l)	Designing cost manual for industries and short form of management information report to keep closer and continuous watch over the operational and business behaviour and implementation thereof;
C.	Computerization		Feasibility study, systems design, software, software development and computerization of cost and management reporting systems in organizations.

D.	Services to Banks, Companies and other financial institutions	(a)	Helping the banks, insurance companies and financial institutions in considering the techno-economic viability of different projects requiring long-term capital and working funds;
		(b)	Aiding in project study, market survey, etc. for investment of funds by term loans, shares or otherwise, by insurance and banking companies and other financial institutions;
		(c)	Analysis of profitability of various insurance companies' activities and/or branch level profitability
		(d)	Analysis of profitability of Banks' activities and/or branch level profitability;
		(e)	Developing systems and structures for conducting studies of the revenue and cost and profitability of banks.
E.	Financial Management	(a)	Control functions such as management of inventories, Debtors, Creditors, Cash and Working Capital etc;
		(b)	Preparation of profitability forecasts for now projects and/or for expansion of existing units to process collaboration agreements, financing arrangements and for Government assistance;
		(c)	Preparation of Credit Authorization Scheme (CAS) Forms for working capital finance from Banks;
		(d)	Advising the industry for obtaining funds, allocation and use of resources under the cooperative and company management;
		(e)	Conducting diagnostic study of existing imported inventories and developing indigenous resources for reducing imports to the minimum consistent with domestic supplies so as to conserve foreign exchange and to promote growth of new or development of existing industries;
		(f)	Preparing Cash Flow Statements, statement of source and application of funds for corporate financial divisions;
		(g)	Financial Planning – raising and allocation of funds.
F.	Project Consultancy		Assisting in the evaluation of economic viability of investment decisions in Capital Projects, right from the stage of feasibility study upto the preparation of project reports, recommendations as to the choice among alternative projects, profitability appraisals and monitoring Cost Control programmes during the execution of projects.
G.	Materials Management		Developing systems for optimization of purchase and consumption of materials and control of inventories.

H.	Management Consultancy	(a)	Developing appropriate Management Information Systems, reviewing adequacy of the existing management information system and rationalizing the information flow in order to weed out non-essential items of existing reports and returns and to strengthen and streamline the internal monitoring and appraisal machinery through Integrated Reporting System.
		(b)	Advising Management on the interpretation and use of the information.
		(c)	Assisting in developing Long Range Corporate Plan.
I.	Organization and Methods	Conducting studies of Organization and Administrative Systems in various departments, viz. Accounts, General Administration, Marketing, personnel, Purchase, Warehousing and Despatch, Credit Collection, etc. Job evaluation and merit-rating to ensure economic use of human, physical and financial resources.	
J.	Tax Planning	Advising and formulating tax planning schemes to individual and corporate assesses.	
K.	Diagnostic Accounting and Revival of Sick units.	Study problems of sick units. Preparation or revival scheme independently or in consultation with Board for Industrial and Financial Reconstruction (BIFR).	
L.	Merchant Banking	Services in connection with raising of resources for the Corporate Sector.	
M.	Investment counselling and portfolio management	Advising individual and corporate sector in optimizing return on investments.	
N.	Internal, Management and Operational Audits.	(a)	Conducting internal, management and operational audits of industrial activity and the decision-making process which have become increasingly complex owing to technical and technological factors;
		(b)	Conducting audit of Marketing and General management functions, such as selling, distribution, personnel, research and development, secretarial, administrative and appraisal thereof.
O.	Organisation Structure Review	Designing organizational structure, developing job responsibilities and job descriptions, evaluating stage requirements.	
P.	Training	Designing and organizing training programmes and conducting training courses for personnel of various functional areas.	
Q.	Executive selection	Assisting in selection of personnel for assignments in India and abroad in the fields of General Administration, Secretarial Marketing, Audit, Costing, etc.	
R.	Incentive plans	Setting up Wages Incentive Schemes for direct and indirect workers, supervisors and executives.	
S.	Productivity	Assessing capacities of plants and advising in the fixation of productivity norms and standards of input and output resources for improvements of overall efficiency and productivity.	
T.	Conservation of Energy and Energy Audit	Study of energy of generation and consumption with a view to optimizing consumption. Monitoring energy consumption and conducting Energy Audit.	

8.3 Other Services

8.3.1 Certification Procedures

8.3.1.1 Cost Accountants are required to give certificates or reports for certain required statutory and/ or other purposes. Some of them are statutorily reserved for Cost Accountants in practice only and quite a few are certificates which can be given by professional other than Cost Accountants also like Chartered Accountants, Company Secretaries, etc. Certificates are normally required for purposes of compliance with the requirements of law or prescribed procedures. As such, a certifying professional is required to look into the facts of the cases in regard to the correctness of facts presented and true and fair view in the compliance to legal or other requirements.

8.3.1.2 A certificate is a written declaration consisting of facts and or opinion, which is capable of being verified subsequently. A report is a detailed description of a situation or an opinion supported by considerable background information. It can cover both the past and the projections.

8.3.1.3 The cost accountant is required to make a clear distinction between certificate and a report. A cost accountant in practice should be fully equipped to compile, verify and certify such economic, accounting, technical and legal information. A certificate bearing stamp and signature of a Cost Accountant in practice should inspire confidence for the authorities to whom the certificates is rendered. It should reflect an honest and accurate assessment of the situation, which is being certified and facilitate speeding up of information by the recipient client.

8.3.1.4 A Cost Accountant in practice has to be very careful in his certification by taking adequate precaution on the information certified particularly when they are in the nature of projections for the future. In case of facts and past information, he has to certify with reference to proper evidences and records, whereas in the case of projected information he is required to look into the reasonableness of simulated information and apply his fair judgment. A Cost Accountant in practice is required to take adequate care of his professional ethics and code of conduct as prescribed for the profession in all its aspects while giving his certificate. In most cases the forms of certificate are prescribed by authorities themselves. Normally they should cover statement of the background and facts like:

(i) terms of reference

(ii) records verified

(iii) period covered

(iv) basis of compilation of data

(v) brief background notes, and

(vi) the certificate itself, in the prescribed format, if any.

8.3.1.5 In cases where alternative methods are available for compiling certain data, the certification shall cover clearly specify the method followed by the Cost Accountant, justifying the reasons for method selected by him. If certain matters are excluded from the purview of certification, such exclusion shall be specifically stated. A Cost Accountant should take adequate care of consistency in the methods followed without which the information may get distorted.

8.3.2 Qualities of a Good Certificate/report

8.3.2.1 While issuing any certificate/report, a Cost Accountant should ensure that it contains the following information:

(i) Name and address of the concern and the product/purpose for which the certificate is issued.

(ii) It should be in the prescribed form, and where there is no prescribed form it should be in the form that gives the required information.

(iii) It should be based on verified data presented and produced before the practicing Cost Accountant or compiled by him for the purpose.

(iv) It should contain the required explanatory notes, reservation or qualifications depending on the records produced before him.

(v) The primary responsibility for the contents of a certificate/statement rests with the enterprise and therefore a suitable declaration or authentication by the management on the face of the certificate/statement should be obtained.

(vi) Certified data should also bear signature of a Director or General Manager of the company preceding the matter in the certificate together with explanatory notes as may be essential by the Cost Accountant.

(vii) Every certificate and every page of the statement and appendices attached to the certificate should bear the date, signature and seal of the Cost Accountant.

(viii) The language used and the information presented in the certificate should always be unambiguous and clear to the authorities calling for the certificate.

(ix) If certain items of expenses/income or any other data are excluded from the calculation for issuing the certificate the Cost Accountant should give a proper note in the certificate to this effect.

(x) The certificate should be so drafted as to convey the factual situation without the ambiguity. Subjective opinion should not be expressed unless there are strong grounds to do so and the opinion could be supported by factual data.

(xi) The certificate should be a self-contained document and should include as relevant information, contained in such certificate and not a mere reference to another report or a certificate.

(xii) The certificate should include a statement showing the reconciliation between the figures in the general purpose financial statements and the figures appearing in the report/certificate.

(xiii) The certificate may be addressed to a client, the public authority, or the person requiring it. In appropriate cases, certificates may be issued without reference to any particular person/authority by using the words "to whomsoever it may concern".

(xiv) A suitable reference to the notes attached to a certificate should be mentioned in the main certificate.

(xv) Where the Cost Accountant wishes to qualify his report, he may indicate such qualifications under "Notes".

3.2.2 While issuing a certificate a cost accountant should be clear on the following matters:

- Be clear what you are certifying
- Understand precisely the purpose for which the certificate is required and its possible implications.
- Study the relevant Act and Rules affecting the operations to which the certificate is required and its possible implications.
- Study the relevant Act and Rules affecting the operations to which the certificate relates.
- Understand accounting system of the client.
- Study relevant case laws on the topic to determine any accounting principle that could be applied to your client's case.
- Verify as much data as you need to enable you to give an opinion.
- Keep notes of your verification drill and file working papers properly for easy access at a later date, if need be.
- Draft your report carefully.
- You should be responsibly certain and definite on facts (which you must state along with their sources). You must give valid reasons for your opinions (including citation of authorities, if required).
- In matters of verification and certification, checking of the figures and tracing them in the books of accounts is a must. At the same time, depending upon the volume of data, a cost accountant may adopt sampling techniques.
- Books of accounts and other registers/report is scrutinized and verified shall be affixed with the official seal and initial. Technical data should not be quoted unless absolutely necessary and unless your source of information is dependable.
- As a professional, the Cost Accountant should be consistent, logical and factual. Consistency should be not only with one's own opinion expressed earlier or in respect of some other client, but also with views expressed by other accountants also.
- Cross check the information certified with similar information available in any other context and reconcile it. The reasonableness of the data certified should be established.
- Apply uniform accounting/cost accounting principles consistently.
- Ascertain if there are any control systems in existence and if so, the controls can be a great help in ascertaining the accuracy of the figures. If they do not exist or not disclosed, the Cost Accountant should develop controls to present as accurate as assessment as possible.
- Whether adjustment is made for exceptional items of income and expenditure.

8.3.2.3 It is essential to obtain an appointment letter in writing, to avoid any misunderstanding, with scope and items and reference of the assignment. Normally certificates are issued whenever specifically required by any specific authority and therefore, it is preferable to address a certificate to a particular authority. In case, an engagement letter is issued in this connection, the certificate may be addressed to an engaging party or to the authority whom the engaging party wishes. The reporting format will vary from case to case depending on the nature of the specific assignment and the circumstances calling for such certificate and also the probable uses of the report. Therefore it is difficult to prescribe any particular form of certificate applicable to all circumstances.

8.4 World Trade Organisation (WTO)

8.4.1 GATT

8.4.1.1 The General Agreement on Tariffs and Trade (GATT), the predecessor of WTO, was born in 1948. The General Agreement on Tariffs and Trade (GATT) was a loose system of International Agreement. It did not crystallize as an institutional framework. The primary objective of GATT was to expand international trade by liberalizing trade so as to bring about all-round economic prosperity. The Preamble to the GATT mentioned the following as its important objectives.

(a) Raising standard of living.

(b) Ensuring full employment and a large and steadily growing volume of real income and effective demand.

(c) Developing full use of the resources of the world.

(d) Expansion of production and international trade.

8.4.1.2 The GATT was transformed into a World Trade Organization (WTO) with effect from January, 1995. India is one of the founder members of the IMF, World Bank, GATT and the WTO.

8.4.2 WTO

8.4.2.1 The World Trade Organization (WTO) is the main organ of implementation of the Multilateral Trade Agreements (MTA). It is the forum for negotiations among its members. It is also the forum for negotiations on terms of the Plurilateral Trade Agreement (PTA). After World Bank and IMF, this is the third biggest international organization in finance and trade matters. It is a permanent body with global status similar to IMF and World Bank. It provides permanent forum for trade negotiations. Its basic principle is equal treatment to products and services of multilateral trading system and equal treatment to products and services for all other WTO countries. (Of course, there are concessions and let-outs). Its scope is much wider than that of GATT and covers multilateral trading system and commercial activities like trade in services, intellectual property protection etc. WTO has very efficient dispute settlement body (DSB) and Trade Policy Review Body (TPRB). WTO is directed by the Ministerial Conference that meets at least once every two years and its regular business is overseen by a General Council. The major differences between GATT and WTO can be summarized as under:

GATT	WTO
GATT was ad hoc and provisional.	WTO and its agreements are permanent.
GATT had contracting parties.	WTO has members.
GATT system allowed existing domestic legislation to continue even if it violated a GATT agreement (Grand-father clause).	WTO does not permit this.
GATT was less powerful, dispute settlement system was slow and less efficient. Its ruling could be easily blocked.	WTO is more powerful, dispute settlement mechanism is fast and more efficient. It is very difficult to block the rulings.

8.4.3 Functions of the WTO

8.4.3.1 The main functions of WTO are –

(i) Facilitate the management of the Multilateral Trade Agreements and the Plurilateral Trade Agreements for the fulfillment of their obligations.

(ii) All Multilateral Trade Relations concerning the above agreements will be negotiated by the Members in this forum.

(iii) WTO will also facilitate implementation of the results of the negotiations as decided by the Ministerial Conference.

(iv) The WTO shall administer the Understanding on Rules and Procedures Governing the Settlement of Disputes, forming part of the Agreements (MTAs and PTAs).

(v) The WTO is responsible for administration of the Trade Policy Review Mechanism (TPRM) forming part of the Agreement.

(vi) WTO is also the organ for establishing coordination with other Wings of the UNO such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) and its affiliated agencies.

8.4.4 Structure of the WTO

8.4.4.1 The Ministerial Conference (MC) is the highest body. It is composed of the representatives of all the Members. The Ministerial Conference is the executive of the WTO and responsible for carrying out the functions of the WTO. The MC has authority to take decisions in any matters under the relevant MTA. The MC shall meet at least once every two years.

8.4.4.2 **The General Council**

The General Council (GC) is an executive forum composed of representatives of all the Members. The General Council discharges the functions of the MC during intervals between meetings of the MC. The GC shall meet as and when necessary. The GC shall establish its own rules of procedures and also approve the rules of procedures for the Councils (mentioned later) established by it. The GC will also be responsible for:

a) The discharge of the responsibilities of the Disputes Settlement Body as outlined in the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) which forms part of the MTA.

b) The discharge of the responsibilities of the Trade Policy Review Body as outlined in the Trade Policy Review Mechanism (TPRM), which forms part of the Agreement.

The Disputes Settlement Body and the Trade Policy Review Body, may have their own respective Chairmen and establish their own respective rules of procedures for fulfillment of their responsibilities.

8.4.4.3 **The Functional Councils under the General Council and Their Functions**

The General Council shall have three functional Councils working under its guidance and supervision. These are:

a) Council for Trade in Goods,

b) Council for Trade in Services,

c) Council for Trade-Related Aspects of Intellectual Property Rights (TRIPS)

8.4.4.4 **Functions of the three Councils**

a) The Council for trade in Goods shall oversee the functioning of the Multilateral Trade Agreement relating to Trade in Goods.

b) The Council for Trade in Services shall oversee the functioning of the Multilateral Trade Agreement relating to Trade in Services.

c) The Council for Trade-Related Aspects of Intellectual Property Rights shall oversee the functioning of the Multilateral Trade Agreement connected with Intellectual Property Rights and Obligations, forming part of the Agreement.

These Councils shall establish their respective rules of procedures subject to the approval of the General Council. Membership of these Councils is open to representatives of all Members. The Councils will meet as and when necessary.

8.4.5 The Ministerial Conference and Committees

8.4.5.1 The Ministerial Conference (MC) shall establish three functional Committees for discharge of functions assigned to them under the Multilateral Trade Agreements (MTAs). These Committees are:

a) Committee on Trade and Development

b) Committee on Balance-of-Payments Restrictions

c) Committee on Budget, Finance and Administration

8.4.5.2 These Committees will also discharge functions specifically assigned to them by the General Council. These Committees may also establish additional Committees with specific functions assigned to them. The Committees are open to representatives of all Members.

8.4.5.3 Specifically, the Committee on Trade and Development shall periodically review the special provisions in the Multilateral Trade Agreement in favour of the least-developed country Members and report to the General Council for appropriate action. The Bodies under the Plurilateral Trade Agreements shall discharge their functions within the institutional framework of the WTO. These Bodies shall keep the General Council informed of their activities on regular basis.

8.4.6 Secretariat of the WTO

8.4.6.1 There will be a Secretariat of the WTO. It will be headed by a Director-General. The Director-General shall be appointed by the Ministerial Conference (MC). The MC will set out all terms and conditions of the office of the Director-General. The Officials of the Secretariat will be appointed by the Director-General who will fix their terms and conditions of service in accordance with the regulations adopted by the Ministerial Conference.

8.4.7 Budget and Contribution by Members

8.4.7.1 The Director-General is responsible for preparing the Annual Budget and Financial Statements of the WTO. He will present the documents to the Committee on Budget, Finance and Administration. The Committee will review the Annual Budget Estimates and Financial Statements and make their recommendations to the General Council. The Annual Estimates must have the approval by the General Council. The Committee on Budget, Finance and Administration shall prepare Financial Regulations based, as far as practicable, on the regulations and practices of the GATT 1947. The Regulation shall include provisions on:

a) Contribution by the Members for the expenses of the WTO.

b) The measures to be taken in respect of the Members in arrears.

8.4.7.2 The General Council shall adopt the financial regulations and the annual budget estimates by two-thirds majority comprising more than half of the Members of the WTO. Each Member shall promptly contribute to the WTO its share in the expenses of the WTO in accordance with the financial regulations adopted by the General Council.

8.4.8 The Status of the WTO

8.4.8.1 The WTO shall have legal personality. Members shall endow it with such legal capacity, privileges and immunities as are necessary for the exercise of its functions. The representatives of the Members and all officials of the WTO shall enjoy International privileges and immunities similar to those stipulated in the Convention on the Privileges and Immunities of the Specialized Agencies approved by the General Assembly of the United Nations on November 21, 1947.

8.4.9 Decision Making

8.4.9.1 The decision-making by the WTO shall be by consensus. Where a consensus is not available, the issue shall be decided by voting. Decision of the Ministerial Conference and the General Council shall be taken by a majority of the votes cast unless otherwise provided in the Multilateral Trade Agreement (MTA).

8.4.9.2 Each Member shall have one Vote. When the European Communities exercise their right to Vote, they shall have a number of Votes equal to the number of their member States which are Members of the WTO. The Ministerial Conference and the General Council shall have the exclusive authority of interpretation of this Agreement (Agreement Establishing the World Trade Organization) and of the Multilateral Trade Agreements.

8.4.9.3 In the case of an interpretation of Multilateral Trade Agreements, where there is a specific Council, the Ministerial Conference and the General Council shall exercise their authority on the basis of recommendation by the respective Council overseeing the functioning of that Agreement. An interpretation shall be adopted by consensus; failing that it shall be adopted by three-fourths majority of the Members.

8.4.9.4 The ministerial Conference may decide to waive an obligation imposed on a Member by this Agreement (Agreement Establishing the World Trade Organization) or any of the Multilateral Trade Agreements, provided that such decision shall have approval of three-fourths of the Members. A request for a waiver concerning the Multilateral Trade Agreement related to Goods, Services or Trade-Related Intellectual Property Rights, shall be submitted initially to the Council for Trade in goods, the Council for Trade in Services or the Council for TRIPS respectively for consideration. Such consideration must be completed within the specified time period not exceeding 90 days. But the end of the period, the relevant Council shall submit its report to the Ministerial Conference. Any waiver of obligations of a Member, granted under these provisions, shall be reviewed as per terms of this Agreement. The decisions under a Plurilateral Trade Agreement, including any decision on interpretations and waivers, shall be governed by the provisions of that Agreement.

8.5 Anti-dumping Processing – Introduction

8.5.1 Dumping occurs, if a company exports its product at a lower price than the normal price charged by it in the domestic market. If such dumping injures the domestic manufacturers in the importing country, the importing country may impose anti-dumping duties under certain circumstances to offset the effects of dumping. Anti-dumping and allied measures constitute the legal framework, within which the domestic industry can seek necessary relief and protection against dumping of goods and articles by exporting companies and firms of any country from any part of the world. These measures have assumed a great deal of relevance in India in recent times in view of the scenario arising out of unfair trade practices adopted by some of our trading partners, especially in the post-QR phase. In other words, even though the WTO aims to eliminate all the trade barriers, it allows anti-dumping countervailing measures as tools for protecting the domestic industry. These measures require the 'Authority' to determine that not only dumping is occurring, it is also causing the material injury to the domestic industry.

8.5.2 Sections 9, 9A, 9B and 9C of the Customs Tariff Act, 1975 as amended in 1995 and the Customs Tariff (Identification, Assessment and Collection of Anti-dumping Duty on Dumped Articles and for Determination of Injury Rules, 1995 and Customs Tariff (Identification, Assessment and Collection of Countervailing Duty on Subsidized Articles and for Determination of Injury) Rules, 1995 framed there under form the legal basis for anti-dumping and anti subsidy investigations and for the levy of anti-dumping and countervailing duties in India. These laws are in consonance with the WTO Agreements on Anti Dumping and Anti Subsidy countervailing measures.

8.5.3 Anti dumping is a measure to rectify the situation arising out of the dumping of goods and its trade distortive effect. Thus, the purpose of anti-dumping duty is to rectify the trade distortive effect of dumping and re-establish fair trade. It may be added here that the anti dumping is an instrument for ensuring fair trade. It is not a measure of protection per se for the domestic industry. It provides relief to the domestic industry against the injury caused by dumping. However, import of cheap products through illegal trade channels like, smuggling do not fall within the purview of antidumping measures.

8.5.4 As already stated above, Dumping means export of goods by one country/territory to the market of another country / territory at a price lower than the normal value. If the export price is lower than the normal value, it constitutes dumping. Thus, there are two requisites essential for determination of dumping, namely, the normal value and the export price. Both these elements have to be compared for assessment of dumping. In other words, the comparison is made between the following for determining dumping, if any:

(i) The normal value of a product in the exporting country, and

(ii) The value at which the product is sold to the importing country.

Where the above comparison is not feasible then comparison may be made between:

(i) The value (price) at which the product is sold to the importing country; and

(ii) Its cost of production in the country of origin plus a reasonable amount for administrative and other costs and normal profit.

8.5.5 The term "Normal value" is the comparable price at which the goods under consideration are sold, in the ordinary course of trade, in the domestic market of the exporting country. In other words, it is the arms length price of the identical product. If the normal value can not be determined by means of the domestic sales, the following two alternative methods may be employed to determine the normal value:-

- Comparable representative export price to an appropriate third country.
- Constructed normal value, i.e. the cost of production in the country of origin with reasonable addition for administrative, selling and general costs and reasonable profits.

8.5.6 The term "Export price" of the goods allegedly dumped into India means the price at which it is exported to India. It is generally the CIF value minus the adjustments on account of ocean freight, insurance, commission, etc. so as to arrive at the value at ex-factory level.

8.5.7 The term "margin of dumping" is the difference between the Normal value and the export price of the goods under complaint. It is generally expressed as a percentage of the export price. This margin of dumping can be explained through an illustration also. Suppose the normal value US$ 110 per kg. Export price US$ 100 per kg., it can be concluded that there is dumping as export price is lower than normal value and dumping margin in this case is US$ 50 per kg., i.e. 50% of the export price. As already stated above, Dumping is a function of two variables, namely Normal Value and Export Price, which must be compared at the same level of trade i.e. at the ex-factory level.

8.5.8 Difficulties in determining the existence of dumping: It is very difficult generally to determine the existence of dumping. These measures sometimes create political and economic tensions between the countries. The following are some of the difficulties faced for determining the dumping margin:

(i) Cost determination of a product is not quite straight-forward or simple. The cost structure in different countries may widely vary depending on technology, the scale of production and other factor costs. Japan is producing electronic goods cheaper than USA or EC countries.

However, there may be difference in quality as well. It is extremely difficult to call two products or a number of them identical especially for branded or hi-tech products.

(ii) There is multiplicity i.e. the network of import or export – the same country importing from several others and the same country exporting to many member countries.

(iii) The dumping margin to be established requires the comparison between products, which are identical i.e. alike in all respects or closely identified to the product under consideration. However, within the like product, there will sometimes be many types or models. For example, in case of colour televisions, CTVs with different screen sizes (14", 20", 24", 27", 29", 32" etc.) will constitute different models. Similarly some countries have PAL/SECAM system while other countries use the NTSC system. Similarly in case of steel plates, the plates of different thickness would constitute different types.

8.5.9 It may be clear from above that the determination of the existence and, if it exists, the extent of dumping under the GATT Rules is a maze of qualification. It is therefore, very necessary to translate different parameters and indicators in financial terms to identify and determine the existence and/ or extent of dumping in the both-way import-export traffic. A Management Accountant is best suited to develop expertise in these areas.

8.5.10 **Investigation on dumping**: Section 9A of Customs Tariff Act empowers the Central Government to levy anti-dumping duty up to margin of dumping on such articles, if the goods are being sold at less than its normal value. However, Anti dumping action can be taken only when there is an Indian industry producing 'like articles' or almost 'identical articles'.

8.5.11 If an exporter or manufacturer in foreign country dumps its products in India, a complaint may be lodged to the Committee on Anti-dumping Practice by or on behalf of the domestic industry. This complaint should be supported by full satisfactory evidence, facts and figures. This is the first step towards anti-dumping. It then becomes necessary to determine the injury to the dumped country as a result of the alleged dumping. The measurement of dumping injury is a highly complex economic exercise. To make a valid and sustainable complaint to the Anti-dumping Committee, a host of analysis is required, namely –

(i) volume of dumped imports

(ii) effect of dumped imports

(iii) the price of like products in the domestic market

(iv) the impact of such dumping.

The following are essential for initiating an anti dumping investigation:-

(a) Sufficient evidence to the effect that;

- there is dumping
- there is injury to the domestic industry; and
- there is a causal link between the dumping and the injury, that is to say, that the dumped imports have caused the alleged injury.

(b) The domestic producers expressly supporting the anti dumping application must account for not less than 25% of the total production of the like article by the domestic industry.

The application is deemed to have been made by or on behalf of the domestic industry, if it is supported by those domestic producers whose collective output constitute more than 50% of the total production of the like article produced by that portion of the domestic industry expressing either support for or opposition as the case may be, to the application.

8.5.12 Based on the merits of the complaint, Investigation on alleged dumping are initiated. If the investigating authority is convinced with the evidence produced that there is a *prima facie* case of dumping, it may decide on the following provisions measures –

(i) Provisional duty

(ii) Security by way of cash deposit or bond equal to the amount of anti-dumping duty as estimated; it shall not be greater than the provisional margin of dumping.

8.5.13 In the anti dumping proceedings, it is imperative to prove that the dumping has caused injury to the domestic industry. No anti dumping duty shall be recommended without a finding of this causal relationship. That is to say, Dumping should lead to Injury. The causal link is to be established generally in terms of the following effects of dumped imports on domestic industry: -

- volume effect
- price effect

8.5.14 The volume effect of dumping relates to the market share of the domestic industry vis-à-vis the dumped imports from the subject country/ies while with regard to the price effect, the Designated Authority shall consider whether there has been a significant price under cutting by the dumped imports as compared with the price of the like product in the country (India), or whether the effect of such imports is otherwise to depress prices to a significant degree or prevent price increase, which otherwise would have occurred to a significant degree.

8.5.15 Broadly, injury may be analysed in terms of the volume effect and price effect of the dumped imports. The parameters by which injury to the domestic industry is to be assessed in the anti dumping proceedings are such economic indicators having a bearing upon the state of industry as the magnitude of dumping, and the decline in sales, selling price, profits, market share, production, utilisation of capacity etc.

8.5.16 Under the WTO arrangement, the National Authorities can impose duties upto the margin of dumping i.e. the difference between the normal value and the export price. The Indian law also provides that the anti dumping duty to be recommended/ levied shall not exceed the dumping margin. However, if an exporter accused of dumping undertakes voluntarily to the satisfaction of authorities to revise its prices or cease export to the area in question at dumped price, the antidumping proceeding may be suspended or terminated.

8.5.17 While preparing a case relating to dumping, the cost accountant has to analyse costs in greater detail. He has to analyse costs according to variability and according to cost relevancy so as to make a decision whether products are being dumped below cost or not. This is only a part of the antidumping exercise and other factors such as normal price (value), the value at which the dumped product is being sold to the exporting country, etc. should also be given due consideration. The normal value of a product generally consist of:

(a) Cost of production;

(b) Reasonable amount for administrative, selling and general costs (often called SGA); and

(c) Reasonable amounts for profits.

8.5.18 The Article 2.2.2 of Anti-Dumping Agreement (ADA) provides w.r.t. (b) and (c) above that amounts for administrative, selling and general costs and for profits shall be based on actual data pertaining to production and sales in the ordinary course of trade of the like product by the exporter or producer under investigation. When such amounts cannot be determined on this basis the amounts may be determined on the basis of :-

(i) the actual amounts incurred and realized by the said exporter or producer in respect of production and sales in the domestic market of the country of origin of the same general category of products;

(ii) the weighted average of the actual amounts incurred and realized by other exporters or producers subject to investigation in respect of production and sales of the like product in the domestic market of the country of origin;

(iii) any other reasonable method, provided that the amount for profit so established shall not exceed the profit normally realized by other exporters or producers on sale of products of the same general category of origin.

8.5.19 It may be clarified here that if domestic producers and distributors are related parties, those transactions are generally ignored on the ground that those are not arms length transactions. Therefore, normal value is determined based on sale made by the distributor to the first independent customer. However, in such cases, price will be generally higher and is therefore more likely to lead to a finding of dumping.

8.5.20 Based on aforesaid procedures, Non-Injurious Price is determined. Non-Injurious Price (NIP) is that level of price, which the industry is, expected to have charged under normal circumstances in the Indian market during the period defined. This price would have enabled reasonable recovery of cost of production and profit after nullifying adverse impact of those factors of production which could have adversely affected the company and for which dumped imports can't be held responsible.

8.5.21 Besides the calculation of the margin of dumping, the Designated Authority also calculates the Injury Margin for the Domestic Industry. The Injury Margin is the difference between the Non-Injurious Price due to the Domestic Industry and the Landed Value of the dumped imports.

8.5.22 Landed Value for this purpose is taken as the assessable value under the Customs Act and the applicable basic Customs duties except CVD, SAD and special duties.

8.5.23 For calculating Non-Injurious Price, the Authority calls for costing information from the domestic industry in the prescribed proforma for the period of investigations and for three previous years. Accounting records maintained on the basis of Generally Acceptable Accounting Principle (GAAP) form the basis for estimating Non-Injurious Price. In the estimation of Non-Injurious Price for the Domestic Industry, the Authority makes appropriate analysis of all relevant factors like usage of raw material, usage of utilities, captive consumption etc. and the actual expanses during the Period of Investigation including the investments, the capacity utilisation etc. The Non-Injurious Price for Domestic Industry is determined considering the reasonable return on the capital employed.

8.5.24 The term 'Export Price' means the price at which goods are exported. If the export price is unreliable due to association or compensatory arrangement between exporter and importer or a third party, export price can be constructed (revised) on the basis of price at which the imported articles are first sold to independent buyer or according to rules made for determining margin of dumping. It should be noted that 'dumping' is with respect to domestic price in exporting country and not the importing county, e.g. if goods are imported to India from (say) Japan, price ruling in Japan of that product will be relevant and not price of similar product ruling in India. Thus, if prices are high in India due to inefficiency or other reasons, dumping duty cannot be imposed simply because manufacturers in Japan are more competent and efficient and can produce goods as lower costs.

8.5.25 Any exporter whose margin of dumping is less than 2% of the export price shall be excluded from the purview of anti-dumping duties even if the existence of dumping, injury as well as the causal link is established. Similarly, investigation against any country is required to be terminated if the volume of the dumped imports, actual or potential, from a particular country accounts for less than 3% of the total imports of the like product. However, in such a case, the cumulative imports of the like product from all these countries who individually account for less than 3%, should not exceed 7% of the import of the like product.

8.5.26 It may be added here that in India, injury to concerned local industry only is considered for levy of anti-dumping duty. Gains to other industry and economy in general due to availability of imports at lower prices are not considered. i.e. welfare of society at large is not taken into account. However, this principle is adopted in Europe and in certain cases, dumping duties were not imposed, even when dumping was established, considering that public at large is being benefited. Anti-dumping duty is not applicable for import by EOU, FTZ or SEZ units, unless it is specifically made applicable in the notification imposing anti-dumping duty [section 9A(2A) of Customs Tariff Act].

Safeguard Duty

8.5.27 Central Government is also empowered to impose 'safeguard duty' on specified imported goods if Central Government is satisfied that the goods are being imported in large quantities and under such conditions that they are causing or threatening to cause serious injury to domestic industry. Such duty is permissible under WTO agreement. The only condition under WTO is that it should not discriminate between imports from different countries having Most Favoured Nation (MFN) status.

8.5.28 Safeguard duty is a step in providing a need based protection to domestic industry for a limited period, with ultimate objective of restoring free and fair competition. Safeguard duty is targeted at remedying or preventing serious injury to domestic industry with a view to making it competitive and to enable it to stand on its own.

8.5.29 Government has to conduct an enquiry and then issue a notification, [Section 8B(1) of Customs Tariff Act]. The duty, once imposed, is valid for four years, unless revoked earlier. This can be extended by Central Government, but total period of 'safeguard duty' cannot be more than ten years [Section 8B(4)]. The duty, is in addition to any other customs duty being imposed on the goods [Section 8B(3)]. In case of imports from developing countries, such safeguard duty can be imposed only if import of that article from that country is more than 3% of total imports of that article in India. [proviso to Section 8B(10)].

EXTRACTS FROM

CUSTOMS TARIFF (IDENTIFICATION, ASSESSMENT AND COLLECTION OF ANTIDUMPING DUTY ON DUMPED ARTICLES AND FOR DETERMINATION OF INJURY) RULES, 1995.

Notification No. 2/95-Cus. (N.T.), dated 1st January, 1995 as amended

In exercise of the powers conferred by sub-section (6) of Section 9A and sub-section (2) of Section 9B of the Customs Tariff Act, 1975 (51 of 1975) and in supersession of the Customs Tariff (Identification, Assessment and Collection of Duty or Additional Duty on Dumped Articles and for Determination of Injury) Rules, 1985, except as respect things done or omitted to be done before such supersession, the Central Government hereby makes the following rules, namely:-

1. **Short title and commencement** -

   (1) These rules may be called the Customs Tariff (Identification, Assessment and Collection of Anti-dumping Duty on Dumped Articles and for Determination of Injury) Rules, 1995.

   (2) They shall come into force on the 1st day of January 1995.

2. **Definitions** - In these rules, unless the context otherwise requires-

   (a) "Act" means the Customs Tariff Act, 1975 (51 of 1975),

   (b) "domestic industry" means the domestic producers as a whole engaged in the manufacture of the like article and any activity connected therewith or those whose collective output of the said article constitutes a major proportion of the total domestic production of that article except when such producers are related to the exporters or importers of the alleged dumped article or are themselves importers thereof in which case 1 such producers may be deemed not to form part of domestic industry.

Provided that in exceptional circumstances referred to in sub-rule (3) of Rule 11, the domestic industry in relation to the article in question shall be deemed to comprise two or more competitive markets and the producers within each of such market a separate industry, if -

   (i) the producers within such a market sell all or almost all of their production of the article in question in that market; and

   (ii) the demand in the market is not in any substantial degree supplied by producers of the said article located elsewhere in the territory;

   Explanation - For the purposes of this clause -

   (i) producers shall be deemed to be related to exporters or importers only if-

      (a) one of them directly or indirectly controls the other; or

      (b) both of them are directly or indirectly controlled by a third person; or

      (c) together they directly or indirectly control a third person subject to the condition that are grounds for believing or suspecting that the effect of the relationship is such as to cause the producers to behave differently from non-related producers.

(ii) a producer shall be deemed to control another producer when the former is legally or operationally in a position to exercise restraint or direction over the latter.

(c) "interested party" includes -

(i) an exporter or a foreign producer or the importer of an article subject to investigation for being dumped in India, or a trader or business association a majority of the members of which are producers, exporters or importers of such an article;

(ii) the government of the exporting country; and

(iii) a producer of the like article in India or a trade and business association a majority of the members of which produce the like article in India;

(d) "like article" means an article which is identical or alike in all respects to the article under investigation for being dumped in India or in the absence of such an article, another article which although not alike in all respects, has characteristics closely resembling those of the articles under investigation;

(e) "provisional duty" means an anti dumping duty imposed under sub-section (2) of Section 9A of the Act;

(f) "specified country" means a country or territory which is a member of the World Trade Organization and includes the country or territory with which the Government of India has an agreement for giving it the most favoured nation treatment;

(g) all words and expressions used and not defined in these rules shall have the meanings respectively assigned to them in the Act.

3. **Appointment of designated authority** -

(1) The Central Government may, by notification in the Official Gazette, appoint a person not below the rank of a Joint Secretary to the Government of India or such other person as that Government may think fit as the designated authority for purposes of these rules.

(2) The Central Government may provide to the designated authority the services of such other persons and such other facilities as it deems fit.

4. **Duties of the designated authority** - (1) It shall be the duty of the designated authority in accordance with these rules-

(a) to investigate as to the existence, degree and effect of any alleged dumping in relation to import of any article;

(b) to identify the article liable for anti-dumping duty;

(c) to submit its findings, provisional or otherwise to Central Government as to-

(i) normal value, export price and the margin of dumping in relation to the article under investigation, and

(ii) the injury or threat of injury to an industry established in India or material retardation to the establishment of an industry in India consequent upon the import of such article from the specified countries.

(d) 3 to recommend the amount of anti-dumping duty equal to the margin of dumping or less, which if levied, would remove the injury to the domestic industry, and the date of commencement of such duty; and

(e) to review the need for continuance of anti-dumping duty.

5. **Initiation of investigation** - (1) Except as provided in sub-rule (4), the designated authority shall initiate an investigation to determine the existence, degree and effect of any alleged dumping only upon receipt of a written application by or on behalf of the domestic industry.

(2) An application under sub-rule (1) shall be in the form as maybe specified by the designated authority and the application shall be supported by evidence of -

(a) dumping

(b) injury, where applicable, and

(c) where applicable, a causal link between such dumped imports and alleged injury.

(3) The designated authority shall not initiate an investigation pursuant to an application made under sub-rule (1) unless -

(a) it determines, on the basis of an examination of the degree of support for, or opposition to the application expressed by domestic producers of the like product, that the application has been made by or on behalf of the domestic industry :

Provided that no investigation shall be initiated if domestic producers expressly supporting the application account for less than twenty five per cent of the total production of the like article by the domestic industry, and

(b) it examines the accuracy and adequacy of the evidence provided in the application and satisfies itself that there is sufficient evidence regarding -

(i) dumping,

(ii) injury, where applicable; and

(iii) where applicable, a casual link between such dumped imports and the alleged injury, to justify the initiation of an investigation.

Explanation - For the purpose of this rule the application shall be deemed to have been made by or on behalf of the domestic industry, if it is supported by those domestic producers whose collective output constitute more than fifty per cent of the total production of the like article produced by that portion of the domestic industry expressing either support for or opposition, as the case may be, to the application.

(4) Notwithstanding anything contained in sub-rule (1) the designated authority may initiate an investigation suo moto if it is satisfied from the information received from the Commissioner of Customs appointed under the Customs Act, 1962 (52 of 1962) or from any other source that sufficient evidence exists as to the existence of the circumstances referred to in clause (b) of sub-rule (3).

(5) The designated authority shall notify the government of the exporting country before proceeding to initiate an investigation.

6. **Principles governing investigations** -

(1) The designated authority shall, after it has decided to initiate investigation to determine the existence, degree and effect of any alleged dumping of any article, issue a public notice notifying its decision and such public notice shall, inter alia, contain adequate information on the following:-

(i) the name of the exporting country or countries and the article involved;

(ii) the date of initiation of the investigation;

(iii) the basis on which dumping is alleged in the application;

(iv) a summary of the factors on which the allegation of injury is based;

(v) the address to which representations by interested parties should be directed; and

(vi) the time-limits allowed to interested parties for making their views known.

(2) A copy of the public notice shall be forwarded by the designated authority to the known exporters of the article alleged to have been dumped, the Governments of the exporting countries concerned and other interested parties.

(3) The designated authority shall also provide a copy of the application referred to in sub-rule (1) of Rule 5 to -

(i) the known exporters or to the concerned trade association where the number of exporters is large, and

(ii) the governments of the exporting countries :

Provided that the designated authority shall also make available a copy of the application to any other interested party who makes a request therefor in writing.

(4) The designated authority may issue a notice calling for any information, in such form as may be specified by it, from the exporters, foreign producers and other interested parties and such information shall be furnished by such persons in writing within thirty days from the date of receipt of the notice or within such extended period as the designated authority may allow on sufficient cause being shown.

Explanation: For the purpose of this sub-rule, the notice calling for information and other documents shall be deemed to have been received one week from the date on which it was sent by the designated authority or transmitted to the appropriate diplomatic representative of the exporting country.

(5) The designated authority shall also provide opportunity to the industrial users of the article under investigation, and to representative consumer organizations in cases where the article is commonly sold at the retail level, to furnish information which is relevant to the investigation regarding dumping, injury where applicable, and causality.

(6) The designated authority may allow an interested party or its representative to present the information relevant to the investigation orally but such oral information shall be taken into consideration by the designated authority only when it is subsequently reproduced in writing.

(7) The designated authority shall make available the evidence presented to it by one interested party to the other interested parties, participating in the investigation.

(8) In a case where an interested party refuses access to, or otherwise does not provide necessary information within a reasonable period, or significantly impedes the investigation, the designated authority may record its findings on the basis of the facts available to it and make such recommendations to the Central Government as it deems fit under such circumstances.

7. **Confidential information** -

(1) Notwithstanding anything contained in sub-rules (2), (3) and (7) of rule 6, sub-rule (2) of rule 12, sub-rule (4) of rule 15 and sub-rule (4) of rule 17, the copies of applications received under sub-rule (1) of rule 5, or any other information provided to the designated authority on a confidential basis by any party in the course of investigation, shall, upon the designated authority being satisfied as to its confidentiality, be treated as such by it and no such information shall be disclosed to any other party without specific authorization of the party providing such information.

(2) The designated authority may require the parties providing information on confidential basis to furnish non-confidential summary thereof and if, in the opinion of a party providing such information, such information is not susceptible of summary, such party may submit to the designated authority a statement of reasons why summarization is not possible.

(3) Notwithstanding anything contained in sub-rule (2), if the designated authority is satisfied that the request for confidentiality is not warranted or the supplier of the information is either unwilling to make the information public or to authorize its disclosure in a generalized or summary form, it may disregard such information.

8. **Accuracy of the information** -

Except in cases referred to in sub-rule (8) of rule 6, the designated authority shall during the course of investigation satisfy itself as to the accuracy of the information supplied by the interested parties upon which its findings are based.

9. **Investigation in the territory of other specified countries** -

The designated authority may carry out investigation in the territories of other countries, if the circumstances of a case so warrant. Provided that the designated authority obtains the consent of the person concerned and notifies the representatives of the concerned government and the concerned government does not object to such investigation.

10. **Determination of normal value, export price and margin of dumping**. -

An article shall be considered as being dumped if it is exported from a country or territory to India at a price less than its normal value and in such circumstances the designated authority shall determine the normal value, export price and the margin of dumping taking into account, inter alia, the principles laid down in Annexure I to these rules.

11. **Determination of injury** -

(1) In the case of imports from specified countries, the designated authority shall record a further finding that import of such article into India causes or threatens material injury to any established industry in India or materially retards the establishment of any industry in India.

(2) The designated authority shall determine the injury to domestic industry, threat of injury to domestic industry, material retardation to establishment of domestic industry and a causal link between dumped imports and injury, taking into account all relevant facts, including the

volume of dumped imports, their effect on price in the domestic market for like articles and the consequent effect of such imports on domestic producers of such articles and in accordance with the principles set out in Annexure II to these rules.

(3) The designated authority may, in exceptional cases, give a finding as to the existence of injury even where a substantial portion of the domestic industry is not injured, if-

(i) there is a concentration of dumped imports into an isolated market, and

(ii) the dumped articles are causing injury to the producers of all or almost all of the production within such market.

12. **Preliminary findings** -

(1) The designated authority shall proceed expeditiously with the conduct of the investigation and shall, in appropriate cases, record a preliminary finding regarding export price, normal value and margin of dumping, and in respect of imports from specified countries, it shall also record a further finding regarding injury to the domestic industry and such finding shall contain sufficiently detailed information for the preliminary determinations on dumping and injury and shall refer to the matters of fact and law which have led to arguments being accepted or rejected. It will also contain:-

(i) the names of the suppliers, or when this is impracticable, the supplying countries involved;

(ii) a description of the article which is sufficient for customs purposes;

(iii) the margins of dumping established and a full explanation of the reasons for the methodology used in the establishment and comparison of the export price and the normal value;

(iv) considerations relevant to the injury determination; and

(v) the main reasons leading to the determination.

2. The designated authority shall issue a public notice recording its preliminary findings.

13. **Levy of provisional duty** -

The Central Government may, on the basis of the preliminary findings recorded by the designated authority, impose a provisional duty not exceeding the margin of dumping:

Provided that no such duty shall be imposed before the expiry of sixty days from the date of the public notice issued by the designated authority regarding its decision to initiate investigations:

Provided further that such duty shall remain in force only for a period not exceeding six months which may upon request of the exporters representing a significant percentage of the trade involved be extended by the Central Government to nine months.

14. **Termination of investigation** -

The designated authority shall, by issue of a public notice, terminate an investigation immediately if-

(a) it receives a request in writing for doing so from or on behalf of the domestic industry affected, at whose instance the investigation was initiated;

(b) it is satisfied in the course of an investigation, that there is not sufficient evidence of dumping or, where applicable, injury to justify the continuation of the investigation;

(c) it determines that the margin of dumping is less than two per cent of the export price;

(d) it determines that the volume of the dumped imports, actual or potential, from a particular country accounts for less than three per cent of the imports of the like product, unless, the countries which individually account for less than three per cent of the imports of the like product, collectively account for more than seven per cent of the import of the like product; or

(e) it determines that the injury where applicable, is negligible.

15. **Suspension or termination of investigation on price undertaking –**

(1) The designated authority may suspend or terminate an investigation if the exporter of the article in question -

(i) furnishes an undertaking in writing to the designated authority to revise the prices so that no exports of the said article are made to India at dumped prices, or

(ii) in the case of imports from specified countries undertake to revise the prices so that injurious effect of dumping is eliminated and the designated authority is satisfied that the injurious effect of the dumping is eliminated:

Provided further that the designated authority shall complete the investigation and record its finding, if the exporter so desires, or it so decides.

(2) No undertaking as regards price increase under clause (ii) of the sub-rule (1) shall be accepted from any exporter unless the designated authority had made preliminary determination of dumping and the injury.

(3) The designated authority may, also not accept undertakings offered by any exporter, if it considers that acceptance of such undertaking is impractical or is unacceptable for any other reason.

(4) The designated authority shall intimate the acceptance of an undertaking and suspension or termination of investigation to the Central Government and also issue a public notice in this regard. The public notice shall, contain inter alia, the non-confidential part of the undertaking.

(5) In cases where an undertaking has been accepted by the designated authority the Central Government may not impose a duty under sub-section (2) of Section 9A of the Act for such period the undertaking acceptable to the designated authority remains valid.

(6) Where the designated authority has accepted any undertaking under sub-rule (1), it may require the exporter from whom such undertaking has been accepted to provide from time to time information relevant to the fulfilment of the undertaking and to permit verification of relevant data:

Provided that in case of any violation of an undertaking, the designated authority shall, as soon as may be possible, inform the Central Government of the violation of the undertaking and recommend imposition of provisional duty from the date of such violation in accordance with the provisions of these rules.

(7) The designated authority shall, suo moto or on the basis of any request received from exporters or importers of the article in question or any other interested party, review from time to time the need for the continuance of any undertaking given earlier.

16. **Disclosure of information**. - The designated authority shall, before giving its final findings, inform all interested parties of the essential facts under consideration which form the basis for its decision.

17. **Final findings** - (1) The designated authority shall, within one year from the date of initiation of an investigation, determine as to whether or not the article under investigation is being dumped in India and submit to the Central Government its final finding -

(a) as to, -

(i) the export price, normal value and the margin of dumping of the said article;

(ii) whether import of the said article into India, in the case of imports from specified countries, causes or threatens material injury to any industry established in India or materially retards the establishment of any industry in India;

(iii) a casual link, where applicable, between the dumped imports and injury;

(iv) whether a retrospective levy is called for and if so, the reasons therefore and date of commencement of such retrospective levy:

Provided that the Central Government may, in its discretion in special circumstances extend further the aforesaid period of one year by six months:

Provided further that in those cases where the designated authority has suspended the investigation on the acceptance of a price undertaking as provided in rule 15 and subsequently resumes the same on violation of the terms of the said undertaking, the period for which investigation was kept under suspension shall not be taken into account while calculating the period of said one year,

(b) recommending the amount of duty which, if levied, would remove the injury where applicable, to the domestic industry.

(2) The final finding, if affirmative, shall contain all information on the matter of facts and law and reasons which have led to the conclusion and shall also contain information regarding-

(i) the names of the suppliers, or when this is impracticable, the supplying countries involved;

(ii) a description of the product which is sufficient for customs purposes;

(iii) the margins of dumping established and a full explanation of the reasons for the methodology used in the establishment and comparison of the export price and the normal value;

(iv) Considerations relevant to the injury determination; and

(v) the main reasons leading to the determination.

(3) The designated authority shall determine an individual margin of dumping for each known exporter or producer concerned of the article under investigation:

Provided that in cases where the number of exporters, producers, importers or types of articles involved are so large as to make such determination impracticable, it may limit its findings either to a reasonable number of interested parties or articles by using statistically valid samples based on information available at the time of selection, or to the largest percentage of the volume of the exports from the country in question which can reasonably be investigated, and any selection, of exporters, producers, or types of articles, made under this proviso shall preferably be made in consultation with and with the consent of the exporters, producers or importers concerned :

Provided further that the designated authority shall, determine an individual margin of dumping for any exporter or producer, though not selected initially, who submit necessary information in time, except where the number of exporters or producers are so large that individual examination would be unduly burdensome and prevent the timely completion of the investigation.

(4) The designated authority shall issue a public notice recording its final findings.

18. **Levy of duty**. - (1) The Central Government may, within three months of the date of publication of final findings by the designated authority under rule 17, impose by notification in the Official Gazette, upon importation into India of the article covered by the final finding, anti-dumping duty not exceeding the margin of dumping as determined under rule 17.

(2) In cases where the designated authority has selected percentage of the volume of the exports from a particular country, as referred to sub-rule (3) of rule 17, any anti-dumping duty applied to imports from exporters or producers not included in the examination shall not exceed -

(i) the weighted average margin of dumping established with respect to the selected exporters or producers or,

(ii) where the liability for payment of anti-dumping duties is calculated on the basis of a prospective normal value/ the difference between the weighted average normal value of the selected exporters or producers and the export prices of exporters or producers not individually examined:

Provided that the Central Government shall disregard for the purpose of this sub-rule any zero margin, margins which are less than 2 per cent expressed as the percentage of export price and margins established in the circumstances detailed in sub-rule (8) of rule 6. The Central Government shall apply individual duties to imports from any exporter or producer not included in the examination who has provided the necessary information during the course of the investigation as referred to in the second proviso to sub-rule (3) of rule 17.

(3) Notwithstanding anything contained in sub-rule (1), where a domestic industry has been interpreted according to the proviso to sub-clause (b) of rule 2, a duty shall be levied only after the exporters have been given opportunity to cease exporting at dumped prices to the area concerned or otherwise give an undertaking pursuant to rule 15 and such undertaking has not been promptly given and in such cases duty shall not be levied only on the articles of specific producers which supply the area in question.

(4) If the final finding of the designated authority is negative that is contrary to the evidence on whose basis the investigation was initiated, the Central Government shall, within forty-five days of the publication of final findings by the designated authority under rule 17, withdraw the provisional duty imposed, if any.

19. **Imposition of duty on non-discriminatory basis** - Any provisional duty imposed under rule 13 or an anti-dumping duty imposed under rule 18 shall be on a non-discriminatory basis and applicable to all imports of such articles, from whatever sources found dumped and, where applicable, causing injury to domestic industry except in the case of imports from those sources from which undertaking in terms of rule 15 has been accepted.

20. **Commencement of duty** -

(1) The anti-dumping duty levied under rule 13 and rule 19 shall take effect from the date of its publication in the Official Gazette.

(2) Notwithstanding anything contained in sub-rule (1) -

(a) where a provisional duty has been levied and where the designated authority has recorded a final finding of injury or where the designated authority has recorded a final finding of threat of injury and a further finding that the effect of dumped imports in the absence of provisional duty would have led to injury, the anti-dumping duty may be levied from the date of imposition of provisional duty;

(b) in the circumstances referred to in sub-section (3) of Section 9A of the Act, the antidumping duty may be levied retrospectively from the date commencing ninety days prior to the imposition of such provisional duty:

Provided that no duty shall be levied retrospectively on imports entered for home consumption before initiation of the investigation:

Provided further that in the cases of violation of price undertaking referred to in sub-rule (6) of rule 15, no duty shall be levied retrospectively on the imports which have entered for home consumption before the violation of the terms of such undertaking.

Provided also that notwithstanding anything contained in the foregoing proviso, in case of violation of such undertaking, the provisional duty shall be deemed to have been levied from the date of violation of the undertaking or such date as the Central Government may specify in each case.

21. **Refund of duty** - (1) If the anti-dumping duty imposed by the Central Government on the basis of the final findings of the investigation conducted by the designated authority is higher than the provisional duty already imposed and collected, the differential shall not be collected from the importer.

(2) If, the anti-dumping duty fixed after the conclusion of the investigation is lower than the provisional duty already imposed and collected, the differential shall be refunded to the importer.

(3) If the provisional duty imposed by the Central Government is withdrawn in accordance with the provisions of sub-rule (4) of rule 18, the provisional duty already imposed and collected, if any, shall be refunded to the importer.

22. **Margin of dumping, for exporters not originally investigated** - (1) If a product is subject to anti-dumping duties, the designated authority shall carry out a periodical review for the purpose of determining individual margins of dumping for any exporters or producers in the exporting country in question who have not exported the product to India during the period of investigation, provided that these exporters or producers show that they are not related to any of the exporters or producers in the exporting country who are subject to the antidumping duties on the product.

(2) The Central Government shall not levy anti-dumping duties under sub-section (1) of Section 9A of the Act, on imports from such exporters or producers during the period of review as referred to in sub-rule (1) of this rule:

Provided that the Central Government may resort to provisional assessment and may ask a guarantee from the importer if the designated authority so recommends and if such a review results in a determination of dumping in respect of such products or exporters, it may levy duty in such cases retrospectively from the date of the initiation of the review.

23. **Review** - (1) The designated authority shall, from time to time, review the need for the continued imposition of the anti-dumping duty and shall, if it is satisfied on the basis of information received by it that there is no justification for the continued imposition of such duty recommend to the Central Government for its withdrawal.

(2) Any review initiated under sub-rule (1) shall be concluded within a period not exceeding twelve months from the date of initiation of such review.

(3) The provisions of rules 6, 7, 8, 9/10, 11, 16, 17, 18, 19, and 20 shall be mutatis mutandis applicable in the case of review.

24. **Dumping causing injury to a third country** - (1) The designated authority may initiate investigation into any dumping alleged to be taking place into India and causing injury to the domestic industry of any third country which is a member of the World Trade Organisation.

    (2) The designated authority in such cases shall follow the procedures laid down in Article 14 of the Agreement on Implementation of Article VI of the General Agreement on Tariff and Trade, 1994, as contained in the Final Act of Uruguay Round Multilateral Trade Negotiations.

Annexure- I (See Rule 8)

Principles governing the determination of normal value, export price and margin of dumping.

The designated authority while determining the normal value, export price and margin of dumping shall take into account inter alia, the following principles -

1. The elements of costs referred to in the context of determination of normal value shall normally be determined on the basis of records kept by the exporter or producer under investigation, provided such records are in accordance with the generally accepted accounting principles of the exporting country, and such records reasonably reflect the cost associated with production and sale of the article under consideration.

2. Sales of the like product in the domestic market of the exporting country or sales to a third country at prices below per unit (fixed and variable) costs of production plus administrative, selling and general costs may be treated as not being in the ordinary course of trade by reason of price. The designated authority may disregard these sales, in determining normal value, provided it has determined that-

    (i) such sales are made within a reasonable period of time (not less than six months) in substantial quantities, i.e. when the weighted average selling price of the article is below the weighted average per unit costs or when the volume of the sales below per unit costs represents not less than twenty per cent of the volume sold in transactions under consideration, and

    (ii) such sales are at prices which do not provide for the recovery of all costs within a reasonable period of time. The said prices will be considered to provide for recovery of costs within a reasonable period of time if they are above weighted average per unit costs for the period of investigation, even though they might have been below per unit costs at the time of sale.

3. (i) The said authority in the course of investigation shall consider all available evidence on the proper allocation of costs, including that which is made available by the exporter or producer provided that such allocation has been historically utilized by the exporter or producer, in relation to establishing appropriate amortization and depreciation periods and allowances for capital expenditure and other development costs.

    (ii) unless already reflected in allocation of costs referred to in clause (1) and sub clause (i) above, the designated authority, will also make appropriate adjustments for those non-recurring items of cost which benefits further and/or current production, or for circumstances in which costs during the period of investigation are affected by start up operation.

4. The amounts for administrative, selling and general costs and for profits as referred to in sub-section (1) of section 9A of the Act, shall be based on actual data pertaining to production and sales in the ordinary course of trade, of the like article by the exporter or producer under investigation. When such amounts cannot be determined on this basis, the amounts may be determined on the basis of:

(i) the actual amounts incurred and realized by the exporter or producer in question, in respect of production and sales in the domestic market of the country of origin of the same general category of article;

(ii) the weighted average of the actual amounts incurred and realized by other exporters or producers subject to investigation in respect of production and sales of the like article in the domestic market of the country of origin; or

(iii) any other reasonable method, provided that the amount for profit so established shall not exceed the profit normally realized by the exporters or producers on sales of products of the same general category in the domestic market of the country of origin.

5. The designated authority, while arriving at a constructed export price, shall give due allowance for costs including duties and taxes, incurred between importation and resale and for profits.

6. (i) While arriving at margin of dumping, the designated authority shall make a fair comparison between the export price and the normal value. The comparison shall be made at the same level of trade, normally at the ex-factory level, and in respect of sales made at as nearly as possibly the same time. Due allowance shall be made in each case, on its merits, for differences which affect price comparability, including differences in conditions and in terms of sale, taxation, levels of trade, quantities, physical characteristics, and any other differences which are demonstrated to affect price comparability.

(ii) In the cases where export price is a constructed one, the comparison shall be made only after establishing the normal value at equivalent level of trade.

(iii) When the comparison under this para requires a conversion of currencies, such conversion should be made by using the rate of exchange on the date of sale, provided that when a sale on foreign currency on forward markets is directly linked to the export sale involved the rate of exchange in the forward sale shall be used. Fluctuations in exchange rates shall be ignored and in an investigation the exporters shall be given at least sixty days to have adjusted their export prices to reflect the sustained movements in exchange rates during the period of investigation.

(iv) Subject to the provisions governing comparison in this paragraph, the existence of margin dumping during the investigation phase shall normally be established on the basis of comparison of a weighted average normal value and export prices on a transaction-to-transaction basis. A normal value established on a weighted average basis may be compared to the prices of the individual export transactions if it is found that the pattern of export prices which differs significantly among different purchasers, regions or time periods and if an explanation is provided as to why such differences cannot be taken into account appropriately by the use of weighted average-to-weighted average or transaction-to-transaction comparison.

7. In case of imports from non-market economy countries, normal value shall be determined on the basis if the price or constructed value in the market economy third country, or the price from such a third country to other countries, including India or where it is not possible, or on any other reasonable basis, including the price actually paid or payable in India for the like product, duly adjusted if necessary, to include a reasonable profit margin. An appropriate market economy third country shall be selected by the designated authority in a reasonable manner, keeping in view the level of development of the country concerned and the product in question, and due account shall be taken of any reliable information made available at the time of selection. Accounts shall be taken within time limits, where appropriate, of the investigation made in any similar matter in respect of any other market economy third country. The parties to the investigation shall be informed without any unreasonable delay the aforesaid selection of the market economy third country and shall be given a reasonable period of time to offer their comments.

8. (1) The term "non-market economy country" means any country which the designated authority determines as not operating on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise, in accordance with the criteria specified in sub-paragraph (3)

(2) There shall be a presumption that any country that has been determined to be, or has been treated as, a non-market economy country for purposes of an anti-dumping investigation by the designated authority or by the competent authority of any WTO member country during the three year period preceding the investigation is a non-market economy country.

Provided, however, that the non-market economy country or the concerned firms from such country may rebut such a presumption by providing information and evidence to the designated authority that establishes that such country is not a non-market economy country on the basis of the criteria specified in sub-paragraph (3).

(3) The designated authority shall consider in each case the following criteria as to whether:

(a) the decisions of the concerned firms in such country regarding prices, costs and inputs, including raw materials, cost of technology and labour, output, sales and investment, are made in response to market signals reflecting supply and demand and without significant State interference in this regard, and whether costs of major inputs substantially reflect market values;

(b) the production costs and financial situation of such firms are subject to significant distortions carried over from the former non-market economy system, in particular in relation to depreciation of assets, other write-offs, barter trade and payment via compensation of debts;

(c) such firms are subject to bankruptcy and property laws which guarantee legal certainty and stability for the operation of the firms, and

(d) the exchange rate conversions are carried out at the market rate.

Provided, however, that where it is shown by sufficient evidence in writing on the basis of the criteria specified in this paragraph that market conditions prevail for one or more such firms subject to anti-dumping investigations, the designated authority may apply the principles set out in paragraphs 1 to 6 instead of the principles set out in paragraph 7 and in this paragraph".

(4) Notwithstanding, anything contained in sub-paragraph (2), the designated authority may treat such country as market economy country which, on the basis of the latest detailed evaluation of relevant criteria, which includes the criteria specified in sub paragraph (3), has been, by publication of such evaluation in a public document, treated or determined to be treated as a market economy country for the purposes of anti dumping investigations, by a country which is a member of the World Trade Organization."

Annexure- II

See Rule 9(2)

Principles for determination of injury

The designated authority while determining the injury or threat of material injury to domestic industry or material retardation of the establishment of such an industry, hereinafter referred to as “injury” and casual link between dumped imports and such injury, shall inter alia, take following principles under consideration-

(i) A determination of injury shall involve an objective examination of both (a) the volume of the dumped imports and the affect of the dumped imports on prices in the domestic market for like article and (b) the consequent impact of these imports on domestic producers of such products.

(ii) While examining the volume of dumped imports, the said authority shall consider whether there has been a significant increase in the dumped imports, either in absolute terms or relative to production or consumption in India. With regard to the affect of the dumped imports on prices as referred to in sub-rule (2) of rule 18 the designated authority shall consider whether there has been a significant price under cutting by the dumped imports as compared with the price of like product in India, or whether the effect of such imports is otherwise to depress prices to a significant degree or prevent price increase which otherwise would have occurred, to a significant degree.

(iii) In cases where imports of a product from more than one country are being simultaneously subjected to anti-dumping investigation, the designated authority will cumulatively assess the effect of such imports, only when it determines that (a) the margin of dumping established in relation to the imports from each country is more than two per cent expressed as percentage of export price and the volume of the imports from each country is three per cent of the import of like article or where the export of individual countries less than three per cent, the imports collectively accounts for more than seven per cent of the import of like article and (b) cumulative assessment of the effect of imports is appropriate in light of the conditions of competition between the imported article and the like domestic articles.

(iv) The examination of the impact of the dumped imports on the domestic industry concerned, shall include an evaluation of all relevant economic factors and indices having a bearing on the state of the industry, including natural and 1 0potential decline in sales, profits, output, market share, productivity, return on investments or utilization of capacity; factors affecting domestic prices; the magnitude of the margin of dumping; actual and potential negative effects on cash flow, inventories, employment, wages, growth, ability to raise capital investments.

(v) It must be demonstrated that the dumped imports are, through the effects of dumping, as set forth in paragraphs (ii) and (iv) above, causing injury to the domestic industry. The demonstration of a casual relationship between the dumped imports and the injury to the domestic industry shall be based on an examination of relevant evidence before the designated authority. The designated authority shall also examine any known factors other than the dumped imports which at the same time are injuring the domestic industry, and the injury caused by these other factors must not be attributed to the dumped imports. Factors which may be relevant in this respect include, inter alia, the volume and prices of imports not sold at dumping prices, contraction in demand or changes in the patterns of consumption, trade restrictive practices of and competition between the foreign and domestic producers, developments in technology and the export performance and the productivity of the domestic industry.

(vi) The effect of the dumped imports shall be assessed in relation to the domestic production of the like article when available data permit the separate identification of that production on the basis of such criteria as the production process, producers' sales and profits. If such separate identification of that production is not possible, the effects of the dumped imports shall be assessed by the examination of the production of the narrowest group or range of products, which includes the like product, for which the necessary information can be provided.

(vii) A determination of a threat of material injury shall be based on facts and not merely on allegation, conjecture or remote possibility. The change in circumstances which would create a situation in which the dumping would cause injury must be clearly foreseen and imminent. In making a determination regarding the existence of a threat of material injury, the designated authority shall consider, inter alia, such factors as:

(a) a significant rate of increase of dumped imports into India indicating the likelihood of substantially increased importation;

(b) sufficient freely disposable, or an imminent, substantial increase in, capacity of the exporter indicating the likelihood of substantially increased dumped exports to Indian markets, taking into account the availability of other export markets to absorb any additional exports;

(c) whether imports are entering at prices that will have a significant depressing or suppressing effect on domestic prices, and would likely increase demand for further imports; and

(d) inventories of the article being investigated.

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EXTRACTS FROM THE GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT 1947)

Article VI

Anti-dumping and Countervailing Duties

1. The contracting parties recognize that dumping, by which products of one country are introduced into the commerce of another country at less than the normal value of the products, is to be condemned if it causes or threatens material injury to an established industry in the territory of a contracting party or materially retards the establishment of a domestic industry. For the purposes of this Article, a product is to be considered as being introduced into the commerce of an importing country at less than its normal value, if the price of the product exported from one country to another

    (a) is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country, or,

    (b) in the absence of such domestic price, is less than either

        (i) the highest comparable price for the like product for export to any third country in the ordinary course of trade, or

        (ii) the cost of production of the product in the country of origin plus a reasonable addition for selling cost and profit.

    Due allowance shall be made in each case for differences in conditions and terms of sale, for differences in taxation, and for other differences affecting price comparability.*

2. In order to offset or prevent dumping, a contracting party may levy on any dumped product an anti-dumping duty not greater in amount than the margin of dumping in respect of such product. For the purposes of this Article, the margin of dumping is the price difference determined in accordance with the provisions of paragraph 1.*

3. No countervailing duty shall be levied on any product of the territory of any contracting party imported into the territory of another contracting party in excess of an amount equal to the estimated bounty or subsidy determined to have been granted, directly or indirectly, on the manufacture, production or export of such product in the country of origin or exportation, including any special subsidy to the transportation of a particular product. The term "countervailing duty" shall be understood to mean a special duty levied for the purpose of offsetting any bounty or subsidy bestowed, directly, or indirectly, upon the manufacture, production or export of any merchandise.*

4. No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to anti-dumping or countervailing duty by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes.

5. No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to both anti-dumping and countervailing duties to compensate for the same situation of dumping or export subsidization.

6. (a) No contracting party shall levy any anti-dumping or countervailing duty on the importation

of any product of the territory of another contracting party unless it determines that the effect of the dumping or subsidization, as the case may be, is such as to cause or threaten material injury to an established domestic industry, or is such as to retard materially the establishment of a domestic industry.

(b) The CONTRACTING PARTIES may waive the requirement of subparagraph (a) of this paragraph so as to permit a contracting party to levy an anti-dumping or countervailing duty on the importation of any product for the purpose of offsetting dumping or subsidization which causes or threatens material injury to an industry in the territory of another contracting party exporting the product concerned to the territory of the importing contracting party. The CONTRACTING PARTIES shall waive the requirements of subparagraph (a) of this paragraph, so as to permit the levying of a countervailing duty, in cases in which they find that a subsidy is causing or threatening material injury to an industry in the territory of another contracting party exporting the product concerned to the territory of the importing contracting party.*

(c) In exceptional circumstances, however, where delay might cause damage which would be difficult to repair, a contracting party may levy a countervailing duty for the purpose referred to in subparagraph (b) of this paragraph without the prior approval of the CONTRACTING PARTIES; Provided that such action shall be reported immediately to the CONTRACTING PARTIES and that the countervailing duty shall be withdrawn promptly if the CONTRACTING PARTIES disapprove.

7. A system for the stabilization of the domestic price or of the return to domestic producers of a primary commodity, independently of the movements of export prices, which results at times in the sale of the commodity for export at a price lower than the comparable price charged for the like commodity to buyers in the domestic market, shall be presumed not to result in material injury within the meaning of paragraph 6 if it is determined by consultation among the contracting parties substantially interested in the commodity concerned that:

   (a) the system has also resulted in the sale of the commodity for export at a price higher than the comparable price charged for the like commodity to buyers in the domestic market, and

   (b) the system is so operated, either because of the effective regulation of production, or otherwise, as not to stimulate exports unduly or otherwise seriously prejudice the interests of other contracting parties.

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EXTRACTS OF ANTI-DUMPING APPLICATION PROFORMA

GENERAL

1. The applicant is advised to familiarize themselves with Sections 9A, 9B, and 9C of the Custom Tariff Act, 1975 and the Customs Tariff (Identification, Assessment and Collection of Anti-Dumping Duty on Dumped Articles and for Determination of injury) Rules, 1995 before filing a petition. The applicant may also refer to the Brochure issued by this Directorate on the subject.

2. The Designated Authority would initiate investigations to determine the existence, degree and effect of any alleged dumping upon receipt of a properly documented petition by or on behalf of the domestic industry in accordance with Rule 5(1).

3. Rules 5(5) requires the Designated Authority to examine the accuracy and adequacy of the evidence provided in the application and satisfy itself that there is sufficient evidence regarding dumping, injury where applicable and a causal link between dumped imports and the alleged injury to justify the initiation of an investigation.

4. No petition will therefore be taken on record of this Directorate until it is fully documented and until all informations elicited therein are furnished by the petitioner. In case of any problem faced in filling the application the concerned Case Officer of the Directorate may be contacted for assistance and help. The petitioner must ensure that the application filed by them is complete in all respects and is fully documented, so that it may be taken on record by the Authority and necessary action initiated.

5. The petition should specifically cover, inter alia, the following:

   i) information on the imported product;

   ii) information the domestic industry and the domestic market;

   iii) evidence of dumping;

   iv) evidence of injury; and

   v) evidence of causal link

6. Confidential information: Rule 7 permits an interested party to furnish information on confidential basis. Any information which is by nature confidential (for instance, information the disclosure of which would be of significant competitive advantage to a competitor or because its disclosure would have a significantly adverse effect upon a person supplying the information or upon a person from whom that person acquired the information), shall be treated as such. Evidences relating to Normal Value, export price, costing profitability, specific adjustments in pricing are examples of such information which is usually accepted by Designated Authority as confidential. If confidentiality is claimed on any other aspect, which generally is not the above criteria, the applicant should give a brief statement of reasons as to why that particular information needs to be kept confidential. In case such information is furnished on confidential basis without recording any reasons for claiming it to be confidential, the Designated Authority may disregard such information. It is of utmost importance that each page and supplementary information furnished on confidential basis is clearly marked "confidential" on the face of it, failing which the request for confidentiality may not be entertained.

   All documents/ arguments/ submissions or correspondence made on a confidential basis should necessarily be accompanied by a non-confidential summary, failing which such communication is liable to be ignored without making any other further reference to the supplier of such information, in view of the time limits laid down under the law.

7. The petition is required to be submitted in two copies along with one non-confidential version thereof. The Designated Authority may, however require additional copies before initiation of investigation at any time during the course of the investigations.

8. The Designated Authority may provide any information submitted by the applicant (or any other party) on non-confidential basis to other interested parties in accordance with Rule 6.

9. The petition should contain information as detailed in the enclosed proforma. The proforma enclosed is not a fill in proforma and, therefore, should be treated as a questionnaire. Any information not requested in the proforma which may be of importance, may also be furnished.

10. Applicants are advised to consider a time period for providing the information. The time period chosen for furnishing information should preferably be 12 months or more. It is desirable that this period be most recent and correspond to the accounting year of the domestic industry. All information, unless otherwise specified, should relate to this period.

11. The Designated Authority may request any additional and/ or supplementary information any time before or after initiation of investigation.

12. All information unless otherwise specified should relate to the relevant product.

13. The Designated Authority requires detailed information on the extent of injury upon initiation. The information generally required to be furnished is indicated in Part IV of these guidelines.

14. The application should be addressed to:

    Designated Authority

    Directorate General of Anti-dumping and allied Duties

    Ministry of Commerce

    Udyog Bhavan, New Delhi 110011

15. Please complete the certificate as at Formal "F" for submission along with the petition.

IMPORTED PRODUCT

INFORMATION

Please provide complete information on the product which is alleged to be dumped in India. The following information is relevant in this section of the complaint:

1. Complete description of alleged dumped goods, including information on its size, quality, category and uses of such goods along with any applicable technical specifications or standards (national or international) and the ITC (HS) classification, customs classification, customs duty, import policy(including Advance Licensing provisions).
2. Country(ies) of origin of the alleged dumped goods.
3. Since when such goods from the named country(ies) is (are) being imported in the Indian market and when did dumping start.
4. Whether such goods are shipped to India through third countries.
5. Volume, value and avg. CIF value of such goods imported from other countries, not alleged to be dumping the goods, for the past two years and the current year to date and the source of information thereof.
6. Volume, value and avg.CIF value of such goods imported from other countries, not alleged to dumping the goods, for the past two years and the current year to date and the source of information thereof.
7. Name(s) and address (es) of known exporters and manufacturers of the alleged dumped goods.
8. Name(s) and address (es) of known importers of the alleged dumped goods in India.
9. Name(s) and address (es) of the users of the alleged dumped goods in India.
10. Name(s) and address (es) of Association of the users of the alleged dumped goods in India.

Note: Data on the volume and value of imported goods can be determined from some published sources, such as the Directorate General of Commercial Intelligence & Statistics (DGCI&S) publications, Customs Daily Lists and/or information otherwise available. Source of information must be specified while furnishing information.

INDIAN INDUSTRY

PROFILE

Please provide complete information about the Indian industry producing the subject goods. The following information is relevant for this section of the complaint:

1. (a) Name(s) , address(es) of the Regd. Office, contact person, telephone numbers, and fox numbers of Indian producers of the subject goods who are lodging the complaint.
2. Name(s), address(es), contact person, telephone numbers, and fax numbers of Delhi Office, if any, of the Indian producers of the subject goods who are lodging the complaint.
3. Name(s) and address(es) of all Indian producers including the complainant alongwith their production (volume and value) of subject goods during the last two years, and the current year.
4. Whether viable substitutes exist for the product. If so, please provide complete information about the substitutes and their degree of substitution.
5. Subject goods (including size, type, range, models) that petitioner(s) produces. Details of articles that petitioner(s) is/are capable of producing. Details of goods the petitioner(s) may purchase to complement the product line.
6. (a) Do any of the petitioner(s) import the subject goods. If yes, please provide details of country-wise volume and value of imports during the last two years and in the current year to date.

   (b) Are any of the petitioners related to the exporters or importers of the alleged dumped article. If so, the nature of such relationship.
7. What are the differences in the petitioner(s) product and the alleged dumped product, if any? To the extent feasible, differences in the imported product and petitioners' product may be quantified.
8. Please indicate any difference in the production process employed by the petitioner(s) and the exporters. It would be appropriate to quantify the impact of such differences, if, any, on prices.
9. Volume and value of total Indian production with a separate breakdown of petitioner(s) and of other Indian producers not party to this complaint for the last two financial years and current year to date.

EVIDENCE OF DUMPING

Please provide complete information to demonstrate dumping of the subject goods. The following information is relevant for this section of the complaint:

1. Estimates of Normal Value

The following information with respect to the Normal Value of the alleged dumped product in the subject country(ies) may be provided :

(a) Comparable price, in the ordinary course of trade, for the like article when meant for consumption in the exporting country or territory. Price lists of the exporters, commercial invoices raised in the local market in the subject country(ies), reputed trade journals, etc may form a reasonable source of evidence to establish Normal Value in the exporting country(ies). Please calculate the exporter's price in the domestic market at ex-factory level. Please provide information on the adjustments in the selling prices required to be made on account of trade/commercial discounts, taxes, merchandise differences, taxation, etc associated with the selling prices considered for determination of Normal Value.

(b) In case there are no sales of the like articles in the ordinary course of trade in; the domestic market of the exporting country or territory, or because of the particular market situation or low volume of the sales in the domestic market of the exporting country or territory, such sales do not permit a proper comparison, please provide.

(i) comparable representative price of the like article when exported from the exporting country or territory to an appropriate third country, or

(ii) the cost of production of the subject goods in the country of origin alongwith reasonable addition for administrative, selling and general cost and for profits.

(c) Normal Value at ex-factory level. Here, please detail all adjustments claimed for arriving at ex-factory level.

It may be mentioned that the most preferred methodology for Normal Value determination is the Normal Value based on the prices prevailing in the domestic market of the exporting country.

2. Estimates of Export Price.

Provide the following information, country-wise, with respect to the Export Price of the product for last two financial years and the current year to date.

- average Export Price to India and the basis of prices (e.g. FOB, CIF, FOR, etc):
- costs per unit after ex-factory and before exports to India that the exporters should have incurred towards items such as inland freight, insurance, taxes, etc. (information on each of these items is to be given separately and should be supported with sufficient evidence);
- the benefits which accrue to the exporters in the subject country(ies) on exports made to India which are not available to the exporter in case of sales in the home market.
- Net export price after adjustments towards freight, insurance, inland freight, storage etc.

3. Estimates of Dumping Margin:

Provide details of estimates dumping margin in case of each country alleged to be dumping the subject goods in India. The information may be provided in the following format.

	In local currency of exporters	**Exchange Rate Vis-à-vis US $**	**In US $**
Normal Value			
Export Price			
Dumping Margin			

PART IV

EVIDENCE OF INJURY

Please provide complete information on how imports of the alleged dumped goods cause or threaten material injury to the domestic industry or materially retards its establishment. The following information is relevant for this section of the complaint:

1. Changes in market share held by Indian producers;
2. Increased imports from the subject country(ies);
3. Significant decline in the production of the petitioner(s);
4. Significant decline in the utilization of capacity of domestic industry (under utilization of capacity);
5. Significant decline in the sales volume of the petitioner(s);
6. Selling price (evidence of price erosion, price undercutting, price suppression or price depression);
7. Evidence of lost contracts or declining sales;
8. Employment (employment levels, lay-off of employees due to increased alleged dumped imports);
9. Profitability (history of profit levels for the petitioner(s) and industry);

Please give the above information as per proforma IV A and IV B.

Proforma IV A

Injury Information on Domestic Industry

Provide information for the domestic industry as a whole for the period of investigation and the preceeding two financial years in the format given below:

Sr. No.	Particulars	Year 1		Year II		Period of Investigation	
		Qty.	Value	Qty.	Value	Qty.	Value
1.	Imports * From the subject country(ies) *Other country(ies)						
2.	Installed capacity						
3.	Production						
4.	Capacity utilization						
5.	Captive consumption						
6.	Indigenous sale						
7.	Export sale						
8.	Opening stock						
9.	Closing stock						
10.	Cost of sales						
11.	Profit / Loss						
12.	Investments						
13.	Networth						
14.	Capital investment for expansion						
15.	Employment (Manpower strength)						
16.	Demand (1+5+6)						
17.	Market Share*						
18.	Any other factor						

Notes:

1. Please indicate unit of measurement wherever applicable.
2. Indicate basis of estimating demand, if it is other than what is specified in the format above.
3. Furnish the Balance Sheet and financial statements for these years for the company(ies) as a whole and for the unit(s) and the specific product in question when the company(ies) is a multi-unit and multi-product one.

   *(Indigenous sale by the domestic industry as a percentage of Demand)

Proforma IV B

Country-Wise Landed Value

Provide details regarding export price, custom duty etc. and work out the landed value of imports per unit of the alleged dumped product for each of the subject country(ies).

Name of the exporting country

Sr. No.	Particulars	Year 1		Year II		Period of Investigation	
		Qty.	Value	Qty.	Value	Qty.	Value
1.	Avg. FOB price (US $)						
2.	Charges after FOB and before CIF 1. Freight 2. Insurance 3. Other charges						
3.	Avg. CIF price (US $) (1+2)						
4.	Avg. Exchange Rate						
5.	Avg. CIF Price (Rs.) (3*4)						
6.	Landing charges						
7.	Avg. Assessable value (5+6)						
8.	Custom clearance & Handling Charges						
9.	Custom Duty i Basic ii Auxiliary iii Countervailing Duty						
10.	Landed Value of Imported Product						
11.	Avg. Selling Price of Indigenous Product (i) Including excise duty (ii) Excluding excise duty						

Notes:

1. Separate proforma for each of the exporting country is to be furnished.
2. Break-up of custom duty is to be indicated separately.
3. Supporting data/details are to be attached.
4. In the absence of FOB price, the statement may be prepared from other stage.

PART V

EVIDENCE OF CAUSAL LINK

Please provide information on the factors which establish that the injury to the domestic industry is due to dumping from the subject country(ies). Factors other than dumping which are also at the same time causing injury to the domestic industry must be segregated. Provide information on the following:

The following information is relevant for this section of the complaint:

1. Volume and value of imports from country(ies) other than the subject country(ies) and an explanation on why imports from these country(ies) are not causing injury to domestic industry.
2. Demand of the product for the past three years including the current year. In case the demand has undergone substantial change, an explanation on why such change in the demand has not caused injury to the domestic industry.
3. Provide explanation on whether trade restrictive practices of an competition between the foreign and domestic producers, developments in technology, the export performance or the productivity of the domestic industry or any other known factors have not caused injury to the domestic industry.

PART VI

COSTING INFORMATION

Please provide information on the following separately superscribing COSTING INFORMATION along-with the documented anti-dumping petition.

1. Production Process: Stagewise process of manufacturing and various routes of manufacture. Process flow chart indicating cycle time taken at each process.
2. Raw materials and packing materials consumption and reconciliation statement as per Format 'A'.
3. Raw Materials consumption norms and comparison with actuals as per Format "B".
4. A statement showing cost of production as per Format "CI" and "CII". A statement classifying expenses shown in Format "CI" into Fixed, Variable and Semi-variable. The semi-variable expenses may further be classified into Fixed and Variable. The basis of classification may be clearly mentioned.
5. Utilities consumption statement as per Format "D" for the investigation period and previous three years.
6. Calculations of working capital as follows:
   a) Working Capital as per Balance Sheet
   b) Working Capital as per Bank Limits,
   c) Working Capital as per Production Cycle Time.
7. Interest on Term Loans: Statement of term loan outstanding at the beginning of the year, at the end of the year, interest paid/payable on term loans and average rate of interest on term loans.
8. Overdue and/or compounding interest: Statement showing details of overdue and/or compounding interest provided in the annual audited accounts relevant to the period of investigation.
9. Depreciation: Statement showing gross and net block for the investigation period and previous year.
10. Return/profit: Statement showing desirable return on capital/equity alongwith justification in support thereof.
11. Details of misc. income earned during the year.
12. Sales Realisation: A statement showing details of gross sales realisation, discounts/commission, excise duty, other taxes and net sales realisation, as per Format "E" for the past three years and month-wise for the investigation period. The figures should reconcile with Balance Sheet of the corresponding years.
13. Details of WIP at the beginning and end of the investigation period, clearly indicating break up of material cost and overheads charged in the valuation.
14. Brief write up on the following:
    (a) Purchase policy including long terms contracts for major materials.
    (b) Sales policy indicating marketing/distribution channels, commission/discount policy, credit terms etc., sales policy to bulk consumers.

(c) Stores accounting and inventory/stock/WIP valuation.

(d) Quality control procedure and tests being conducted.

15. A statement showing Production, Sales Quantities, Capacity Utilisation, Stock, Net Average Sales Realisation, Cost of Production, Profit/Loss for the past three years and month-wise for the period of investigation.

16. Details of job work done or got done during the investigation period.

17. Audited and printed annual accounts for the investigation period and past three years, and trial balance for the investigation period.

NOTE:

1) All the information, unless otherwise stated, should relate to the investigation period.

2) Information may be compiled, to the extent possible, from the annual audited accounts and supplementary records being maintained by the Company.

3) All the information is subject to verification, and therefore, all supporting papers, including working sheets may be preserved for verification by the Designated Authority.

4) The information, to the extent possible, should be supplied in the formats prescribed.

5) The hard copy of COSTING INFORMATION should invariably be accompanied with a soft copy (on floppy disc/compact disc).

Format "A"

STATEMENT OF RAW MATERIALS AND PACKING MATERIALS CONSUMPTION AND RECONCILIATION

Particulars	Opening Stock			Purchases			Closing Stock			Consumption		
	Qty	Rate	Value	Qty	Rate	Value	Qty	Rate	Value	Qty	Rate	Value
Raw Materials (Item wise)												
Packing Materials (Item wise)												
Total												

Note: This statement should be for the investigation period.

Format "B"

STATEMENT OF RAW MATERIAL CONSUMPTION

Particulars	Unit	Consumption per unit of production	Actual Consumption per unit of production			Average Rate for Investigation period
			Year 1	Year 2	Year 3	
Raw Materials (Item Wise)						
Total Cost per unit of production Considering Rates for the investigation period						

Format "CI"

STATEMENT OF COST OF PRODUCTION

Name of the Company								
Installed capacity								
Production in Installed								
Capacity Utilisation (%)								
Production in Investigation Period								
Capacity Utilisation in Investigation Period Sales (quantity)								
Particulars	Previous Accounting Year				Investigation Period			
	Qty.	Rate	Value	Cost per unit	Qty	Rate	Value	Cost per unit
Manufacturing expenses Raw materials (specify the major raw materials) Utilities Depreciation Others (please specify the Nature of expenditure)								
Administrative Expenses - Variable - Fixed								
Selling & Distribution Expenses - Variable - Fixed								
Financial Expenses - Variable - Fixed								
Less: Misc. Income (from Product concerned)								
Total Cost to make and Sell								
Selling price								
Profit / Loss								

Note: Please specify the unit, wherever applicable.

The information in this proforma is to be certified by practicing Cost Accountant.

Format "CII"

ALLOCATION AND APPORTIONMENT OF EXPENDITURE

Please provide the basis alongwith the amount allocated to the subject product and to other products out of the total expenses of the company, as per following format

Sl. No.	Particulars Expenses	Total applicable to product under investigation	Share Applicable to product under investigation	Share not allocation / Apportionment	Basis of
1	2	3	4	5	6
	Raw Material				
	(itemwise)				
	Consumable stores and				
	spares/other inputs				
	Utilities (power, fuel, steam, etc.)				
	Direct labour				
	Manufacturing Overheads				
	(Specify under major heads)				
	Research & Development				
	Administrative Overheads				
	Selling & Distribution cost				
	Depreciation				
	Financial expenses				
	Other misc. expenses				
	Total expenditure				
	Sales				
	Other income				
	Total income				
	Profits / Loss				

Note:

1. The information in this proforma is to be certified by practising Cost Accountant.
2. All items of income and expenditure shall be reconciled with Annual Accounts.

Format "D"

STATEMENT OF CONSUMPTION OF UTILITIES

Particulars	Consumption Norms (per unit of Production)				Actual Consumption (per unit of production)			Investigation Period	
	Y1	Y2	Y3	POI	Year1	Year2	Year3	Unit	Rate
a) Power									
b) Water									
c) Other (please specify)									
Total Cost Considering investigation period rates									

Note:

The details should be in terms of items of utilities purchased and paid by the company.

The rates should be the average cost for the investigation period

Format "E"

STATEMENT OF SALES RELATIONS

Year Sold	Quantity Sales (Rs.)	Gross Commission	Discounts / Duty	Excise Realisation	Net Sales Realisation per unit (Rs.)	Net Sales
Year 1						
Year 2						
Year 3						
POI						

Investigation Period (month-wise) and total for the investigation period

Note: Please indicate applicable units

Format "F"

CERTIFICATE

I hereby certify that the information contained in this submission is true, Complete and correct to the best of my knowledge and belief, on the basis of the records available and generally maintained by the company, and no material has been concealed or misrepresented.

____

(Signature)

Date ____________________

____

(Name / Designation)

Note: (1) This page should be completed and appended at the beginning of your petition.

(2) The certificate should be signed by Chief Executive of the Co./Directors/Partners or the proprietor of the firm.

8.6 Assessment and Quantification of Losses Under Marine, Fire and Accident Policies.

8.6.1 The success of any business or venture depends on hard work, sincerity, dedication and ingenuity of its employees and staff. However no matter how industrious, efficient or dedicated is the staff, one disaster may wipe out entire profit or even destroy the business. These risks have always been present since life first appeared on earth. What distinguished man from other forms of life is his awareness of risk? Man anticipates risk and attempts either to avoid or to minimize the likely loss and damage caused by such eventuality.

8.6.2 Initially the variety of risk was limited and the loss or damage was small. However, the risks are immense and the financial losses and damages are colossal in this technological age. Efforts to minimize the loss and damage caused by risk led to Insurance which is a method of sharing of financial losses of a few from a common fund formed by contributions of many who are equally exposed to the same risk. It is a system of spreading the loss of risk of an individual over a group of individuals. In case of Marine Insurance, all transits are subject to cargo clauses devised by London Institute of Underwriters. These are clauses, which are used worldwide. Moreover, insurable interest must exist at the time of a claim under Marine Insurance.

8.6.3 Insurance companies persuade many individuals to pool their individual risks in a large group, by paying a premium and thereby reduce or eliminate their risks. Out of insurance arose the need of persons able to measure by amount of financial loss or damage sustained so that the insurer may reimburse that amount to the insured in case of any eventuality. Perhaps initially this measurement was done by the insurers themselves but later the need of independent and impartial persons equipped with adequate knowledge and expertise was felt giving rise to the profession of insurance surveyors. Simply stated insurance surveyors measure, assess and report on the insured's financial loss or damage. Their report is the basis on which the insurers compensate the insured. He handles claims that at times arise out of natural calamities like floods and cyclones or huge claims arising out of fires and also the claims of persons attempting to cheat the insurers by fraud.

8.6.4 The surveyor is a professional licensed under Section 64 UM of the Insurance Act. The scope of work of a Surveyor is to assess the loss independently, impartially in the event of claim reported to the underwriters. He uses his technical skills to establish the cause of loss or damage, assess the degree of damage and provide a complete picture of the situation in his report. This will include suitable recommendations as to minimizing or making good the damage, and if necessary, recommendations of the best market for damaged goods, should a sale become necessary. Overall the report should enable the insurer to properly consider whether the loss or damage is covered by the policy conditions, as well as determining if there is a third party involved, who could be held liable. This third party may be the shipping company, the airline or the road carrier. It is the surveyor's job to determine and report upon the cause and extent of loss or damage.

8.6.5 The Indian Institute of Insurance Surveyors and Loss Adjusters (IIISLA) is an association of Practicing Insurance Surveyors and Loss Adjustors in India. Its main objectives as set down in its memorandum are:

(a) To ensure quality in the profession of surveyors;

(b) To control and regulate entry into the profession through conducting of examinations;

(c) To develop and administer code of conduct to bring about high standards of integrity, transparency, discipline and professional conduct.

8.6.6 Following are the steps generally involved in any insurance claim:

(b) The claimant intimates a claim to insurer, who in turn deputes a Surveyor for loss assessment. While intimating the loss, the following details have to be given by the claimant :

- Exact location of the loss.
- Brief description of the cause of loss
- Name and contact details of the person at the loss site.

It is very important to intimate the insurance provider about the probable loss. This will not only help in quick assessment of loss but will also ensure that the direct and proximate cause of loss can also be determined.

(a) Surveyor will then inspect the spot/site of loss. He will also advise on claim supporting documents to be given by the claimants. After verifications of damages/documents, surveyor will assess the loss and submit his report to the Insurance Company.

8.6.7 It may be noted that the Insured has a common law and statutory duty to take reasonable steps to avert or minimize loss or damage. The Insured (often the consignee, as ownership of the goods transfers during the transit) must act pro-actively, as if the goods were uninsured. They should provide absolute co-operation to the insurers representative or independent surveyor in loss mitigation actions or salvaging process. Mitigation of loss is usually achieved, by removing any sources of continuing deterioration and then by repairing or reconditioning the goods.

8.6.8 'SALVAGE' is a very critical issue under any insurance claim. Every damaged item has some residual value depending on the item, exact usability, market value, time and place of loss and options available of new item. Salvage is considered by an insurer as a 'credit' against what is owed under the policy for an insured loss. There are professional salvers, who are experts in their field and can clean, repair and put back in operating the asset damaged.

8.6.9 Marine surveyors carry out inspections of passenger and cargo ships, fishing vessels, etc. They make sure that a vessel's construction, machinery, equipment and cargo meet government classification, society and international maritime regulations. Marine surveyors work for governments, classification societies (groups that lay down specifications for the construction of ships) and private companies. Marine surveyors may specialise as a Classification Society Marine Surveyor who inspects ships to make sure that ships, components and machinery are built according to the standards required for their class, and examines accident damage. Government Marine Surveyor who inspects ships to make sure that ships, components and machinery meet crew and passenger safety regulations and construction standards. Private Marine Surveyor who examines ships' cargoes, investigates accidents at sea (e.g. oil spillages) and prepares accident reports for insurance purposes.

8.6.10 The fundamental principle of any insurance policy is that the sum insured declared should reflect the present market value of the property as far as possible to avoid any under/over insurance. The procedures for deriving the most suitable present market value are as follows;

- **Building:** The cost of constructing a new building of same type less depreciation for the number of years in use. The rate of depreciation applicable depends on the type of construction and its approximate useful life;
- **Machinery:** For the machinery that can be replaced, the same principle as in the case of building shall apply i.e. cost of replacement less depreciation for number of years in use. However, for the old and obsolete machinery, the value of new similar machinery less depreciation with proper adjustments for its utility & condition etc. and balance useful life shall apply.
- **Stock:** The cost/value of stock should reflect all expenses such as cost, insurance, freight and overhead, if any, upto the place of insurance depending on the status of the insured such as manufacturer, wholesaler and retailer.

However, if the sum insured declared does not reflect its present market value then the condition of average applies in case of any claim (i.e. if the sum insured is less than the present market value, the amount of loss payable will also be proportionately less and if the sum insured is higher than the present market value, the loss payable will be as per the present market value only despite the premium being paid for the higher value).

STATEMENT – DBK-I

Description of the Export Product ________________ Bill of Materials* issued for manufacture of (No. of Units @ of the Export product).

*(Bill of materials should consist of raw materials and components going into the manufacture of export product and the actual packing materials used).

Sl. No.	Name of the Material / component	Quantity	Technical Charactristics	Whether imported or indigenous	UNIT	Gross quantity reqd.	Wastage Qty.			By-product /co-product		Net weight of the material	Remarks
							Irrecoverable	Recoverable	Sale price of waste per unit of Qty.	Qty	Sale value per unit		
1	2	3	4	5	6	7	8	9	10	11	12	13	14

@ Give convenient units by which goods are invoiced for export (e.g. per tonne, per dozen/pcs., per Sq. meter etc.).

Notes:

1. The Units of quantity to be furnished in Co. 6 should be given in such a manner that it could be related to Statements II and III respectively.
2. Maintenance stores/materials such as lubricating oil, greases, fuel etc. which are employed to run the machinery and plant should be excluded.
3. The data for packing materials should be for the same unit quantity for which data for export product for raw materials and components have been given.
4. Only these raw materials/components etc. to be indicated for which proof of payment of Customs/Central Excise duties is shown in DBK-II/III. Details of such inputs need not be given where no benefit of duty paid is claimed because of MODVAT or absence of proof of duty. Only a brief mention of such inputs being used would be sufficient.

CERTIFICATE REQUIRED FOR DBK-I STATEMENT

I. On behalf of the applicant, I hereby certify that the materials as mentioned above are actually required and being used for production of export product.

Station: Signature ....

Date: (Name & Designation of the Chief Executive/ Production incharge (with seal).

II. It is certified that (To be given by an independent Chartered Engineer):

(a) The consumption of various materials shown in DBK-I has been examined by us and these are actually required and being consumed in the factory of production for manufacture of export product as checked by us on verification of the production process and relevant technical and related documents.

(b) The imported materials above shown in DBI-I are being actually used in the manufacture of the export product and are not being substituted by indigenous materials;

(c) The wastage/co-product/by-product claimed are as per production process in the factory. There is no suppression of co-product/by-products. The wastage claimed in our views are reasonable and are comparable to the general norms for the industry. Where wastages are considered high, an indication of the normal wastage in the industry has been indicated by us under 'Remarks' column.

Place: Signature ______________________________

Name ________________________________

Date: Designation ____________________________

Address ______________________________

Branch of Engg. In which qualified ________

Name & Address of the institution under which Charterd. Ref. No. and date of Membership

STATEMENT – DBK-II

Direct import of materials/components made by the manufacturer and foreign materials obtained locally by the manufacturer during the period commencing three months prior to the date of shipment/first shipment upto the date of application, for manufacture of ______________________________ (Name of export product).

Sl. No.	Descri-ption	Technical charac-teristics	S.No. in DBK-I Statement	B/E No. and date under which imported	Name of Customs House	Unit	Qty. imported	Assessable	Heading No. in Customs Tarrif Act, 1975
1	2	3	4	5	6	6A	7	8	9

Rate of duty	Country from where imported & name of supplier	Is assessment final?	Amount of duty paid	Name & full address of the supplier in case the foreign materials / components obtained locally	Remarks
10	**11**	**12**	**13**	**14**	**15**

Note: 1. If any of the materials mentioned above have also been procured from indigenous origin, this must be specifically stated in remarks column and full details of the procurement alongwith proof of payment of duty should be furnished in DBK-III statement, <u>even if it is claimed that they are not used in the products exported</u>.

2. Minor items which do not contribute to any significant proportion to the expected drawback rates may be ignored, at the discretion of the applicant.

3. If the assessment against any B/E is not final the nature of dispute may be clearly indicated supported by appropriate letter from concerned customs authorities. Normally no DBK is admitted for provisionally assessed B/Es.

4. Refund application made against any B/E, with details must be indicated.

5. Stock position of the above materials/components also to be given separately (in linked Statement II-A).

<u>CERTIFICATE</u>

Certified that the particulars mentioned in this statement are correct to the best of my knowledge and belief and no claims for refund of duty in respect of any of the above-mentioned bills of entries (other than whose details are furnished) has been or will be lodged with the Customs Authorities.

Signature of the Power of Attorney Holder or Authorised Agent.

Signature and Stamp of independent
Chartered Accountant/Cost Accountant

STATEMENT DBK-II A

Details of procurements relating to stock of imported materials as on commencement *date (*the date three months prior to the date of shipment/first shipment) based on FIFO principle, required for the manufacture of ______________________________________ (Name of export product).

Sl. No.	Description	Technical characteristics	S.No. in DBK-I Statement	B/E No. and date under which imported	Name of Customs House	Unit	Qty. imported	Assessable	Heading No. in Customs Tarrif Act, 1975	Rate of duty
1	2	3	4	5	6	6A	7	8	9	10

Country from where imported & name of supplier	Is assessment final?	Amount of duty paid	Name & full address of the supplier in case the foreign materials / components obtained locally	Stock as on ______	Remarks
11	12	13	14	15	16

Note: 1. In this statement please furnish details of stock of all the imported inputs mentioned in Statement II which were in stock 3 months prior to the date of shipment/first shipment of the export product and how these were imported /procured. (Actual stock to be given under Col. 15, with procurement details in other Columns).

2. If the assessment for any of the inputs in stock as shown is not final, the nature and current status of dispute may be clearly indicated. (Normally no DBK for provisionally assessed B/E are admitted.

3. Refund applications made if any for procurement shown in stock with details to be indicated.

4. Photo copies of all Bills of Entries mentioned above must be enclosed.

CERTIFICATE

Certified that the particulars mentioned in this statement are correct to the best of my knowledge and belief and no claims for refund of duty in respect of any of the above-mentioned bills of entries has been or will be lodged with the Customs Authorities.

Signature of the Power of Attorney Holder or Authorized Agent.

Signature and Stamp of independent
Chartered Accountant/Cost Accountant

STATEMENT – DBK-III

Materials/components of Indian Origin obtained by the manufacturer during the period commencing three months prior to the date of shipment/first shipment upto the date of application for manufacture of ___________________ (Name of export product).

Sl. No.	Description	Technical characteristics	S.No. in DBK-I Statement	Unit	Qty. purchased	Assessable Value	C. Ex. Tariff Heading No.
1	2	3	4	5	6	7	8

Effective Rate of duty paid	Amount of duty paid	Name & address of the supplier	G.P. N. & date	Is assessment of duty final?	Remarks
9	10	11	12	13	14

Notes:

1. In this statement details of only those items which are chargeable to the excise duty to be given for which proof of C. Excise duty can be established by Gate Passes.
2. Material/components specified in Drawback-II Statement if these are also of indigenous origin and procured locally should be included in this statement, whether dutiable or not. This is irrespective of the fact whether the said materials/components are used for export production or not. Where the said materials/components are claimed to be only for manufacture of goods for local sales and not for exports, this should be specifically indicated in the remarks column, against the respective serial No. of the said material/component.
3. The particulars of gate pass numbers and date where the applicant is the consignee should be furnished under Col. 11. Photo copies of all Gate Passes for inputs which are subject to Central Excise Duties of 20% or higher and some representative copies for other Gate Passes must be enclosed.
4. If the assessment which is not final or duty is paid under protest the extent of dispute may please be clearly indicated.
5. Refund applications made if any against any Gate Pass with details, to be indicated.

CERTIFICATE

Certified that the particulars mentioned in this statement are correct to the best of my knowledge and no claims for refund of duty in respect of any of the above-mentioned materials/components procured against Gate Passes/subsidiary Gate Passes has been or will be lodged with the Central Excise Authorities.

Signature of the Power of Attorney
Holder or Authorized Agent

Signature and stamp of independent
Chartered Accountant/Cost Accountant

STATEMENT – DBK-III(A)

Details of procurements relating to stocks of indigenous materials as on commencement to (the date three months prior to the date of shipment/first shipment) based on FIFO principle.

Sl. No.	Descri- ption	Technical charac- teristics	S.No. in DBK-I Statement	Unit	Qty. purchased originally	Assessable Value	C. Ex. Tariff No.
1	2	3	4	4A	5	6	7

Effective Rate of duty	Amount of duty paid	Name & address of the supplier	Gate Pass No. & date	Is assessment of duty final?	Stocks as on	Remarks
8	9	10	11	12	13	14

Notes :

1. In this statement furnish details of stock of all the indigenous materials mentioned in statements I & III which were in stock three months prior to date of shipment/first shipment of the export product and how these were procured (including Gate Pass Nos. etc.)

1A. In this statement details of only those items which are chargeable to the excise duty may be given for which proof of payment of Central Excise duty can be established.

2. The particulars of Gate Pass number, date etc. should be furnished in Column 11.
3. If the assessment which is not final or duty is paid under protest the extent of dispute may please be clearly indicated
4. Refund applications made if any with details to be indicated.

CERTIFICATE

Certified that the particulars mentioned in this statement are correct to the best of my knowledge and belief and no claims for refund of duty in respect of any of the above-mentioned materials/components has been or will be lodged with the Central Excise Authorities.

Station : Signature of Power of Attorney

Date : Holder or Authorized Agent.

Signature and stamp of independent
Chartered Accountant/Cost Accountant

8.7 Specimen Questions with Answers

Question No. 1.

Enumerate ten statutory and specific fields of audit, verification and certification open to Cost Accountants in practice other than Cost Audit. Indicate a reference to the concerned authority/ stature under which the work is prescribed.

Answer:

The statutory and specific fields of audit open to Cost Accountants in practice are:

(i) Cost Audit under Section 233B of the Companies Act, 1956.

(ii) Central Excise Audit under Section 14A of Central Excise Act, 1944 and Central Excise Special Audit under Section 14AA of the Central Excise Act, 1944

(iii) Inventory Audit

(iv) Concurrent Audits in Banks

(v) Sales Tax / VAT Audit

(vi) Telecom Regulatory Authority of India (TRAI) Audit

(vii) Special Audit under Customs Act

(viii) Management and Operational Audit etc.

(ix) Service Tax Audit

(x) Anti-Dumping

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STUDY NOTE - 9

Professional Ethics

This Study Note includes:

- Professional Values and Ethics
- Misconduct for Cost Accountants
- Professional Competence and Due Care
- Confidentiality

9.1 Professional Values and Ethics

9.1.1 "Ethics" are defined as the rules or standards governing our conduct in making decisions. These "Ethics" are our beliefs governing our thought process during decision making and ask such fundamental questions as:

- What is right and what is wrong?
- How ought we to act under these circumstances?
- What should we do in specific situations and why?
- How should we approach and resolve ethical issues?
- What are the benefits and harms of certain practices?

9.1.2 Ethical values mean honesty, integrity, trustworthiness and discretion or simply stated morally acceptable action. Ethics are important for number of reasons. Ethics give us a baseline for understanding the concepts of right and wrong. They also help us to have a ready understanding of how to react to a certain situation long before that situation happens. Promoting and ensuring sound values and ethics is critical components of any profession.

9.1.3 A profession is an occupation, vocation or career, where specialized knowledge of a subject, field or science is applied. It involves systematic knowledge and proficiency. All professions are generally regulated by professional bodies, which may set competence examinations, act as a licensing authority for practitioners and enforce adherence to an ethical code of practice. Professional values and ethics are both an individual characteristic as well as an ideological position. These values and ethics are also sometimes called Professionalism. Professionalism can be defined as a membership of a profession, which carries with it a set of internalized values, which will be reflected in the way in which professional work is carried out by the members of that profession while adhering to ethical standards. In fact each profession has an obligation to articulate its basic values, ethical principles and ethical standards. These values and ethics can broadly be described as:

(a) Respect the law, contracts and agreements.

(b) Ensure no conflicts of interest.

(c) Adherence to common values such as honesty, integrity, transparency, co-operative, equitable and fair.

(d) Maintenance of high performance standards such as exceptional quality, competitive pricing etc.

9.1.4 The client places trust in the professional on the assumption that the service provided will be of benefit to them. It may be quite possible for the professional to use his authority to exploit the client. An obvious example is that of the doctor, who may carry out unneeded lab or pathological tests or other investigations on his patients in order to gain more money. It is likely that the patient may not have sufficient knowledge to question what is being done, and so will undergo and pay for the treatment.

9.1.5 Therefore, most of the professions have internally enforced codes of practice that members of the profession must adhere to preserve the integrity of the profession. For example, a businessman may approach a civil engineer to certify the safety of an unauthorized building, which is not safe. Whilst one engineer may refuse to certify the building due to its unsafe construction, the other engineer may agree to certify the building plan for a certain consideration. The disciplinary codes allow the profession to draw a standard of conduct and to ensure that the individual practitioners meet this standard, by disciplining them from the professional body if they do not practice accordingly. It also helps in maintaining the public's trust in the profession, meaning that the public will continue to seek their services.

9.1.6 In view of above, it is clear that the profession of cost accounting and cost auditing also needs self-imposed professional values and ethics to command the respect and confidence to the public or the users of services. These have been prescribed by ICWAI in term of "Code of Conduct". The code offers a set of values, principles and standards to guide decision making and conduct when ethical issues arise. This code summarises broad ethical principles that reflect the profession's core values and establishes a set of specific ethical standards, which can be used to guide the practice of Cost & Management Accountancy. This code provides the ethical standards to which the general public can hold the cost accounting profession responsible.

9.2 Misconduct for Cost Accountants – Introduction

9.2.1 A cost accountant in practice is one who is holding a certificate of practice under Sections 6 and 7 of the Cost and Works Accountants Act, 1959. If a person desires to practice as a Cost Accountant, he should apply to the Council of the Institute of Cost and Works Accountants of India in proper form and obtain a certificate of practice.

9.2.2 Each and every member of the profession in practice is required to follow certain professional ethics and code of conduct as prescribed by the Cost and Works Accountants Act, 1959 and regulations thereunder. Section 22 of the Cost and Works Accountants Act, 1959 defines that "professional or other misconduct" is deemed to include any act or omission provided in any of the Schedules but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under Section (1) of section 21 to enquire into the conduct of any member of the Institute under any other circumstances.

9.2.3 This definition under Section 22 of the Cost and Works Accountants Act, 1959 read with the two schedules to the Act clarifies or indicates that the schedules provide an illustrative list of acts and omissions constituting "professional or other misconduct" as Director (Discipline) is competent to enquire into the conduct of any member of the Institute under any other circumstances.

9.2.4 Similarly Para 2 of Para IV of the First Schedule provides that a member of the institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if in the opinion of the council he brings disrepute to the profession or the institute as a result of his action whether or not related to his professional work. In view of above, it is clear that the definition of misconduct is very wide and should be adhered in letter and spirit. The Acts or omissions constituting professional misconduct as defined in Section 22 are detailed in two schedules of the Act. The First Schedule is divided into the following four parts:

Part-I - Professional Misconduct in relation to Cost Accountants in practice;

Part-II - Professional Misconduct in relation to Members of the Institute in Service;

Part III - Professional Misconduct in relation to Members of the Institute Generally; and

Part IV - Other Misconduct in relation to Members of the Institute Generally.

9.2.5 The Second Schedule requiring action by the Disciplinary Committee is divided into the following two parts:

Part-I - Professional Misconduct in relation to Cost Accountants in practice;

Part-II - Professional Misconduct in relation to Members of the Institute generally.

9.2.6 In addition to above, Para 1 of Part-II of the Second Schedule provides that a member of the institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made there-under or any guidelines issued by the council. Reference is also drawn to Cost Accounting Standards (CAS) issued by the Cost Accounting Standard Board of the ICWAI. These CAS are recommendatory in nature by the Council of ICWAI and every member of the Institute is expected to honour the same (Para 5 of the Preface to Cost Accounting Standard Board). Para 5.8 of the preface further provides that Cost Auditors will adopt and encourage the adoption of the standards, wherever applicable, in maintenance of Cost Accounting Records Rules under section 209(1) (d) and report the deviations, if any, in the Cost Audit Reports u/s 233B. Para 6.3 provides that disciplinary restriction may be imposed by the Council of the Institute at appropriate stages as may be felt necessary for not complying with or not honouring the standard. In view of above, it is clear that non-compliance of non-honouring of Cost Accounting Standards may also be termed as misconduct.

9.3 Constitution of Disciplinary Directorate, Board of Discipline and Disciplinary Committee

9.3.1 Section 21 (1) of the Cost and Works Accountants Act, 1959 provides for constitution of the Disciplinary Directorate headed by an officer of the Institute designated as Director (Discipline) and such other employees for making investigations in respect of any information or complaint received by it. This Section also prescribes the broad procedure in conducting of inquiries relating to misconduct by the Members of the profession.

9.3.2 Sub section (3) of Section 21 provides that where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the First Schedule, he shall place the matter before the Board of Discipline. If the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the second schedule or in both the schedules, he shall place the matter before the Disciplinary Committee.

9.3.3 Section 21(1) read with Section 21(2) makes it amply clear that all information or complaints shall be received alongwith requisite fee in the Disciplinary Directorate headed with Director (Discipline). Section 21(2) further provides that on receipt of any information or complaint along with prescribed fee, the Director (Discipline) shall arrive at a prima facie opinion on the occurrence of the alleged misconduct.

9.3.4 Section 21A (1) provides that the Board of Discipline constituted by the council shall consist of the following:

(a) a person with experience in law and having knowledge of disciplinary matters and the profession, as its presiding officer;

(b) one member of the council to be elected by the council;

(c) one person designated under clause (c) of sub-section (1) of Section 16 of the Cost and Works Accountants Act, 1959 i.e., chief executive designated to carry out the administrative functions of the Institute; and

(d) the Director (Discipline) shall function as the Secretary of the Board.

9.3.5 Section 21A (2) provides that the Board of Discipline shall follow the summary disposal procedure in dealing with all the cases before it. Section 21A (3) further provides that where the Board of Discipline is of the opinion that a member is guilty of a professional or other misconduct mentioned in the First Schedule, it shall affect to the member an opportunity of being heard before making any order against him. After giving an opportunity to the member and after listening him, if the Board of Discipline still considers the member guilty of a professional or other misconduct mentioned in the First Schedule, it may take any one or more of the following action, namely:

(a) reprimand the member;

(b) remove the name of the member from the Register upto a period of three months;

(c) impose such fine as it may think fit which may extend to rupees one lakh.

9.3.6 Section 21A (4) provides that the Director (Discipline) shall submit before the Board of Discipline all information and complaints where he is of the opinion that there is no prima facie case and the Board of Discipline may close the matter, if it agrees with the opinion of the Director (Discipline). Otherwise, the Board shall advise the Director (Discipline) to further investigate the matter.

9.3.7 Section 21B (1) provides that the Disciplinary Committee shall consist of the following:

(a) president or the Vice President of the council as the Presiding Officer;

(b) two members to be elected from amongst the members of the council; and

(c) two members to be nominated by the Central Government from amongst the persons of eminence having experience in the field of law, economics, business, finance or accountancy.

Section 21B (1) further empowers the council to constitute more Disciplinary Committees as and when it considers necessary.

9.3.8 Section 21B (3) provides that where the Disciplinary Committee is of the opinion that a member is guilty of a professional or other misconduct mentioned in the second schedule or both the First Schedule and the Second Schedule, it shall afford to the member an opportunity of being heard before making order against him. After hearing him, if the Disciplinary Committee still considers the member guilty of a professional or other misconduct mentioned in the Second Schedule or both the First Schedule and the Second Schedule. It may take any one or more of the following actions, namely:

(a) reprimand the member;

(b) remove the name of the member from the Register permanently or for such period, as it thinks fit;

(c) impose such fine, as it may think fit, which may extend to rupees five lakhs.

9.3.9 Section 21 (c) provides that the Authority i.e. the Disciplinary Committee, Board of Discipline and the Director (Discipline) shall have all the powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908) in respect of the following matters:

(a) summoning and enforcing the attendance of any person and examining him as oath;

(b) the discovery and production of any document; and

(c) receiving evidence on affidavit.

9.3.10 The member on whom the complaint is made shall have a right to defend himself before the disciplinary committee either in person or through a legal practitioner or other member of the Institute. The disciplinary committee shall have the power to regulate its procedure in such a manner as it considers necessary during the course of enquiry (Section 21B (2)) and examine the certificates received, affidavits or any other documentary evidence.

9.4 Procedure of Enquiring into Misconduct

9.4.1 The first and second schedules of the Cost and Works Accountants Act prescribes the acts or omissions constituting misconduct by a member. Section 21 of the Cost and Works Accountants Act, 1959 deals with misconduct. The provisions of the Section 22 of the Cost and Works Accountants Act provide that any infringement of the provision contained in the First and Second Schedules referred to above shall be deemed as "professional or other misconduct". A complaint against members of the Institute can be made under rule 3 of the Cost and Works Accountants (Procedure of Investigations of Professional and other Misconduct and Conduct of Cases) Rules, 2007 by any person in Form-I, in triplicate before the Director (Discipline) in person or by post or courier inter-alia containing the following particulars:

(a) The acts and omissions which if proved would render the member complained against, guilty of professional or other misconduct.

(b) The oral or documentary evidence relied upon in support of the allegations made in the complaint.

9.4.2 Section 21 (1) and 21 (2) provides that even information with or without complaint alongwith the prescribed fee is sufficient to cause initiation of investigation by Director (Discipline) in respect of any information or complaint received by it. However, rule 7(3) of the Cost and Works Accountants (Procedure of Investigations of Professional and other Misconduct and Conduct of Cases) Rules, 2007 provides that no anonymous information received by the Directorate will be entertained. If on a perusal of the complaint or information, the Director (Discipline) arrives at a prima facie opinion against such member, the Director (Discipline) shall under section 21(3) of the Act:

(a) Place the matter before the Board of Discipline, in case the member is prima facie guilty of any professional or other misconduct mentioned in the first schedule; and

(b) Place the matter before the Disciplinary Committee, in case the member is prima facie guilty of any professional or other misconduct mention in the second schedule or in both the schedules.

9.4.3 The perusal of the rules shows that even though Director (Discipline) shall investigate each case to arrive at a prima facie opinion on the occurrence of alleged misconduct, he has no ex-officio power to finally adjudicate the complaint or dispose of the complaint even if it has no merit. For example in case of professional or other misconduct mentioned in the First Schedule, Section 21 A (4) of the Act provides that the Director (Discipline) shall submit before the Board of Discipline all information and complaints where he is of the opinion that there is no prima facie case and the Board of Discipline may, if it agrees with the opinion of the Director (Discipline), close the matter or in case of disagreement, may advise the Director (Discipline) to further investigate the matter.

9.4.4 Similar view is also contained in rule 9(3) of the Cost and Works Accountants (Procedure of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules, 2007, which provides that where the Director (Discipline) is of the prima facie opinion that the member or the firm is not guilty of any misconduct either under the First Schedule or the Second Schedule, he shall place the matter before the Board of Discipline, and the Board of Discipline, -

(a) If it agrees with such opinion of the Director (Discipline), shall pass order, for closure.

(b) If it disagrees with such opinion of the Director (Discipline), then it may either proceed under Chapter IV of these rules, if the matter pertains to First Schedule, or refer the matter to the Disciplinary Committee to proceed under Chapter V of these rules, if the matter pertains to the Second Schedule or both the Schedules, or may advise the Director to further investigate the matter.

9.4.5 Similar view is also contained in rule 5(6) and 5(7) of the Cost and Works Accountants (Procedure of Investigations of Professional and other Misconduct and Conduct of Cases) Rules, 2007, which provide w.r.t defective complaints, which are not rectified within time allowed, the Director (Discipline) shall form the opinions that there is no prima facie case and present the complaint before the Board of Discipline for its closure. However, the Board of Discipline may again not agree with the opinion of the Director and advise him to further investigate the matter. Provisions of Section 21 (5) provides that if a complainant withdraws the complaint, the Director (Discipline) shall still place such withdrawal before the Board of Discipline or as the case may be, the Discipline Committee, and the said Board or Committee may, if it is of the view that the circumstances so warrant, permit the withdrawal at any stage.

9.5 Procedure for Filing Complaint

9.5.1 Rule 3 (1) of the Cost and Works Accountants (Procedure of Investigations of Professional and other Misconduct and Conduct of Cases) Rules, 2007 provides that a complaint under section 21 of the Act against a member or a firm shall be filed in Form-I, in triplicate before the Director in person or by post or courier. This section further provides that the complaint sent by post or by courier under this sub-rule shall be deemed to have been presented to the Director on the day on which it is received in the Directorate. The implication of this section shall also mean that no anonymous complaint shall be entertained by the Directorate.

9.5.2 Rule 3 (2) of the said rules further provides that a complaint filed by or on behalf of the Central Government or any State Government, shall be authorized by an officer holding a post not below the rank of a Joint Secretary or equivalent and shall be signed by an officer holding a post not below the rank of an officer holding a post not below the rank of an Under Secretary or equivalent in the Central or State Government, as the case may be.

9.5.3 Rule 3 (3) of the said rules provide that a complaint filed by or on behalf of any statutory authority, such as Reserve Bank of India or Securities and Exchange Board of India, shall be authorized by an officer holding a post equivalent to the post of Joint Secretary in the Government of India and shall be signed by an officer holding a post not below the rank of an Under Secretary or equivalent in the Central or State Government, as the case may be.

9.5.4 Rule 3 (4) of the said rules further provides that a complaint filed by or on behalf of a company or a firm, shall be accompanied by a resolution, duly passed by the Board of Directors of the Company or the partners of the firm, as the case may be, specifically authorizing an officer or a person to make complaint on behalf of the company or the firm. However, in the case of a bank or financial institution, the general resolution or power of attorney authorizing an officer holding a particular position to file complaints on behalf of the bank or financial institution, shall be deemed to be the specific resolution passed by the bank or financial institution concerned, for the purposes of these rules.

9.5.5 Rule 3 (6) provides that every complaint received by the Disciplinary Directorate shall be acknowledged by ordinary post together with an acknowledgement number.

9.5.6 Rule 4 provides that every complaint shall be accompanied by a fee as prescribed by the council through regulations. However, no fee shall be required in case of complaint filed by or on behalf of the Central Government or any State Government or any Statutory authority. This fee shall be paid in the form of a demand draft drawn on any bank in India in favour of the Institute of Cost and Works Accountants of India and payable at the place where the Directorate of Discipline is situated (Rule 4 (2)). However, the fee once paid shall not be refunded. Similarly no additional fee shall be payable if the complaint is re-submitted after rectification of detect under sub-rule (5) of rule 5.

9.5.7 Regulation 12 (3A) of the Cost and Works Accountants Regulation, 1959 provides that every complaint other than a complaint made by or on behalf of the Central Government or any State Government shall be accompanied by a deposit of a sum of Rs.50/- , which will be forfeited if the council after considering the complaint comes to the conclusion that no prima facie case is made out and the complaint is either frivolous one or is made with mala fide intention.

9.5.8 Rule 7 (1) of the Cost and Works Accountants (Procedure of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules, 2007 provides that any written information containing allegation or allegations against a member or a firm, received in person or by post or courier, by the Disciplinary Directorate shall be treated as information received under Section 21 of the Act, if it is not in Form-I prescribed under sub-rule (1) of rule 3 and shall be dealt with in accordance with the provisions of these rules.

9.5.9 Rule 7 (2) of the rules provide that on receipt of such an information, the sender of the information, including the Central Government, any State Government or any statutory authority shall in the first instance, be asked whether he or it would like to file a complaint in Form-I apprising him of the following information:-

(a) that relatively longer time is taken for disposal of any information than the complaint;

(b) that the person giving information will not have the right to be represented during the investigation or hearing of the case;

(c) that the Institute will be under no obligation to inform the sender the information of the progress made in respect of the information received under sub-rule (1) including the final orders. However, if the sender of the information is Central Government, any State Government or any Statutory Authority, a copy of final order shall be sent to such sender.

9.5.10 Rule 5 of the Cost and Works Accountants (Procedures of Investigations of Professional and Other Misconduct and Conduct of cases) Rules, 2007 provide for following procedure to be followed by the Disciplinary Directorate w.r.t. each of complaints received:

(a) Rule 5(1) provides that the Director (Discipline) or an officer or officers authorized by the Director (Discipline) shall endorse on every complaint the date on which it is received or presented and the Director or the officer of officers so authorized, shall sign on each such endorsement. Rule 5(2) further provides that the Director (Discipline) or an officer or officers authorized by him shall also scrutinize all the complaints so received.

(b) If the complaint is found to be in order on scrutiny, it shall be duly registered and a unique reference number shall be allotted to it, which shall be quoted in all future correspondence. (Rule 5(3)) It may be clarified that the scrutiny at this stage will only look into the procedural aspects i.e. the complaint is in proper format and that it has been properly signed or is accompanied by appropriate fee, if applicable etc. The Director (Discipline) or other such authorized officials shall not go into the merit of complaint at this stage.

(c) If the Director (Discipline) is of the opinion that the subject matter of a complaint is substantially the same as or has been covered by any previous complaint or information received, which is already under process or has already been dealt with, he shall take any of the following actions under rule 5(4), as the case may be:

(i) If such a previous complaint is still under the examination of the Director, then the new complaint may be clubbed with the previous complaint and in such case the fact may be conveyed to the first complainant, new complainant and respondent respectively.

(ii) If prima facie opinion has been formed by the Director in such a previous complaint and the case is pending before the Board of Discipline or the Committee, then the Director shall bring the new complaint before the Board of Discipline or the Committee, as the case may be, and the latter shall either club the complaint with the previous complaint or close it or ask the Director to deal with it as a separate complaint, as it deems fit.

(iii) If orders have already been passed by the Board of Discipline or the Committee on such a previous complaint, then the Director shall present the new complaint before the Board of Discipline for its closure.

However, this rule further provides that the first complainant only would be the complainant for the purposes of investigations in case any new complaint is clubbed with a previous complaint under this rule.

9.5.11 Rule 8(1) of the Rules provides that the Director (Discipline) or an officer or officers authorized by the Director, within sixty days of the receipt of a complaint under rule 3 shall:

(a) if the complaint is against an individual member, send particulars of the acts of commission or omission alleged or a copy of the complaint, as the case may be, to that member at his professional address;

(b) if the complaint is against a firm, send particulars of the acts of commission or omission alleged or a copy of the complaint, as the case may be, to the firm at the address of its head office, as entered last in the Register of Offices and Firms maintained by the Institute, with a notice calling upon the firm to disclose the name or names of the member or members concerned and to send particulars of acts of commission or omission or a copy of the complaint, as the case may be, to such members.

9.5.12 This Rule further provides that a notice to the firm shall be deemed to be a notice to all the members, who are partners or employees of that firm as on date of registration of complaint. The firm, while disclosing the name or names of the member or members shall also send a declaration signed or, as the case may be, jointly signed by the member or members concerned to the effect that he or she or they shall be responsible for answering the complaint and that the particulars of acts of commission or omission or the copy of the complaint sent to the firm by the Director had been duly received by him, her or them.

9.5.13 Rule 8(2) further provides that member whose name is disclosed by the firm shall be responsible for answering the complaint, provided such a member was associated, either as partner or employee, with the firm, against which the complaint has been filed, at the time of occurrence of the alleged misconduct.

9.5.14 Rule 8(3) provides that the member who has been informed of the complaint filed against him (hereinafter referred to as the respondent) shall, within 21 days of the service of a copy of the complaint, or within such additional time, not exceeding thirty days, as may be allowed by the Director (Discipline), forward to the Director (Discipline), a written statement in his defence. On receipt of the written statement, if any, the Director (Discipline) may send a copy thereof to the complainant and the complainant shall, within 21 days of the service of a copy of the written statement, or within such additional time, not exceeding thirty days, as may be allowed by the Director (Discipline), forward to the Director (Discipline), his rejoinder on the written statement (Rule 8(4)).

9.5.15 On perusal of the complaint, the respondent's written statement, if any, and rejoinder of the complainant, if any, the Director (Discipline) may call for such additional particulars or documents connected therewith either from the complainant or the respondent or any third party or parties, as he may consider appropriate (Rule 8(5)). However, if no reply is sent by the respondent within the time allowed under sub-rule (3) or by the complainant within the time allowed under sub-rule (4), the Director (Discipline) shall presume that the respondent or the complainant, as the case may be, have nothing further to state (Rule 8(5)) and take further action as provided under the Chapter-III of the Cost and Works Accountants (Procedure of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules, 2007.

9.5.16 Rule 9 provides that The Director (Discipline) shall examine the complaint, written statement, if any, rejoinder, if any, and other additional particulars or documents, if any, and form his prima facie opinion as to whether the member or the firm is guilty or not of any professional or other misconduct under the First Schedule or the Second Schedule or both. Where the Director is of the prima facie opinion that –

(i) the member or the firm is guilty of any misconduct under the First Schedule, he shall place his opinion along with the complaint and all other relevant papers before the Board of Discipline;

(ii) the member or the firm is guilty of misconduct under the Second Schedule or both the First and Second Schedules, he shall place his opinion along with the complaint and all other relevant papers before the Committee.

If the Board of Discipline or the Committee, as the case may be, agrees with the prima facie opinion of the Director under sub-clause (*a*) of rule 9(2), then the Board of Discipline or the Committee may proceed further under Chapter IV or V respectively. However, if the Board of Discipline or the Committee, as the case may be, disagrees with the *prima facie* opinion of the Director under sub-clause (*a*) of rule 9(2), it shall either close the matter or advise the Director to further investigate the matter.

9.5.17 Rule 9(3) provides that Where the Director is of the prima facie opinion that the member or the firm is not guilty of any misconduct either under the First Schedule or the Second Schedule, he shall place the matter before the Board of Discipline, and the Board of Discipline -

(a) if it agrees with such opinion of the Director, shall pass order, for closure;

(b) if it disagrees with such opinion of the Director, then it may either proceed under Chapter IV of these rules, if the matter pertains to the First Schedule, or refer the matter to the Committee to proceed under Chapter V of these rules, if the matter pertains to the Second Schedule or both the Schedules, or may advise the Director to further investigate the matter.

The Director (Discipline) shall, after making further investigation as advised by the Board of Discipline under sub-rule (2) or (3) of rule 9 or by the Committee under sub-rule (2), shall further proceed under this rule. Rule 11 of the rules provide that similar procedure shall be followed w.r.t. information received relating to misconduct of members.

9.5.18 Where the Director (Discipline) is satisfied that there would be difficulty in securing proper evidence of the alleged misconduct, or that the member or firm against whom the information has been received or the complaint has been filed, would find it difficult to lead evidence to defend himself or itself, as the case may be, on account of the time lag, or that changes have taken place rendering the inquiry procedurally inconvenient or difficult, he may refuse to entertain a complaint or information in respect of any misconduct made more than seven years after the same was alleged to have been committed and submit the same to the Board of Discipline for taking decision on it under sub-section (4) of Section 21A of the Act (Rule 12).

9.6 Penalties for Misconduct

9.6.1 If any member is found guilty of a professional or other misconduct specified in the First Schedule, the Board of Discipline has the power under section 21A(3) to impose either of the following penalties after affording to the member an opportunity of being heard:

(a) reprimand the member;

(b) remove the name of the member from the Register upto a period of three months;

(c) impose such fine as it may think fit which may extend to rupees one lakh.

9.6.2 If any member is found guilty of a professional or other misconduct specified in the Second Schedule or both the First Schedule and the Second Schedule, Disciplinary Committee has the power under section 21B(3) to impose the following penalties after affording to the member an opportunity of being heard:

(b) reprimand the member;

(c) remove the name of the member from the Register permanently or for such period, as it thinks fit;

(d) impose such fine as it may think fit, which may extend to rupees five lakhs.

9.6.3 Section 9(2) of the Cost and Works Accountants Act, 1959 further provides that a fellow of the Institute, who has been found guilty of any professional or other misconduct, and whose name is removed from the Register or has been awarded penalty of fine, shall not be eligible to contest the election, –

(i) in case of misconduct falling under the First Schedule of the Cost and Works Accountants Act, 1959, for a period of three years;

(ii) in case of misconduct falling under the Second Schedule of this Act, for a period of six years, from the completion of the period of removal of name from the Register or payment of fine, as the case may be.

9.6.4 If any person who, not being a member of the Institute, represents as a member of the Institute or has a designation "Cost Accountant" or practices as a cost accountant without obtaining the certificate of practice, he shall be punishable under section 24 of the Cost and Works Accountants Act, 1959 on first conviction with fine which may extend to one thousand rupees, and on any subsequent conviction with imprisonment which may extend to six months or with fine which may extend to five thousand rupees or with both.

9.6.5 Section 25 of Cost and Works Accountants Act, 1959 further provides that if any person uses a name or a common seal which is identical with the name or the common seal of the Institute or so nearly resembles it as to deceive or is likely to deceive the public, he shall, without prejudice to any other proceedings which may be taken against him, be punishable on first conviction with fine which may extend to one thousand rupees and on any subsequent conviction with imprisonment which may extend to six months, or with fine which may extend to five thousand rupees, or with both. Similar penalties have been provided for a person awarding any degree, diploma or certificate or bestow any designation which indicates or purports to indicate the position or attainment of any qualification or competence in cost accountancy similar to that of a member of the Institute.

9.7 Board of Discipline

9.7.1 Rule 13(1) of the Cost and Works Accountants (Procedure of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules, 2007 provides that all questions which come up before the Board of Discipline shall be decided by a majority of members present and voting. In the event of equality of votes, the Presiding Officer or in his absence, the person presiding shall have a second or casting vote. Rule 13(2) provides that the quorum for any meeting of the Board of Discipline shall be two members. Rule 13(3) provides that the member of the council appointed under clause (b) of sub-section (1) of Section 21A of the Cost and Works Accountants Act, 1959 shall act as the presiding officer in the event of the Presiding Offer not being able to attend a meeting of the Board of Discipline.

9.7.2 Rule 14(2) provides that if the Board of Discipline decides to proceed further under clause (b) of sub-rule (2) of rule 9 or under clause (b) of sub-rule (3) of rule 9, it shall expeditiously cause to deliver to the respondent and the complainant, a copy each of the following:

(a) prima facie opinion formed by the Director (Discipline); and

(b) particulars or documents relied upon by the Director (Discipline), if any, during the course of formulation of prima facie opinion.

9.7.3 Rule 14(3) provides that the Board of Discipline shall inform the respondent to file a written statement, within such time as may be specified. The Board of Discipline may also give him additional time for submitting his written statement on application by the respondent on his adducing sufficient reasons to the satisfaction of the Board of Discipline for seeking additional time. However, such additional time shall not be given more than once and if the respondent still does not submit a written statement, the Board of Discipline shall presume that he has no further submissions to make and shall proceed to decide the case on merits.

9.7.4 Rule 14(4) provides that the respondent shall send a copy of his written statement, along with supporting documents to the Director (Discipline) and the complainant within the stipulated time. The complainant or the Director (Discipline) may, after receipt of the written statement, submit a rejoinder to the Board of Discipline, with a copy to the respondent along with supporting documents, if any.

9.7.5 Rule 14(6) provides that the Presiding Officer of the Board of Discipline shall fix a date, hour and place of hearing, which shall not ordinarily be later than 45 days from the date of receipt of prima facie opinion and the Board of Discipline shall cause a notice to be sent of such date, hour and place to the Director (Discipline), respondent and complainant and require them to appear before it in person to make oral submissions, if any. For the purpose of this rule, the appearance includes, unless and otherwise directed, appearance by an advocate or through any authorized representative, who may be a Chartered Accountant, Cost Accountant or Company Secretary.

9.7.6 Rule 14(7) provides that on the date of hearing, if the respondent, in spite of the service of notice under sub-rule (6), does not appear either in person or through his authorized representative, the Board of Discipline may proceed *ex parte* and pass such orders as it may think fit or direct fresh notice to be served. The rule 14(8) also provides that the Board of Discipline may, on such terms as it thinks fit, and at any stage of the proceedings, adjourn the hearing. However, such adjournment shall not be given more than once at any stage of the proceedings.

9.7.7 Rule 14(9) provides that the Board of Discipline shall consider the written representations, including the written statements, rejoinder and supporting documents, and the oral submissions, if any made by the Director, the complainant and the respondent, and arrive at a finding on whether the respondent is guilty or not of any professional or other misconduct.

9.7.8 Rule 15(1) provides that on arriving at a finding under sub-rule (9) of rule 14 that the respondent is guilty of professional or other misconduct, the Board of Discipline shall give the respondent an opportunity to be heard before passing any order under sub-section (3) of Section 21A of the Act. However, if the respondent does not appear before the Board of Discipline at the time directed to do so when given such an opportunity to be heard, the Board of Discipline shall presume that he has nothing more to represent before it and shall pass orders under sub-section (3) of Section 21A of the Act.

9.7.9 Rule 14(2) provides that on arriving at a finding under sub-rule (9) of rule 14 that the respondent is not guilty of professional or other misconduct, the Board of Discipline shall pass orders closing the case. Rule 14(3) provides that the Board of Discipline shall send a certified copy of the final order free of charge, to the Director (Discipline), respondent and the complainant.

9.8 Disciplinary Committee

9.8.1 Rule 16(2) of the Cost and Works Accountant (Procedure of Investigation of Professional and Other Misconduct and Conduct of Cases) Rules, 2007 provides that all questions which come up before the Committee shall be decided by a majority of the members present and voting and in the event of an equality of votes, the Presiding Officer or in his absence, the person presiding, shall have a second or casting vote. Rule 16(3) provides that the quorum for meeting of the Disciplinary Committee shall be three members, of which at least one shall be a member nominated by the Central Government under sub-section (1) of Section 21B of the Act.

9.8.2 Rule 16(4) further provides that the senior-most member amongst the members nominated by the Central Government under sub-section (1) of Section 21B of the Act shall act as the Presiding Officer in the event of the Presiding Officer not being able to attend a meeting of the Committee. It may be clarified that the senior-most member is the member who has been nominated earlier by the Central Government and in case both the members are nominated on the same date, then the Central Government shall indicate the name of the senior-most member, either at the time of nominating the members or on a written request for the same from the Secretary of the Institute.

9.8.3 Rule 16(5) provides that the Presiding Officer of the Committee constituted at place where the Directorate is situated, wherever considered appropriate, may transfer a matter from one Committee to another, if more than one committee have been constituted. Rule 16(6) further provides that the Committee shall, subject to the other provisions of the Act and these rules, regulate its own procedure for matters not covered under this Chapter.

9.8.4 Rule 18(1) provides that the Committee shall be guided by the principles of natural justice and shall follow the procedure in dealing with all cases before it, as laid down in Chapter-V.

9.8.5 Rule 18(2) provides that if the Committee decides to proceed further under clause (*b*) of sub-rule (2) of rule 9 or if it receives a reference from Board of Discipline under clause (*b*) of sub-rule (3) of rule 9, it shall expeditiously cause to deliver to the respondent and the complainant, a copy each of the following,—

(a) prima facie opinion formed by the Director (Discipline); and

(b) particulars or documents relied upon by the Director, if any, during the course of formulation of prima facie opinion.

9.8.6 The Rule 18(3) provides that the Disciplinary Committee shall inform the respondent, as the case may be to file a written statement, within such time as may be specified. The Committee may also give him additional time for submitting his written statement, on application by the respondent on his adducing sufficient reasons to the satisfaction of the Committee for seeking additional time. However, such additional time shall not be given more than once and if the respondent still does not submit a written statement, the Committee shall presume that he has no further submissions to make and shall proceed to decide the case on merits.

9.8.7 Rule 18(4) provides that the respondent shall send a copy of his written statement, along with supporting documents and a list of witnesses, to the Director (Discipline) and the complainant within the stipulated time. Rule 18(5) provides that the complainant or the Director (Discipline) may, after receipt of the written statement, submit a rejoinder to the Committee with a copy to the respondent along with supporting documents, if any.

9.8.8 Rule 18(6) provides that the Presiding Officer of the Committee shall fix a date, hour and place of hearing, which shall not ordinarily be later than 45 days from the date of receipt of prima facie opinion and the committee shall cause a notice to be sent of such date, hour and place to the Director (Discipline), respondent and complainant and require them to appear before it in person to make oral submissions, if any. For the purpose of this rule, the appearance includes, unless and otherwise directed, appearance by an advocate or through any authorized representative, who may be a Chartered Accountant, Cost Accountant or Company Secretary.

9.8.9 Rule 18(7) provides that during the first hearing, the Committee shall read out the charge or charges to the respondent along with the summary of prima facie opinion arrived at by the Director (Discipline) and ask the respondent whether he pleads guilty to the charge or charges made against him. However, if the respondent does not appear for the first hearing even after one adjournment, the reading out of charge or charges along with the summary of prima facie opinion shall be made in his absence and the case proceeded with in accordance with the provisions of this Chapter. Rule 18(8) provides that if the respondent pleads guilty, the Committee shall record the plea and take action as per provisions under rule 19. However, if the respondent does not plead guilty, then the Committee shall fix a date for examination of witnesses and production of documents. Rule 18(10) provides that the Committee may, on application of the Director (Discipline), issue notice for appearance to any of his witnesses directing him to attend or to produce any other document or material evidence.

9.8.10 Rule 18(11) provides that on the date so fixed, the Committee shall proceed to take all such evidence as may be produced by the Director (Discipline), including oral examination of witnesses and production of documents. The Committee may also permit the cross-examination of any witness to be deferred until any other witness or witnesses have been examined or recall any witness for further cross-examination.

9.8.11 Rule 18(12) further provides that after the presenting of evidence by the Director (Discipline) is over, the complainant shall be given an opportunity, if present during the hearing, to present any additional evidence after satisfying the Committee that such evidence is relevant and has not been brought forward during the presentation by the Director (Discipline). Rule 18(13) provides that the respondent shall be then called upon to enter upon his defence and produce his evidence.

9.8.12 Rule 18(16) provides that after evidences have been presented, the Director (Discipline) and the respondent shall present their arguments before the Committee. If the complainant, provided he is present during the hearing, feels that any vital argument has been left out by the Director (Discipline), he may present the argument after convincing the Committee of the same after the Director (Discipline) has presented his argument.

9.8.13 Rule 18(17) provides that the Committee shall consider the evidences and arguments produced before it and arrive at a finding on whether the respondent is guilty or not of any professional or other misconduct.

9.8.14 Rule 19 (1) provides that on arriving at a finding under sub-rule (8) or sub-rule (17) of rule 18 that the respondent is guilty of professional or other misconduct, the Committee shall give the respondent an opportunity to be heard before passing any order under sub-section (3) of Section 21B of the Act. However, if the respondent does not appear before the Committee at the time directed to do so when given such an opportunity to be heard, the Committee shall presume that he has nothing more to represent before it and shall pass orders under sub-section (3) of Section 21B of the Act. However, on arriving at a finding under sub-rule (17) of rule 18 that the respondent is not guilty of professional or other misconduct, the Committee shall pass orders closing the case. The Committee shall also send to the Director (Discipline), respondent and the complainant, a certified copy of the final order free of charge.

9.9 IFAC Guidelines for Professional Values and Ethics

9.9.1 The International Federation of Accountants (IFAC) was founded on October 7, 1977 in Munich, Germany at the 11th World Congress of Accountants. The organization's headquarters have been based in New York City. Sixty three professional accountancy bodies from 51 countries were signatories to IFAC's first constitution. The Institute of Cost and Works Accountants of India (ICWAI) and the Institute of Chartered Accountants of India (ICAI) are the founding members of IFAC. Today, there are 158 members and associates of IFAC in 123 countries. IFAC was established to strengthen the accountancy profession worldwide in the public interest by:

- Developing high quality international standards and supporting their adoption and use;
- Facilitating collaboration and cooperation among its member bodies;
- Collaborating and cooperating with other international organizations; and
- Serving as the international spokesperson for the accountancy profession.

9.9.2 Over the years, IFAC activities have expanded to include such areas as the following:

- Increased role in the regulation of the international profession;
- Greater communications with international regulators, standard setters, development agencies, investment community and other stakeholders;
- Addressing the need for high quality financial reporting and financial management through the development of International Public Sector Accounting standards;
- Expanded focus on small and medium practices and developing nations;
- Increased collaboration with IFAC members and greater outreach to regional accountancy organizations; and
- Closer liaison with the largest accountancy firms through the Forum of Firms.

9.9.3 IFAC develops international standards on ethics, auditing and assurance, education and public sector accounting standards through its independent standard-setting boards. It also issues guidance to support professional accountants in business, small and medium practices, and developing nations. IFAC also issues policy positions on topics of public interest.

9.9.4 IFAC has issued "Code of Ethics" for Professional Accountants. This Code of Ethics establishes ethical requirements for professional accountants. All member bodies of IFAC or firm are expected not to apply less stringent standards than those stated in this code unless that member body is prohibited by law or regulations from complying with certain parts of this Code. This code is in three parts - Part A establishes the fundamental principles of Professional ethics for professional accountants and provides a conceptual framework for applying those principles. Part B and Part C illustrate how the conceptual framework is to be applied in specific situations. It provides examples of safeguards that may be appropriate to address threats to compliance with the fundamental principles and also provide examples of situations where safeguards are not available to address the threats and consequently the activity or relationship creating the threats should be avoided. Part B applies to professional accountants in public practice and Part C applies to professional accountants in business.

9.9.5 Part A of IFAC Code requires that a professional accountant is required to comply with the following fundamental principles:

(i) **Integrity** (Section 110): A professional accountant should be straight forward and honest in performing professional services.

(ii) **Objectivity** (Section 120): A professional accountant should not allow bias, conflict of interest or under influence of others to override professional or business judgements.

(iii) **Professional Competence and Due Care** (Section 130): A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

(iv) **Confidentiality** (Section 140): A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

(v) **Professional Behaviour** (Section 150): A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

9.9.1 Integrity

9.9.1.1 The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in professional and business relationships. Integrity also implies fair dealing and truthfulness.

9.9.1.2 A professional accountant should not be associated with reports, returns, communications or other information where they believe that the information:

(a) Contains a materially false or misleading statement;

(b) Contains statements or information furnished recklessly; or

(c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

9.9.2 Objectivity

9.9.2.1 The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

9.9.2.2 A professional accountant may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations. Relationships that bias or unduly influence the professional judgment of the professional accountant should be avoided.

9.9.3 Professional Competence and Due Care

9.9.3.1 The principle of professional competence and due care imposes the following obligations on professional accountants:

(a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service; and

(b) To act diligently in accordance with applicable technical and professional standards when providing professional services.

9.9.3.2 Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service. Professional competence may be divided into two separate phases:

(a) Attainment of professional competence; and

(b) Maintenance of professional competence.

9.9.3.3 The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical professional and business developments. Continuing professional development develops and maintains the capabilities that enable a professional accountant to perform competently within the professional environments.

9.9.3.4 Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

9.9.3.5 A professional accountant should take steps to ensure that those working under the professional accountant's authority in a professional capacity have appropriate training and supervision.

9.9.3.6 Where appropriate, a professional accountant should make clients, employers or other users of the professional services aware of limitations inherent in the services to avoid the misinterpretation of an expression of opinion as an assertion of fact.

9.9.4 Confidentiality

9.9.4.1 The principle of confidentiality imposes an obligation on professional accountants to refrain from:

(a) Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and

(b) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

9.9.4.2 A professional accountant should maintain confidentiality even in a social environment. The professional accountant should be alert to the possibility of inadvertent disclosure, particularly in circumstances involving long association with a business associate or a close or immediate family member.

9.9.4.3 A professional accountant should also maintain confidentiality of information disclosed by a prospective client or employer.

9.9.4.4 A professional accountant should also consider the need to maintain confidentiality of information within the firm or employing organization.

9.9.4.5 A professional accountant should take all reasonable steps to ensure that staff under the professional accountant's control and persons from whom advice and assistance is obtained respect the professional accountant's duty of confidentiality.

9.9.4.6 The need to comply with the principle of confidentiality continues even after the end of relationships between a professional accountant and a client or employer. When a professional accountant changes employment or acquires a new client, the professional accountant is entitled to use prior experience. The professional accountant should not, however, use or disclose any confidential information either acquired or received as a result of a professional or business relationship.

9.9.4.7 The following are circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

(a) Disclosure is permitted by law and is authorized by the client or the employer;

(b) Disclosure is required by law, for example:

(i) Production of documents or other provision of evidence in the course of legal proceedings; or

(ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and

(c) There is a professional duty or right to disclose, when not prohibited by law:

(i) To comply with the quality review of a member body or professional body;

(ii) To respond to an inquiry or investigation by a member body or regulatory body;

(iii) To protect the professional interests of a professional accountant in legal proceedings; or

(iv) To comply with technical standards and ethics requirements.

9.9.4.8 In deciding whether to disclose confidential information, professional accountants should consider the following points:

(a) Whether the interests of all parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by the professional accountant;

(b) Whether all the relevant information is known and substantiated, to the extent it is practicable; when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment should be used in determining the type of disclosure to be made, if any; and

(c) The type of communication that is expected and to whom it is addressed; in particular, professional accountants should be satisfied that the parties to whom the communication is addressed are appropriate recipients.

9.10 Professional Behaviour

9.10.1 The principle of professional behaviour imposes an obligation on professional accountants to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession. This includes actions which a reasonable and informed third party, having knowledge of all relevant information, would conclude negatively affects the good reputation of the profession.

9.10.2 In marketing and promoting themselves and their work, professional accountants should not bring the profession into disrepute. Professional accountants should be honest and truthful and should not:

(a) Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or

(b) Make disparaging references or unsubstantiated comparisons to the work of others.

The conceptual framework requires a professional accountant to identify, evaluate and address threats to comply with the fundamental principles, rather than merely complying with a set of specific rules, which may be arbitrary. If threats to ethics are not clearly insignificant, a professional accountant should apply safeguards to eliminate the threats or reduce them to an acceptable level.

9.10.1 Part B – Introduction

9.10.1.1 Part B of the Code applicable to professional accountants in public practice illustrates how the conceptual framework contained in Part A is to be applied by professional accountants in public practice. The examples in the following sections are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances experienced by a professional accountant in public practice that may create threats to compliance with the principles. Consequently, it is not sufficient for a professional accountant in public practice merely to comply with the examples presented; rather, the framework should be applied to the particular circumstances faced.

9.10.1.2 A professional accountant in public practice should not engage in any business, occupation or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the rendering of professional services.

9.10.2 Threats and Safeguards

9.10.2.1 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

(a) Self-interest;

(b) Self-review;

(c) Advocacy;

(d) Familiarity; and

(e) Intimidation.

9.10.2.2 The nature and significance of the threats may differ depending on whether they arise in relation to the provision of services to a **financial statement audit client**, a non-financial statement audit **assurance client** or a non-assurance client.

9.10.2.3 Self-interest threats may occur as a result of the financial or other interests of a professional accountant or of an immediate or **close family** member. Examples of circumstances that may create self-interest threats for a professional accountant in public practice include, but are not limited to:

- A **financial interest** in a client or jointly holding a financial interest with a client.
- Undue dependence on total fees from a client.
- Having a close business relationship with a client.
- Concern about the possibility of losing a client.
- Potential employment with a client.
- **Contingent fee**s relating to an **assurance engagement***.
- A loan to or from an assurance client or any of its directors or officers.

9.10.2.4 Self-review threats may occur when a previous judgment needs to be reevaluated by the professional accountant responsible for that judgment. Examples of circumstances that may create self-review threats include, but are not limited to:

- The discovery of a significant error during a re-evaluation of the work of the professional accountant in public practice.
- Reporting on the operation of financial systems after being involved in their design or implementation.
- Having prepared the original data used to generate records that are the subject matter of the engagement.
- A member of the assurance team being, or having recently been, a director or officer of that client.
- A member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement.

- Performing a service for a client that directly affects the subject matter of the assurance engagement.

9.10.2.5 Advocacy threats may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised. Examples of circumstances that may create advocacy threats include, but are not limited to:

- Promoting shares in a listed entity* when that entity is a financial statement audit client.
- Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

9.10.2.6 Familiarity threats may occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others. Examples of circumstances that may create familiarity threats include, but are not limited to:

- A member of the engagement team having a close or immediate family relationship with a director or officer of the client.
- A member of the engagement team having a close or immediate family relationship with an employee of the client who is in a position to exert direct and significant influence over the subject matter of the engagement.
- A former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement.
- Accepting gifts or preferential treatment from a client, unless the value is clearly insignificant.
- Long association of senior personnel with the assurance client.

9.10.2.7 Intimidation threats may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived. Examples of circumstances that may create intimidation threats include, but are not limited to:

- Being threatened with dismissal or replacement in relation to a client engagement.
- Being threatened with litigation.
- Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

9.10.2.8 A professional accountant in public practice may also find that specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. Such unique threats obviously cannot be categorized. In either professional or business relationships, a professional accountant in public practice should always be on the alert for such circumstances and threats.

9.10.2.9 Safeguards that may eliminate or reduce threats to an acceptable level fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and

(b) Safeguards in the work environment.

9.10.2.10 Safeguards created by the profession, legislation or regulation include, but are not restricted to:

- Educational, training and experience requirements for entry into the profession.
- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- Professional or regulatory monitoring and disciplinary procedures.
- External review by a legally empowered third party of the reports, returns, communications or information produced by a professional accountant.

9.10.2.11 In the work environment, the relevant safeguards will vary depending on the circumstances. Work environment safeguards comprise firm-wide safeguards and engagement specific safeguards. A professional accountant in public practice should exercise judgment to determine how to best deal with an identified threat. In exercising this judgment a professional accountant in public practice should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would reasonably conclude to be acceptable. This consideration will be affected by matters such as the significance of the threat, the nature of the engagement and the structure of the firm.

9.10.2.12 Firm-wide safeguards in the work environment may include:

- Leadership of the firm that stresses the importance of compliance with the fundamental principles.
- Leadership of the firm that establishes the expectation that the members of an assurance team will act in the public interest.
- Policies and procedures to implement and monitor quality control of engagements.
- Documented policies regarding the identification of threats to compliance with the fundamental principles, the evaluation of the significance of these threats and the identification and the application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level.
- For firms that perform assurance engagements, documented independence* policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the evaluation and application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level.
- Documented internal policies and procedures requiring compliance with the fundamental principles.
- Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
- Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client.

- Policies and procedures to prohibit individuals who are not members of an engagement team from inappropriately influencing the outcome of the engagement.
- Timely communication of a firm's policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.
- Designating a member of senior management to be responsible for overseeing the adequate functioning of the firm's quality control system.
- Advising partners and professional staff of those assurance clients and related entities from which they must be independent.
- A disciplinary mechanism to promote compliance with policies and procedures.
- Published policies and procedures to encourage and empower staff to communicate to senior levels within the firm any issue relating to compliance with the fundamental principles that concerns them.

9.10.2.13 Engagement-specific safeguards in the work environment may include:

- Involving an additional professional accountant to review the work done or otherwise advise as necessary.
- Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.
- Discussing ethical issues with those charged with governance of the client.
- Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged.
- Involving another firm to perform or re-perform part of the engagement.
- Rotating senior assurance team personnel.

9.10.2.14 Depending on the nature of the engagement, a professional accountant in public practice may also be able to rely on safeguards that the client has implemented. However, it is not possible to rely solely on such safeguards to reduce threats to an acceptable level.

9.10.2.15 Safeguards within the client's systems and procedures may include:

- When a client appoints a firm in public practice to perform an engagement, persons other than management ratify or approve the appointment.
- The client has competent employees with experience and seniority to make managerial decisions.
- The client has implemented internal procedures that ensure objective choices in commissioning non-assurance engagements.
- The client has a corporate governance structure that provides appropriate oversight and communications regarding the firm's services.

9.10.2.16 Certain safeguards may increase the likelihood of identifying or deterring unethical behaviour. Such safeguards, which may be created by the accounting profession, legislation, regulation or an employing organization, include, but are not restricted to:

- Effective, well publicized complaints systems operated by the employing organization, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behaviour.
- An explicitly stated duty to report breaches of ethical requirements.

9.10.2.17 The nature of the safeguards to be applied will vary depending on the circumstances. In exercising professional judgment, a professional accountant should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would conclude to be unacceptable.

9.10.2.18 **PART C** applicable to Professional Accountants in Business illustrates how the conceptual framework contained in Part A is to be applied by professional accountants in business.

9.10.2.19 Investors, creditors, employers and other sectors of the business community, as well as governments and the public at large, all may rely on the work of professional accountants in business. Professional accountants in business may be solely or jointly responsible for the preparation and reporting of financial and other information, which both their employing organizations and third parties may rely on. They may also be responsible for providing effective financial management and competent advice on a variety of business-related matters.

9.10.2.20 A professional accountant in business may be a salaried employee, a partner, director (whether executive or non-executive), an owner manager, a volunteer or another working for one or more employing organization. The legal form of the relationship with the employing organization, if any, has no bearing on the ethical responsibilities incumbent on the professional accountant in business.

9.10.2.21 A professional accountant in business has a responsibility to further the legitimate aims of their employing organization. This Code does not seek to hinder a professional accountant in business from properly fulfilling that responsibility, but considers circumstances in which conflicts may be created with the absolute duty to comply with the fundamental principles.

9.10.3 Threats and Safeguards

9.10.3.1 Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

(a) Self-interest;

(b) Self-review;

(c) Advocacy;

(d) Familiarity; and

(e) Intimidation.

9.10.3.2 Examples of circumstances that may create self-interest threats for a professional accountant in business include, but are not limited to:

- Financial interests, loans or guarantees.
- Incentive compensation arrangements.

- Inappropriate personal use of corporate assets.
- Concern over employment security.
- Commercial pressure from outside the employing organization.

9.10.3.3 Circumstances that may create self-review threats include, but are not limited to, business decisions or data being subject to review and justification by the same professional accountant in business responsible for making those decisions or preparing that data.

9.10.3.4 When furthering the legitimate goals and objectives of their employing organizations professional accountants in business may promote the organization's position, provided any statements made are neither false nor misleading. Such actions generally would not create an advocacy threat.

9.10.3.5 Examples of circumstances that may create familiarity threats include, but are not limited to:

- A professional accountant in business in a position to influence financial or non-financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.
- Long association with business contacts influencing business decisions.
- Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

9.10.3.6 Examples of circumstances that may create intimidation threats include, but are not limited to:

- Threat of dismissal or replacement of the professional accountant in business or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported.
- A dominant personality attempting to influence the decision making process, for example with regard to the awarding of contracts or the application of an accounting principle.

9.10.3.7 Professional accountants in business may also find that specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. Such unique threats obviously cannot be categorized. In all professional and business relationships, professional accountants in business should always be on the alert for such circumstances and threats.

9.10.3.8 Safeguards that may eliminate or reduce to an acceptable level the threats faced by professional accountants in business fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and

(b) Safeguards in the work environment.

9.10.3.9 Safeguards in the work environment include, but are not restricted to:

- The employing organization's systems of corporate oversight or other oversight structures.
- The employing organization's ethics and conduct programs.
- Recruitment procedures in the employing organization emphasizing the importance of employing high caliber competent staff.
- Strong internal controls.
- Appropriate disciplinary processes.

- Leadership that stresses the importance of ethical behavior and the expectation that the employees will act in an ethical manner.
- Policies and procedures to implement and monitor the quality of employee performance.
- Timely communication of the employing organization's policies and procedures, including any changes to them, to all employees and appropriate training and education on such policies and procedures.
- Policies and procedures to empower and encourage employees to communicate to senior levels within the employing organization any ethical issues that concern them without fear of retribution.
- Consultation with another appropriate professional accountant.

9.10.3.10 In circumstances where a professional accountant in business believes that unethical behaviour or actions by others will continue to occur within the employing organization, the professional accountant in business should consider seeking legal advice. In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, a professional accountant in business may conclude that it is appropriate to resign from the employing organization.

9.10.3.11 The extracts from the code of conduct or ethics under the Cost and Works Accountant Act are given below:

Extracts from the

COST AND WORKS ACCOUNTANTS ACT, 1959

[AS AMENDED BY THE COST AND WORKS ACCOUNTANTS (AMENDMENT) ACT, 2006]

[23 OF 1959]

THE FIRST SCHEDULE

[See Sections 21(3), 21A(3) and 22]

PART I

PROFESSIONAL MISCONDUCT IN RELATION TO COST ACCOUNTANTS IN PRACTICE

A cost accountant in practice shall be deemed to be guilty of professional misconduct, if he –

(1) allows any person to practice in his name as a cost accountant unless such person is also a cost accountant in practice and is in partnership with or employed by him;

(2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualifications as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

Explanation – In this item, "partner" includes a person residing outside India with whom a cost accountant in practice has entered into partnership which is not in contravention of item (4) of this Part;

(3) accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute:

Provided that nothing herein contained shall be construed as prohibiting a member from entering into profit sharing or other similar arrangements, including receiving any share, commission or brokerage in the fees, with a member of such professional body or other person having qualifications, as is referred to in item (2) of this Part;

(4) enters into partnership, in or outside India, with any person other than a cost accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (iv) of sub-section (1) of Section 4 or whose qualifications are recognised by the Central Government or the Council for the purpose of permitting such partnerships;

(5) secures, either through the services of a person who is not an employee of such cost accountant or who is not his partner or by means which are not open to a cost accountant, any professional business:

Provided that nothing herein contained shall be construed as prohibiting any arrangement permitted in terms of items (2), (3) and (4) of this Part;

(6) solicits clients or professional work, either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means:

Provided that nothing herein contained shall be construed as preventing or prohibiting –

(i) any cost accountant from applying or requesting for or inviting or securing professional work from another cost accountant in practice;

(ii) a member from responding to tenders or enquiries issued by various users of professional services or organisations from time to time and securing professional work as a consequence;

(7) advertises his professional attainments or services, or uses any designation or expressions other than cost accountant on professional documents, visiting cards, letter heads or sign boards, unless it be a degree of a University established by law in India or recognised by the Central Government or a title indicating membership of the Institute of Cost Accountants of India or of any other institution that has been recognised by the Central Government or may be recognised by the Council:

Provided that a member in practice may advertise through a write up, setting out the services provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council;

(8) accepts a position as cost accountant previously held by another cost accountant in practice without first communicating with him in writing;

(9) charges or offers to charge, accepts or offers to accept in respect of any professional employment, fees which are based on a percentage of profits or which are contingent upon the findings or results of such employment, except as permitted under any regulation made under this Act;

(10) engages in any business or occupation other than the profession of cost accountant unless permitted by the Council so to engage:

Provided that nothing contained herein shall disentitle a cost accountant from being a director of a company (not being a managing director or a whole-time director) unless he or any of his partners is interested in such company as accountant;

(11) allows a person not being a member of the Institute in practice, or a member not being his partner to sign on his behalf or on behalf of his firm, any cost or pricing statements or any other statements relating thereto.

PART II

PROFESSIONAL MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE IN SERVICE

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person –

(1) pays or allows or agrees to pay, directly or indirectly, to any person any share in the emoluments of the employment undertaken by him;

(2) accepts or agrees to accept any part of fees, profit or gains from a lawyer, a cost accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

PART III

PROFESSIONAL MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE GENERALLY

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he –

(1) not being a fellow of the Institute acts as a fellow of the Institute;

(2) does not supply the information called for, or does not comply with the requirements asked for by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

(3) while inviting professional work from another cost accountant or while responding to tenders or enquiries or while advertising through a write up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

PART IV

OTHER MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE GENERALLY

A member of the institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if—

(1) he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months;

(2) in the opinion of the Council he brings disrepute to the profession or the institute as a result of his action whether or not related to his professional work.

THE SECOND SCHEDULE

[See sections 21(3), 21B(3) and 22]

PART I

PROFESSIONAL MISCONDUCT IN RELATION TO COST ACCOUNTANTS IN PRACTICE

A cost accountant in practice shall be deemed to be guilty of professional misconduct, if he –

(1) discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client, or otherwise than as required by any law for the time being in force;

(2) certifies or submits in his name, or in the name of his firm, a report of an examination of cost accounting and related statements unless the examination of such statements has been made by him or by a partner or an employee in his firm or by another cost accountant in practice;

(3) permits his name or the name of his firm to be used in connection with an estimate of cost or earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast;

(4) expresses his opinion on cost or pricing statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest;

(5) fails to disclose a material fact known to him in a cost or pricing statement, which is not disclosed in a cost or pricing statement but disclosure of which is necessary in making such statement where he is concerned with such statement in a professional capacity;

(6) fails to report a material mis-statement known to him to appear in a cost or pricing statement with which he is concerned in a professional capacity;

(7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties;

(8) fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion;

(9) fails to invite attention to any material departure from the generally accepted procedure of costing and pricing applicable to the circumstances;

(10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

PART II

PROFESSIONAL MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE GENERALLY

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he —

(1) contravenes any of the provisions of this Act or the regulations made there-under or any guidelines issued by the Council;

(2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment, except as and when required by any law for the time being in force or except as permitted by the employer;

(3) includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false;

(4) defalcates or embezzles moneys received in his professional capacity.

PART III

OTHER MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE GENERALLY

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

CHAPTER V

MISCONDUCT

Disciplinary Directorate.

21. (1) The Council shall, by notification, establish a Disciplinary Directorate headed by an officer of the Institute designated as Director (Discipline) and such other employees for making investigations in respect of any information or complaint received by it.

(2) On receipt of any information or complaint along with the prescribed fee, the Director (Discipline) shall arrive at a prima facie opinion on the occurrence of the alleged misconduct.

(3) Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the First Schedule, he shall place the matter before the Board of Discipline and where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the Second Schedule or in both the Schedules, he shall place the matter before the Disciplinary Committee.

(4) In order to make investigations under the provisions of this Act, the Disciplinary Directorate shall follow such procedure as may be specified.

(5) Where a complainant withdraws the complaint, the Director (Discipline) shall place such withdrawal before the Board of Discipline or as the case may be, the Disciplinary Committee, and the said Board or Committee may, if it is of the view that the circumstances so warrant, permit the withdrawal at any stage.

Board of Discipline

21A. (1) The Council shall constitute a Board of Discipline consisting of –

(a) a person with experience in law and having knowledge of disciplinary matters and the profession, to be its Presiding Officer;

(b) two members one of whom shall be a member of the Council elected by the Council and the other member shall be the person designated under clause (c) of sub-section (1) of Section

(c) the Director (Discipline) shall function as the Secretary of the Board.

(2) The Board of Discipline shall follow summary disposal procedure in dealing with all the cases before it.

(3) Where the Board of Discipline is of the opinion that a member is guilty of a professional or other misconduct mentioned in the First Schedule, it shall afford to the member an opportunity of being heard before making any order against him and may thereafter take any one or more of the following actions, namely:—

(a) reprimand the member;

(b) remove the name of the member from the Register up to a period of three months;

(c) impose such fine as it may think fit which may extend to rupees one lakh.

(4) The Director (Discipline) shall submit before the Board of Discipline all information and

complaints where he is of the opinion that there is no prima facie case and the Board of Discipline may, if it agrees with the opinion of the Director (Discipline), close the matter or in case of disagreement, may advise the Director (Discipline) to further investigate the matter.

Disciplinary Committee

21B. (1) The Council shall constitute a Disciplinary Committee consisting of the President or the Vice-President of the Council as the Presiding Officer and two members to be elected from amongst the members of the Council and two members to be nominated by the Central Government from amongst the persons of eminence having experience in the field of law, economics, business, finance or accountancy:

Provided that the Council may constitute more Disciplinary Committees as and when it considers necessary.

(2) The Disciplinary Committee while considering the cases placed before it, shall follow such procedure as may be specified.

(3) Where the Disciplinary Committee is of the opinion that a member is guilty of a professional or other misconduct mentioned in the Second Schedule or both the First Schedule and the Second Schedule, it shall afford to the member an opportunity of being heard before making any order against him and may thereafter take any one or more of the following actions, namely: –

(a) reprimand the member;

(b) remove the name of the member from the Register permanently or for such period, as it thinks fit;

(c) impose such fine as it may think fit, which may extend to rupees five lakhs.

(4) The allowances payable to the members nominated by the Central Government shall be such as may be specified.

Authority, Disciplinary Committee, Board of Discipline and Director (Discipline) to have powers of civil court.

21C. For the purposes of an inquiry under the provisions of this Act, the Authority, the Disciplinary Committee, Board of Discipline and the Director (Discipline) shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), in respect of the following matters, namely:—

(a) summoning and enforcing the attendance of any person and examining him on oath;

(b) the discovery and production of any document; and

(c) receiving evidence on affidavit.

Explanation – For the purposes of Sections 21, 21A, 21B, 21C and 22, "member of the Institute" includes a person who was a member of the Institute on the date of the alleged misconduct although he has ceased to be a member of the Institute at the time of the inquiry.

Transitional provisions

21D. All complaints pending before the Council or any inquiry initiated by the Disciplinary Committee or any reference or appeal made to a High Court prior to the commencement of the Cost and Works Accountants (Amendment) Act, 2006 shall continue to be governed by the provisions of this Act, as if this Act had not been amended by the Cost and Works Accountants (Amendment) Act, 2006.]

Professional or other misconduct defined

22. For the purposes of this Act, the expression "professional or other misconduct" shall be deemed to include any act or omission provided in any of the Schedules but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under sub-section (1) of Section 21 to inquire into the conduct of any member of the Institute under any other circumstances.

Constitution of Appellate Authority

22A. The Appellate Authority constituted under sub-section (1) of Section 22A of the Chartered Accountants Act, 1949 (38 of 1949), shall be deemed to be the Appellate Authority for the purposes of this Act subject to the modification that for clause (b) of said sub-section (1), the following clause had been substituted, namely : –

"(b) the Central Government shall, by notification appoint two part-time members from amongst the persons who have been members of the Council of the Institute of Cost and Works Accountants of India for at least one full term and who is not a sitting member of the Council;"

Term of office of members of Authority

22B. A person appointed as a member shall hold office for a term of three years from the date on which he enters upon his office or until he attains the age of sixty-two years, whichever is earlier.

Procedure, etc., of Authority.

22C. The provisions of Section 22C, Section 22D and Section 22F of the Chartered Accountants Act, 1949 (38 of 1949) shall apply to the Authority in relation to allowances and terms and conditions of service of its Chairperson and members and in the discharge of its functions under this Act as they apply to it in the discharge of its functions under the Chartered Accountants Act, 1949.

Officers and other Staff of Authority

22D. (1) The Council shall make available to the Authority such officers and other staff members as may be necessary for the efficient performance of the functions of the Authority.

(2) The salaries and allowances and conditions of service of the officers and other staff members of the Authority shall be such as may be prescribed.

Appeal to Authority

22E. (1) Any member of the Institute aggrieved by any order of the Board of Discipline or the Disciplinary Committee imposing on him any of the penalties referred to in sub-section (3) of section 21A and sub-section (3) of Section 21B, may within ninety days from the date on which the order is communicated to him, prefer an appeal to the Authority:

Provided that the Director (Discipline) may also appeal against the decision of the Board of

Discipline or the Disciplinary Committee to the Authority if so authorised by the Council, within ninety days:

Provided further that the Authority may entertain any such appeal after the expiry of the said period of ninety days, if it is satisfied that there was sufficient cause for not filing the appeal in time.

(2) The Authority may, after calling for the records of any case, revise any order made by the Board of Discipline or the Disciplinary Committee under sub-section (3) of Section 21A and subsection (3) of Section 21B and may –

(a) confirm, modify or set aside the order;

(b) impose any penalty or set aside, reduce, or enhance the penalty imposed by the order;

(c) remit the case to the Board of Discipline or Disciplinary Committee for such further enquiry as the Authority considers proper in the circumstances of the case; or

(d) pass such other order as the Authority thinks fit:

Provided that the Authority shall give an opportunity of being heard to the parties concerned before passing any order.]

CODE OF ETHICS BY COUNCIL OF ICWAI

Extracts from "Code of Ethics" approved by Council on ______________. The Code of Ethics as approved by the Council contains extracts from Cost and Works Accountants Act, 1959 and Regulations, which have since been amended hence these have not been published.

CODE OF ETHICS

CHAPTER-1: INTRODUCTION

As professionals in the field of Cost and Management Accounting, the members of our Institute are bound by a code of professional ethics. This code stipulates and binds them to the highest level of care, duty and responsibility to their employers and clients, the public and their fellow professionals.

ICWAI Guidelines shall-

(a) Set Standards for code of ethics of Cost Accountants such that a member will:

(i) maintain at all times independence of thought and action;

(ii) not express an opinion on cost / financial reports or statements without first assessing her or his relationship with her or his client to determine whether such Member might expect her or his opinion to be considered independent, objective and unbiased by one who has knowledge of all the facts; and

(iii) When preparing cost / financial reports or statements or expressing an opinion on cost / financial reports or statements, disclose all material facts known to such Member in order not to make such cost / financial reports or statements misleading, acquire sufficient information to warrant an expression of opinion and report all material misstatements or departures from generally accepted accounting principles.

(iv) not disclose or use any confidential information concerning the affairs of such Member's employer or client unless acting in the course of his or her duties or except when such information is required to be disclosed in the course of any defense of himself or herself or any associate or employee in any lawsuit or other legal proceeding or against alleged professional misconduct by order of lawful authority or any committee of the Society in the proper exercise of their duties but only to the extent necessary for such purpose;

(v) inform his or her employer or client of any business connections or interests of which such Member's employer or client would reasonably expect to be informed;

(vi) not, in the course of exercising his or her duties on behalf of such Member's employer or client, hold, receive, bargain for or acquire any fee, remuneration or benefit without such employer's or client's knowledge and consent; and

(vii) take all reasonable steps, in arranging any engagement as a consultant, to establish a clear understanding of the scope and objectives of the work before it is commenced and will furnish the client with an estimate of cost, preferably before the engagement is commenced, but in any event as soon as possible thereafter.

(viii) conduct himself or herself toward other Members with courtesy and good faith;

(ix) not accept any engagement to review the work of another Member for the same employer except with the knowledge of that Member, or except where the connection of that Member with the work has been terminated, unless the Member reviews the work of others as a normal part of his or her responsibilities;

(x) not attempt to gain an advantage over other Members by paying or accepting a commission in securing management accounting work;

(xi) not act maliciously or in any other way which may adversely reflect on the public or professional reputation or business of another Member.

(xii) at all times maintain the standards of competence expressed by the Institute from time to time;

(xiii) undertake only such work as he or she is competent to perform by virtue of his or her training and experience and will, where it would be in the best interests of an employer or client, engage, or advise the employer or client to engage, other specialists;

CHAPTER – 2: OBJECTIVES

These Guidelines recognize that the objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement. These objectives require four basic needs to be met:

(a) Credibility in information and information systems;

(b) Professionalism identified by employers, clients and other interested parties;

(c) Quality of service carried out to the highest standards of performance; and

(d) Confidence that there is a framework of professional ethics to govern the provision of services.

In order to achieve the objectives of the accountancy profession, cost accountants have to observe fundamental principles, which are:

(a) Integrity

A cost accountant should be straightforward and honest in performing his services.

(b) Objectivity

A cost accountant should be fair and should not allow prejudice or bias or the influence of others to override objectivity.

(c) Competence

A cost accountant must refrain from performing any service which he is not competent to carry out unless proper advice and assistance is obtained to ensure that the service is performed to the satisfaction.

(d) Confidentiality

A cost accountant must not disclose information acquired during the course of his engagement and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

(e) Professional Behaviour

A cost accountant should act in a manner consistent with the good reputation of the profession.

In addition to the fundamental principles above a cost accountant in practice, should be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity, objectivity and independence.

9.11 Self Regulation Guidelines

9.11.1 **Self regulation guidelines:** Self Regulation Guidelines/directions in the context of use of designation etc. and manner of printing letter-heads and visiting cards, of the President, Vice-President of the Institute, Members of the Council, Chairmen of various Non-Standing Committees of the Institute; Chairmen, other office bearers and Members of the Regional Councils; Chairmen, other office bearers and Members of the Managing Committees of Chapters, which are given hereunder:-

1. The Institute will print the letter-heads for President and Vice- President of the Institute with their names, designation and address of the Institute with emblem. In these letter-heads, the President's or Vice-President's personal addresses, including their professional and residential addresses shall not be printed.

2. The Regional Councils and their Chapters shall print the letter- heads for official use of the Chairmen of the respective Regional Councils/Chapters with their designation, address of the Regional Council/Chapter concerned and the Institute's emblem without mentioning their names in the letter-heads. As far as other office-bearers of Regional Councils and Chapters are concerned, they should use the common letter-head bearing the name and address of the Regional Council or the Chapter, as the case may be, and their designation may be typed below their signatures.

3. It is clarified that no member of the Councilor any Regional Council or the Managing

Committee of any Chapter shall print any letter-head in relation to the position he holds in various Committees or as a member of the Council/Regional Council/Managing Committee, at his cost.

4. The visiting cards will be printed for both the elected and nominated Central Council members. The visiting Cards be also printed for members of Regional Councils and Managing Committees of the Chapters. The visiting cards will be used only for official work of the Institute. The Head office of the Institute will print the visiting cards for President, Vice-President and Members of Central Council. The offices of Regional Councils and Chapters will print the visiting cards for respective Regional Councils and Chapters. The members themselves will not print the visiting cards.

5. In the visiting card, the designation viz., President/Vice-President/Member, Central Council/ Chairman of the Regional Council/Chairman of the Chapter/Member of the Regional Council/Member of the Managing Committee of the ……Chapter of…..Regional Council will be used. There will not be any mention of any other designation like Chairman of particular Committee, etc.

6. The full term of the Council/Regional Council/Chapter will be mentioned for example 1998 to 2001. In case of the President/Vice-President/Chairman Regional Council and Chapter, the year of Presidentship/ Vice Presidentship/Chairmanship will be mentioned, for example, 1999-2000. The President, Vice President, Chairmen of Regional Councils and Chapters will use their cards for the year in which they are elected. Cards with the designation/description viz., former/past President, membership of national/international bodies even at personal cost will not be permitted.

7. The address of the Institute in the case of Central Council member, that of the concerned Regional Council in the case of Regional Council member and that of the concerned Chapter in the case of Member of the Managing Committee of the Chapter will be printed. The Residential address of the members will not be printed. However, on the back of the visiting cards the residential telephone number may be printed. The professional office address also will not be printed. The Telephone No., Fax No. & E-mail address of the Institute in the case of Central Council Member, those of concerned Regional Council in the case of the Regional Council Member and those of the concerned Chapter in the case of Member of Managing Committee of the Chapter will be given.

8. The visiting Cards will be returned to the offices of the Institute as soon as the term of the President and Vice-President, the Membership of the Central Council/Chairmanship/ Membership of the Regional Council/Managing Committee of the Chapter expires.

9. The number of cards permissible to be printed for the Central Council member, Chairman and Member of Regional Council and Chairman of the Chapter, Member of the Managing Committee of the Chapter will be 400 per year. For President and Vice-President, the number of cards to be printed will be left to be decided by them.

10. The visiting cards will be printed in the prescribed formats. The type of paper, printing, colour of ink of the visiting cards will be uniform and of the same type and manner.

11. In the visiting cards of Regional Councils and Chapters, the name of the respective Regional Council and Chapter will be printed in bold letters and the name of the Institute in normal letters.

9.12 Guidelines for Advrtisement by Cost Accountants in Practice

THE INSTITUTE OF COST AND WORKS ACCOUNTANTS OF INDIA

(Constituted under the Cost and Works Accountants Act, 1959)

ICWAI Guideline No.1 of April, 2008

[Pursuant to Clause (1) *of Part II of the Second Schedule to the Cost and Works Accountants Act, 1959, as amended]* New Delhi, the 1st April, 2008

GUIDELINES FOR ADVERTISEMENT BY COST ACCOUNTANTS IN PRACTICE

In exercise of the powers conferred by Clause (1) of Part II of the Second Schedule to the Cost and Works Accountants Act, 1959 (23 of 1959), as amended by the Cost and Works Accountants(Amendment) Act, 2006, the Council of the Institute of Cost and Works Accountants of India hereby issues the following guidelines:

1. Introduction

1.1 The Institute of Cost and Works Accountants of India, (the Institute) constituted under the Cost and Works Accountants Act, 1959 (the Act) is a statutory body to develop and regulate the profession of Cost Accountants in India. Members of the Institute who hold the Certificate of Practice issued by it are authorised to practise the profession of Cost Accountants and these members are known as Cost Accountants in Practice.

1.2 The areas in which the Cost Accountants in Practice can and do render their services and the names, addresses and other particulars of Cost Accountants in Practice are displayed on the website of the Institute.

1.3 Members of the Institute are required under the Act to maintain high standards of professional conduct.

1.4 Part I of the First schedule of the Cost and Works Accountants Act, 1959, enumerates professional misconduct in relation to a member in practice and inter-alia includes if such a member:

(6) solicits clients or professional work, either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means:

Provided that nothing herein contained shall be construed as preventing or prohibiting-

(i) *any Cost Accountant from applying or requesting for or inviting or securing professional work from another Cost Accountant in Practice;*

(ii) *a member from responding to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence;*

(7) *advertises his professional attainments or services, or uses any designation or expressions other than Cost Accountant on professional documents, visiting cards, letterheads or sign boards, unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Cost Accountants of India or-of any other institution that has been recognized by the Central Government or may be recognized by the Council: Provided that, a member in practice may advertise through a write up setting out* ***the services provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council;***

1.5 The Council of the Institute of Cost and Works Accountants of India at its 245th meeting held on 26th March, 2008 approved the following Guidelines for Advertisement by Cost Accountant in Practice.

1.6 The Guidelines herein, as issued by the Central Council of the Institute on **1st April, 2008** deal with the manner in which a Cost Accountant in Practice can advertise the services provided by him or his firm and the particulars of his firm through a write-up.

1.7 Any non compliance or violation of these Guidelines as may be in force from time to time in any manner whatsoever shall be deemed to be an act of professional misconduct and the concerned member shall be liable to disciplinary proceedings under the Act.

2. Key Definitions

For the purposes of these Guidelines,

2.1 The" Act" means the Cost and Works Accountants Act, 1959 (as amended)

2.2 "Institute" means the Institute of Cost and Works Accountants of India.

2.3 "Advertisement or advertising" means advertisement or advertising in any mode including written, recorded, displayed communication through print or electronic mode or otherwise including in newspapers, journals, internet, online, websites, banners, letters, circulars issued, circulated or published in accordance with these guidelines.

2.4 "Cost Accountant in Practice" means a member of the Institute who holds a Certificate of Practice issued to him by the Institute.

2.5 "Firm of Cost Accountants" means sole proprietorship concern, the sole proprietor of which is a Cost Accountant in Practice or a firm, wherein all partners are Cost Accountants and such firm is approved by the Council.

2.6 "write up" includes any writing or display setting out services rendered by a Cost Accountant in Practice or firm of Cost Accountants and any writing or display of the particulars of the Cost Accountant in Practice or of firm of Cost Accountants issued, circulated or published in accordance with these guidelines.

The terms not defined herein have the same meaning as assigned to them in the Cost and Works Accountants Act, 1959 (as amended) and the rules and regulations made thereunder.

3. Prohibition to Advertise

3.1 No Cost Accountant or a firm of Cost Accountants is permitted to advertise the services as specified in the Act, Rules, Regulations framed thereunder except through a write-up as defined in Clause 2.6.

4. The Write-up shall be made in compliance with the following:

4.1 Applicability

These guidelines shall apply to advertisements issued by a Cost Accountant in Practice not only in India but would also apply to those circulated, communicated, published, issued or allowed to be issued abroad.

4.2 Permitted list of information

4.2.1 Name of Cost Accountant, Membership number, Certificate of Practice Number and date of issue (for each partner in case of firm)

4.2.2 Address and web site (if any), telephone, mobile, e-mail, fax number of the member

4.2.3 Name of the firm in which the member is a partner

4.2.4 Year of Establishment

4.2.5 Date and place of Issue of Advertisement

4.2.6 Age

4.2.7 Gender

4.2.8 Additional recognized qualifications

4.2.9 Languages spoken by the partner(s)

4.2.10 Honours or awards in the field of teaching, research, authorship etc. conferred by nationally accredited institutions

4.2.11 Current teaching or research appointments at a university or college of advanced education or professional Institute

4.2.12 Name of firm in case of partnership

4.2.13 Details of networking through own office or through formal association in other places within and outside India

4.2.14 Number, name of employees of the firm and their qualifications and other particulars

4.2.15 Business address, telephone numbers, (including email, fax and other details) of the firm

4.2.16 Office hours and after office hours availability

4.2.17 Advertisement about setting up of certified filing centers

4.2.18 Frequently Asked Questions (FAQs) in conformity to these guidelines

4.2.19 Declaration indicating

(a) willingness to accept work, either generally or in particular areas of practice;

(b) unwillingness to accept work in particular areas;

(c) willingness or unwillingness to accept work directly from clients, either generally or in particular areas of practice. .

4.2.20 The write-up may display the passport size photograph of the member or partners of the firm of Cost Accountants

4.2.21 Fees:

(a) Willingness to give written estimates of fees;

(b) Methods for determining fees;

(c) Mode of Acceptance of Fees.

4.2.22 Speed of Service

(a) willingness to give written estimates concerning completion of particular work;

(b) maximum time within which specific services will be completed.

4.2.23 Write-up may include the names of clients and services rendered

4.2.24 Particulars of Services

(i) The write-up to be circulated, distributed, published, issued by or on behalf of Cost Accountant in Practice shall set out the professional services rendered or to be rendered by the advertiser.

(ii) The write-up may explain the nature and usefulness of the professional services rendered by the Cost Accountant in Practice.

(iii) The write-up may include the names of clients and services rendered provided that the Cost Accountant in Practice shall maintain record of his having provided such professional services.

4.2.25 In case of advertisement through website:

(a) A Cost Accountant or a firm of Cost Accountants may display photograph of the Cost Accountant or partners of the firm of Cost Accountants in Practice.

(b) While designing and / or hosting the particulars on the website, certain keywords should be provided so as to enable the search engine/s to locate the website and these keywords will not be visible or displayed on the website. Any one of the following key words may be used for this purpose. Cost Accountant / Cost Accountant in Whole-time Practice/ Cost Accountant in Practice/Practising Cost Accountant/ AICWA/FICWA/ Management Consultant.

However, the keywords shall not be materially different from the designations used for a Cost Accountant.

(c) The website may provide a hyperlink to the website of ICWAI, its Regional Councils and Chapters and other regulatory bodies of the Government, after obtaining necessary permission from the concerned body.

(d) A Cost Accountant in Practice may provide online advice to their clients or other members/ firms of Cost Accountants who specifically request for the same.

4.2.26 Changes in any of the above particulars.

4.3 Restrictions

The write-up shall:

(i) not be false or misleading;

(ii) not claim superiority over any or all other Cost Accountants in Practice;

(iii) not be indecent, sensational or otherwise of such nature as to be likely to bring the profession into disrepute;

(iv) not contain testimonials or endorsements concerning the Cost Accountant in Practice.

(v) not refer the Cost Accountants in practice in terms such as "specialists" or "experts".

(vi) In case of advertisement through website:

(a) A Cost Accountant in Practice or a firm of Cost Accountants shall ensure that no information contained in the website is circulated to other websites/e-mail accounts etc. through e-mail or otherwise without the same having been specifically requested for.

(b) A Cost Accountant in Practice or a firm of Cost Accountants shall not use logo(s) unless otherwise permitted by the Institute.

4.4 Declaration:

The Advertiser shall declare that the contents of the advertisement are true to the best of his knowledge and belief and are in conformity with these Guidelines.

4.5 Disclaimer

The Advertiser shall also include the following Statement of Responsibility and Disclaimer in the Advertisement:

Disclaimer: The contents or claims in the Advertisement issued by the advertiser are the sole and exclusive responsibility of the Advertiser. The Institute of Cost and Works Accountants of India does not own any responsibility whatsoever for such contents or claims by the Advertiser.

5. Responsibility for the observance of these Guidelines

5.1 The responsibility for the observance of these guidelines lies with members who commission, create, place or publish any advertisement or assist in the creation or publishing of any advertisement covered under these guidelines. Members are expected not to commission, create, place or publish any advertisement, which is in contravention of these Guidelines. This is a self-imposed discipline required to be observed by all those involved in the commissioning, creation, placement or publishing of advertisements.

6. Effective Date:

6.1 These guidelines become effective from **1st April, 2008** and consequently the existing Guidelines for Display of Particulars on Website by Cost Accountants in Practice stand repealed.

By order of the Council

Dr. DEBASIS BAGCHI, SECRETARY

ANNEXURE

MODEL ADVERTISEMENT

Passport Size Photograph

(i) Name of Cost Accountant

(ii) Membership number

(iii) Certificate of Practice number and date of issue

(iv) Website (if any)

(v) Name of the sole proprietary concern under which the member is practicing/Name of the partnership in which the member is a partner

(vi) Age

(vii) Gender

(viii) Languages spoken

(ix) Number, name of employees and their qualifications and other particulars

(x) Business address telephone numbers (including email, fax and other details)

(xi) Office hours and after office hours availability

(xii) Additional recognized qualifications

(xiii) Current teaching or research appointments at a university or college of advanced education or professional Institute

(xiv) Honours or awards conferred

(xv) Frequently Asked Questions (FAQs)

(xvi) Declaration indicating:

- willingness to accept work, either generally or in particular areas of practice;
- unwillingness to accept work in particular areas;
- willingness or unwillingness to accept work directly from clients, either generally or in particular areas of practice.

(xvii) Fees:

- Mode of Acceptance of Fees
- Methods for determining fees
- Willingness to give written estimates of fees

(xviii) Speed of Service:

- willingness to give written estimates concerning completion of particular work;
- maximum time within which specific services will be completed.

(xix) Particulars of Services:

(xx) **Declaration**: I…………………………declare that the contents of the advertisement are true to the best of my knowledge and belief and are in conformity with these Guidelines.

(xxi) **Disclaimer**: The contents or claims in the Advertisement issued by the advertiser are the sole and exclusive responsibility of the Advertiser. The Institute of Cost and Works Accountants of India does not own any responsibility whatsoever for such contents or claims by the Advertiser.

(xxii) Date and Place of Issue of Advertisement………………………………..

RULES OF NETWORK AND MERGER - DEMERGER AMONGST THE FIRMS REGISTERED WITH THE INSTITUTE OF COST & WORKS ACCOUNTANTS OF INDIA

The Council at its 228th Meeting held from 4th December, 2005 at Kolkata has decided that the Rules of Network amongst the firms registered with ICWAI, Rules of Merger & Demerger formulated and finalised on the basis of recommendations of the Membership Department shall come into force w.e.f 1st January, 2006.

In the matter relating to network of firms registered with ICWAI and entities outside India, the Council decided that in addition to the compliance with the Rules of Network amongst the firms registered with ICWAI, the entities outside India willing to form network with Indian ICWAI firms would give a declaration in Form 'DN' (enclosed).

RULES of NETWORK

1. These Rules are called Rules for Network amongst the firms Registered with The Institute of Cost and Works Accountants of India.
2. **Definition.**

(i) Network -

"Network amongst two or more firms means an arrangement to facilitate the better functioning of the affiliate member firms in the interest of the profession and not for acquisition of any gain. Such Network shall include the formal Network to use the collective resources such as turnover, infrastructures, manpower, location for execution of Professional services of one or more type.

[Explanation -

1. **An affiliation as referred to above shall also include:**

   (i) having an association with an accounting entity within or outside India such that it results directly or indirectly in a common professional economic or beneficial interest.

   (ii) one or more of the entities holding out that it is so affiliated or networked.

2. An entity shall not be treated as an affiliate of another merely for the reason that they

   (a) share professional knowledge and data base;

   (b) refer certain professional assignments or authorize the other to represent certain specific matters.

3. If different Indian firms are networked with a common Multi-National Accounting Firm (MAF) then irrespective of the presence/absence of any 'affiliate' relationship between the Indian firms inter-set they shall be considered as part of a network.]

   (i) Formal Network - Formal network means *a* network amongst two or more firms registered with The Institute of Cost & Works Accountants of India (lCWAI), where the object of network is to use the collective resources of the affiliates *for* execution of professional services of one or more types at one and/or at multinational points. The resources would include financial, technical and other logistic support required to execute the professional assignments. In such type of network, the common resources may be pooled and exhibited together before the service user as those belonging to one particular set of professionals.

   (ii) Referal Practice - Referal Practice means a practice to refer professional work by *a* firm to one of its associate/affiliate either situated *at a* different place or rendering professional services not provided by it, to the user of the services. The pre-dominant objective of such *a* network is not to pool in their collective resources and exhibit them *as* those belonging to one particular set of professionals.

   (iii) Act - Act means The Cost and Works Accountants Act, 1959.

   (iv) Regulations - Regulations means Cost and Works Accountants Regulations, 1959.

   (v) Code of Ethics - Code or Ethics means the Code of Ethics issued by the Institute and decisions of the Council in this regard.

   (vi) Institute - Institute means the Institute of Cost and Works Accountants of India.

   (vii) Council - Council means the Central Council of the Institute.

   (viii) Member - Member means a Member in Practice. Member in Practice means a Member in Practice as defined in the Cost & Works Accountants Act, 1959.

3. Name of Network:

Practice a

(i) The Network may have distinct name which should be approved by the Institute. To distinguish *a* "Network" from a firm" of Cost Accountants, the words "&" Affiliates" should be used *after* the name of the network and the words "& Co." / "& Associates" should not be used. The prescribed format of application for approval of Name for Network is Form 'AN' (enclosed).

(ii) Standards prescribed in Regulations of the Cost & Works Accountants Regulations, 1959 shall be applicable to the name of network. However, even if a name is provided and subsequently it is found that the same is undesirable then, the said name ICWAI be withdrawn at any time by the Institute. The Institute shall reject any undesirable name *and* the provisions in respect of names of companies. as prescribed in the Companies Act, 1956 shall be applicable in spirit.

(iii) The network should neither be permitted to advertise nor to use logo. The firms constituting the network are permitted to use the words "Affiliates/Members of …" (a network of Indian ICWAI firms) on their professional stationery.

(iv) Network may work without a Name also.

4. Registration:

(i) A Formal Network is required to be registered with the Institute in a prescribed Form 'BN' (enclosed).

(ii) Referal Practice requires no registration.

(iii) It is for each firm to decide whether its affairs and relations with another firm results in creation of a Formal Network. Network shall evaluate for itself whether or not it is a formal network requiring registration with the Institute.

(iv) If different Indian firms are networked with a common multinational Accounting Firm (MAF) then irrespective of the presence/absence of any 'affiliate' relationship between the Indian firms inter-se, they shall be considered as part of a network. As such, for these firms the registration with the Institute is not mandatory. It is only if these Indian firms decide to constitute a Formal Network, then the registration with the Institute is mandatory.

5. Ethical Compliance:

Once the relationship of network arises, whether registered or not with the Institute, it will be necessary for such a network to comply with all applicable ethical requirements prescribed by the Institute from time to time in general and the following requirements in particular:

(a) If one firm of the network is the statutory auditor of an entity then the associate [including the networked firm(s)] or the said firm directly/indirectly should not accept the internal audit or book-keeping or such other professional assignments which are prohibited for the statutory auditor firm.

(b) In those cases where rotation of firms is prescribed by any regulatory authority, no member firm of the network can accept appointment as an auditor in place of any member firm of the network which is retiring. However, this restriction shall not apply in case of appointment as Statutory Central Auditor of Government agencies Undert a kings such as Public Sector Undertakings (PSUs), Public Sector Banks and Financial Institutions etc.

(c) The Constituent member firms of a Network and the Network shall comply with all the ethical Standards prescribed by the Council from time to time.

6. Consent of Client:

The network shall obtain consent of the client to engage an affiliate in discharging the professional assignments.

7. **Constitution of Network:**
   - (i) Proprietary/partnership firm(s) as well as individual member(s) are permitted to form a Network.
   - (ii) A proprietary/partnership firm as well as individual Member are allowed to join only one Formal network.
   - (iii) Firms having common partners shall join only one network.
8. **Object of Network:** The Network itself will not carry on any business for acquisition of gain for itself and only act as a facilitator for its members/constituent Member firms to pursue their professional jobs.
9. **Responding to Enquiries:** Only one firm/Member can apply on behalf of the network showing the collective strength of all the constituent firms of the network, when responding to any enquiry.
10. **Issuing Reports:** Only the firm(s)/ Member(s) forming Network are eligible to issue/sign/attest any certificate/Report/professional document/ assignment.
11. **Violation of Act:** In case of alleged violation of the provisions of the "Act, Regulations framed thereunder, guidelines/directions laid down by the Council from time to time and Code of Ethics by the Network firm, the proprietary/partnership firm(s)/individual Member constituting the Network would be answerable.
12. **Exit from Network:** A constituent Member firm/Member of a Network can exit from the network by sending the declaration in Form 'CN' (enclosed) to the Institute and also to each and every constituent of the network. The concurrence/acceptance of the same by other firms forming part of the network firm shall not be required.
13. **Framework of Internal Byelaws of Network requiring Registration:** To streamline the networking, a network shall formulate operational byelaws. Byelaws may contain the following clauses on which the affiliates of the network may enter into a written agreement among themselves:
    - (i) Appointment of a Managing Committee, from among the managing partners of the member firms of the network and the terms and conditions under which it should function. The minimum and maximum number of members of the Managing Committee shall also be agreed upon.
    - (ii) Administration of the network
    - (iii) Contribution of membership fees to meet the cost of the administration of the network.
    - (iv) Identifying a partner of any of the member firms of the network to be responsible for the assignment (engagement partner)
    - (v) Dispute settlement procedures through arbitration and conciliation
    - (vi) Development of training materials for members of the network
    - (vii) Issue of News-letters for staff and clients
    - (viii) Development of softwares for different types of assignments Development and maintenance of data bases relevant for different types of assignments
    - (ix) Library
    - (x) Appointment of a technical director to whom references can be made
    - (xi) Determining the methodology for drawing resources from each member firm
    - (xii) Determining compensation to member firms for resources to be drawn from them
    - (xiii) Peer review of the member firms

These clauses are illustrative.

Form 'AN'

APPLICATION FOR APPROVAL OF NAME FOR NETWORK OF FIRMS

THE INSTITUTE OF COST AND WORKS ACCOUNTANTS OF INDIA

[See Rule 3 of Rules of Network amongst the firms registered with the Institute of Cost and Works Accountants of India)

1. Proposed name of Network	1. ______________________
(in order of preference) if the Network	2. ______________________
has a distinct name	3. ______________________
	4. ______________________

2. Name(s) of the	Firm Name/	Firm Regn.No.
firm(s)/Member(s)	Member Name	M.No.
forming network	1.__________	______________
	2. __________	______________
	3. __________	______________
	4. __________	______________

3. Address of the Office of the Network

____

____

____

_________________Pin_________________

E-mail (if any) ________________________

4. We hereby declare that the above firm(s)/Member(s) proposed/ have entered into an understanding to form a network in accordance with Rules of Network amongst the firms registered with The Institute of Cost and Works Accountants of India and further affirm and confirm that the partner signing the application has been duly authorised by the other partners of the respective firms.

Place: …………..

Date: ……………

Name(s) with Membership No(s).
and signature(s) of duly authorised
Partner(s)/Proprietor(s) of the firms/
Member constituting Network

Form 'BN'

DECLARATION FOR REGISTRATION OF FORMAL NETWORK AMONGST FIRMS REGISTERED WITH ICWAI

THE INSTITUTE OF COST AND WORKS ACCOUNTANTS OF INDIA

PARTICULARS OF NETWORK HAVING INDIAN AFFILIATION

1. Name of the Network
2. Address of the Network
3. Names and addresses of firms/Member constituting the Network

   Names and addresses of Firm(s)/Member(s) — Firm Registration No./M.No.

4. (a) Date of formation of Network

   (b) Date on which present network arrangement was entered into
5. We undertake to comply with the guidelines/directions laid down by the Council regarding Network from time to time.

We hereby declare that:

(a) the network constituents have entered into an agreement to form this network.

(b) that the partner(s) signing this declaration has been duly authorized by the other partners of the firm

Place: …………..

Date: ……………

Name(s) with Membership No(s).
and signature(s) of duly authorised
Partner(s)/Proprietor(s) of the firms/
Member constituting Network

Form 'CN'

DECLARATION FOR DISSOCIATION FROM A NETWORK

THE INSTITUTE OF COST & WORKS ACCOUNTANTS OF INDIA

[See Rule 12 of Rules of Network amongst the firms registered with The Institute of Cost and Works Accountants of India]

1. Name of the Network
2. Address of the Network
3. Names and addresses of firms constituting the Network

Names and addresses of Firm(s)/Member(s)	Firm Registration No./M. No.

4. Name and address of the firm/member willing to dissociate from the Network

Name and address of	Firm Registration No./M. No.

In pursuance to the Rule 12 of Rules of the Network issued by The Institute of Cost and Works Accountants of India, Well hereby declare our dissociation from the Network w.e.f….. ……………………..

I hereby declare that I have been duly authorised by the other partners to issue this declaration.

Place: …………..

Date: ……………

Name(s) with Membership No(s).
and signature(s) of duly authorised
Partner(s)/Proprietor(s) of the firms/
Member dissociating from the Network

Form 'DN'

<u>DECLARATION TO BE FILED FOR NETWORK</u> WITH

<u>ENTITIES OUTSIDE INDIA</u>

NETWORK WITH ENTITIES OUTSIDE

REGISTRATION NO.

THE INSTITUTE OF COST AND WORKS ACCOUNTANTS OF INDIA

PARTICULARS OF NETWORK WITH ENTITIES OUTSIDE INDIA

1. Name of the Network
2. Address of the Network
3. Name(s) & address(es) of firm(s)/entity(ies) constituting the Network

   (A) Indian firm{s) forming part of Network:

   Name(s) of Firm(s) Firm Registration Number(s)

   (B) Outside entity(ies) forming part of Network:

Name(s) of the entity(ies) .	**Registration No. of entity(ies), the name(** s) **of enactment(s)/ charter(s) under which Registered with the name of country(ies)**

4. (a) Date of formation of Network

   (b) Date on which present network arrangement was entered into
5. Detail of ownership and management structure of outside entity(ies) constitution Network

We, the authorized representative(s) of the entity(ies) outside India, hereby solemnly declare and undertake that:

(1) We are conversant with the provisions of the Cost and Works Accountants Act, 1959, Cost and Works Accountants Regulations, 1959, the Code of Ethics guidelines/directions regarding Network issued by the Council from time to time;

(2) in regard to the activities of the Network in India, we undertake to comply with the aforesaid provisions/guidelines/directions, in general, and in particular clauses (2) to (7) of Part-I of the First Schedule to the Cost and Works Accountants Act, 1959; and

(3) the activities under the Network will not tantamount to rendering services so as to constitute a commercial presence in India or in any way result in Mode 3* or Mode 4* rendering of services as per WTO terminology.

Place: …………..

Date: ……………

Name(s) with Membership No.(if any)(s).
and signature(s) of duly authorised
Representative(s) of the entity(ies)
Outside India constituting Network

We, the authorized representative(s) of Indian Firm(s), solemnly declare as under:-

(1) the information given above is true and correct as per our information and belief; and

(2) non-compliance with the provisions of the Clauses (6) & (7) of Part I of the First Schedule to the Cost and Works Accountants Act, 1959 and the guidelines/directions laid down by the Council thereunder by the outside entity(ies) shall be deemed to be on our behest, unless proved otherwise.

Place: …………..

Date: ……………

Name(s) with Membership No.(if any)(s).
and signature(s) of duly authorised
Representative(s) of the entity(ies)
Outside India constituting Network

* Mode 3: Commercial Presence - Where services are provided through establishment of an office in the other country.

* Mode 4: Movement of Natural Persons - Where the professional accountant travels from one country to another to deliver a service.

Cost and Works Accountants (Procedure of Investigations of Professional and other Misconduct and Conduct of Cases) Rules, 2007

NOTIFICATION

New Delhi the 27th February 2007

GSR 113(E).- In exercise of the powers conferred by clauses (c) and (d) of subsection (2) of Section 38A, read with sub-section (4) of Section 21 and sub-sections (2) and (4) of Section 21B of the Cost and Works Accountants Act, 1959 (23 of 1959), the Central Government hereby makes the following rules, namely:-

1. **Short title and commencement-**.

   (1) These rules may be called the Cost and Works Accountants (Procedure of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules, 2007.

   (2) They shall come into force from the date of their publication in the Official Gazette.

CHAPTER I

PRELIMINARY

2. **Definitions and Interpretations -** (1) In these rules, unless the context otherwise requires -

   (a) "Act" means the Cost and Works Accountants Act, 1959 (23 of 1959);

   (b) "Committee" means the Disciplinary Committee or Committees constituted by the Council under sub-section (1) of Section 21B of the Act;

   (c) "Director" means the person appointed as Director (Discipline) by the Council under clause (b) of sub-section (1) of Section 16 of the Act;

   (d) "Directorate" means the Disciplinary Directorate established under sub-section (1) of Section 21 of the Act;

   (e) "Firm" means a firm registered with the Institute under the Regulations;

   (f) "Institute" means the Institute of Cost and Works Accountants of India constituted under the Act;

   (g) "Member" means an associate or fellow member of the Institute and includes a person who was a member of the Institute on the date of the alleged misconduct, although he has ceased to be a member of the Institute at the time of filing the complaint, initiation of the inquiry or thereafter;

   (h) "Presiding Officer" means the Presiding Officer of the Board of Discipline or Committee, as the case may be;

   (i) "Professional Address" means –

      (i) the last registered address where a member is carrying on his profession (or when he is carrying on his profession at more than one place, the principal place); or

      (ii) the last registered place of employment or at his option, the place of his residence (if the member is employed); or

(iii) the last registered place of residence (if the member neither carried on the profession nor is employed); or

(iv) the last registered overseas address or at his option, the place of residence in India which shall be deemed to be the professional address for the purposes of these rules.

(a) "Regulations" means the Cost and Works Accountants Regulations, 1959, made under the Act, as amended from time to time;

(b) "Respondent" means a member or a firm against whom the complaint or information has been received;

(c) "Schedule" means any Schedule or Schedules annexed to the Act;

(2) Words and expressions used but not defined in these rules and defined in the Cost and Works Accountants Act, 1959 (23 of 1959) shall have the same meanings respectively assigned to them in that Act.

CHAPTER II

Procedures of Investigation related to Complaints and Information

3. Procedure for filing complaint –

(1) A complaint under section 21 of the Act against a member or a firm shall be filed in Form I, in triplicate before the Director in person or by post or courier:

Provided that the complaint sent by post or courier under this sub-rule shall be deemed to have been presented to the Director on the day on which it is received in the Directorate.

(2) A complaint filed by or on behalf of the Central Government or any State Government, shall be authorized by an officer holding a post not below the rank of a Joint Secretary or equivalent and shall be signed by an officer holding a post not below the rank of an Under Secretary or equivalent in the Central or State Government, as the case may be.

(3) A complaint filed by or on behalf of any statutory authority, such as Reserve Bank of India or Securities and Exchange Board of India, shall be authorised by an officer holding a post equivalent to the post of Joint Secretary in the Government of India and shall be signed by an officer holding a post not below the rank of an Under Secretary or equivalent in the Central or State Government, as the case may be.

(4) A complaint filed by or on behalf of a company or a firm, shall be accompanied by a resolution, duly passed by the Board of Directors of the company or the partners of the firm, as the case may be, specifically authorizing an officer or a person to make the complaint on behalf of the company or the firm.

Explanation - In the case of a bank or financial institution, the general resolution or power of attorney authorizing an officer holding a particular position to file complaints on behalf of the bank or financial institution, shall be deemed to be the specific resolution passed by the bank or financial institution concerned, for the purposes of these rules.

(5) In case of complaints filed by any Government, statutory authority, bank or financial institution, a change in the name of complainant at any later stage, shall be duly supported by a specific authorization made by an officer holding a post equivalent to that of the original complainant.

(6) Every complaint received by the Directorate shall be acknowledged by ordinary post together with an acknowledgement number.

4. Fee for filing complaint –

(1) Every complaint, other than a complaint filed by or on behalf of the Central Government or any State Government or any statutory authority, shall be accompanied by a fee as prescribed by the Council through regulations.

(2) The fee shall be paid in the form of a demand draft drawn on any bank in India in favour of the Institute of Cost and Works Accountants of India payable at the place where the Directorate is situated.

(3) The fee once paid shall not be refunded:

Provided that no additional fee shall be payable if the complaint is resubmitted after rectification of defect under sub-rule (5) of rule 5.

5. Registration of complaint –

(1) The Director or an officer or officers authorized by the Director, shall endorse on every complaint the date on which it is received or presented and the Director or the officer or officers so authorized, shall sign on each such endorsement.

(2) The Director or an officer or officers authorized by him shall scrutinize the complaints so received.

(3) If, on scrutiny, the complaint is found to be in order, it shall be duly registered and a unique reference number allotted to it, which shall be quoted in all future correspondence, and shall be dealt with in the manner as prescribed in Chapter III of these rules.

(4) If the subject matter of a complaint is, in the opinion of the Director, substantially the same as or has been covered by any previous complaint or information received and is under process or has already been dealt with, he shall take any of the following actions, as the case may be,-

(a) if such a previous complaint is still under the examination of the Director, then the new complaint may be clubbed with the previous complaint and in such case the fact may be conveyed to the first complainant, new complainant and respondent respectively.

(b) if prima facie opinion has been formed by the Director in such a previous complaint and the case is pending before the Board of Discipline or the Committee, then the Director shall bring the new complaint before the Board of Discipline or the Committee, as the case may be, and the latter shall either club the complaint with the previous complaint or close it or ask the Director to deal with it as a separate complaint, as it deems fit.

(c) if orders have already been passed by the Board of Discipline or the Committee on such a previous complaint, then the Director shall present the new complaint before the Board of Discipline for its closure:

Provided that even in case where the new complaint is clubbed with a previous complaint under this sub-rule, only the first complainant would be the complainant for the purposes of investigation under these rules.

(5) If, the complaint, on scrutiny, is found to be defective, including the defects of technical nature, the Director may allow the complainant to rectify the same in his presence or may return the complaint for rectification and resubmission within such time as he may determine.

(6) If, the complainant fails to rectify the defect or defects within the time allowed under sub-rule (5), the Director shall form the opinion that there is no prima facie case and present the complaint before the Board of Discipline for its closure.

(7) The Board of Discipline may, after the presentation of the complaint by the Director under sub-rule (6), either -

(a) agree with the opinion of the Director and pass an order for the closure; or

(b) disagree with the opinion of the Director and advise him to further investigate the matter.

6. **Withdrawal of a complaint -** The Director, on receipt of a letter of withdrawal of a complaint by the complainant, shall place the same before the Board of Discipline or the Committee, as the case may be, and the Board of Discipline or Committee, as the case may be, may, if it is of the view that the circumstances so warrant, permit the withdrawal, at any stage, including before or after registration of the complaint:

Provided that in case the Director has not yet formed his prima facie opinion on such a complaint, he shall place the same before the Board of Discipline, and the Board of Discipline may, if it is of the view that the circumstances so warrant, permit the withdrawal.

7. **Information -**

(1) Any written information containing allegation or allegations against a member or a firm, received in person or by post or courier, by the Directorate, which is not in Form I under sub-rule (1) of rule 3, shall be treated as information received under section 21 of the Act and shall be dealt with in accordance with the provisions of these rules.

(2) On receipt of such an information, the sender of the information, including the Central Government, any State Government or any statutory authority, shall be, in the first instance, asked whether he or it would like to file a complaint in Form I apprising him of, the following information,-

(a) that relatively longer time is taken for disposal of any information than the complaint;

(b) that the person giving information will not have the right to be represented during the investigation or hearing of the case;

(c) that the Institute will be under no obligation to inform the sender the information of the progress made in respect of the information received under sub-rule (1) including the final orders:

Provided that where the sender of the information is the Central Government, any State Government or any statutory authority, a copy of final order shall be sent to such sender.

(3) An anonymous information received by the Directorate will not be entertained by the Directorate.

CHAPTER III

Procedure of Investigation

8. Procedure to be followed by Director on a complaint -

(1) The Director or an officer or officers authorized by the Director, within sixty days of the receipt of a complaint under rule 3, shall,-

(a) if the complaint is against an individual member, send particulars of the acts of commission or omission alleged or a copy of the complaint, as the case may be, to that member at his professional address;

(b) if the complaint is against a firm, send particulars of the acts of commission or omission alleged or a copy of the complaint, as the case may be, to the firm at the address of its head office, as entered last in the Register of Offices and Firms maintained by the Institute, with a notice calling upon the firm to disclose the name or names of the member or members concerned and to send particulars of acts of commission or omission or a copy of the complaint, as the case may be, to such members:

Provided that while disclosing the name or names of the member or members, the firm shall also send a declaration signed or, as the case may be, jointly signed by the member or members concerned to the effect that he or she or they shall be responsible for answering the complaint and that the particulars of acts of commission or omission or the copy of the complaint sent to the firm by the Director had been duly received by him, her or them.

Explanation - A notice to the firm shall be deemed to be a notice to all the members who are partners or employees of that firm as on the date of registration of the complaint.

(2) A member whose name is disclosed by the firm shall be responsible for answering the complaint, provided such a member was associated, either as partner or employee, with the firm, against which the complaint has been filed, at the time of occurrence of the alleged misconduct:

Provided that if no member, whether erstwhile or present, of the firm, own responsibility for the allegation or allegations made against the firm, then the firm as a whole shall be responsible for answering the allegation or allegations and, as such, all the members who were partners or employees of that firm, as on the date of occurrence of the alleged misconduct, shall be responsible for answering the allegation or allegations as contained in the complaint.

(3) A member who has been informed of the complaint filed against him (hereinafter referred to as the respondent) shall, within 21 days of the service of a copy of the complaint, or within such additional time, not exceeding thirty days, as may be allowed by the Director, forward to the Director, a written statement in his defence.

(4) On receipt of the written statement, if any, the Director may send a copy thereof to the complainant and the complainant shall, within 21 days of the service of a copy of the written statement, or within such additional time, not exceeding thirty days, as may be allowed by the Director, forward to the Director, his rejoinder on the written statement.

(5) On perusal of the complaint, the respondent's written statement, if any, and rejoinder of the complainant, if any, the Director may call for such additional particulars or documents connected

therewith either from the complainant or the respondent or any third party or parties, as he may consider appropriate:

Provided that if no reply is sent by the respondent, within the time allowed under sub-rule (3) or by the complainant within the time allowed under sub-rule (4), the Director shall presume that the respondent or the complainant, as the case may be, have nothing further to state and take further action as provided under this Chapter.

9. Examination of the Complaint -

(1) The Director shall examine the complaint, written statement, if any, rejoinder, if any, and other additional particulars or documents, if any, and form his prima facie opinion as to whether the member or the firm is guilty or not of any professional or other misconduct or both under the First Schedule or the Second Schedule or both.

(2) (a) Where the Director is of the prima facie opinion that –

(iii) the member or the firm is guilty of any misconduct under the First Schedule, he shall place his opinion along with the complaint and all other relevant papers before the Board of Discipline;

(iv) the member or the firm is guilty of misconduct under the Second Schedule or both the First and Second Schedules, he shall place his opinion along with the complaint and all other relevant papers before the Committee.

(b) If the Board of Discipline or the Committee, as the case may be, agrees with the prima facie opinion of the Director under clause (*a*) above, then the Board of Discipline or the Committee may proceed further under Chapter IV or V respectively.

(c) If the Board of Discipline or the Committee, as the case may be, disagrees with the prima facie opinion of the Director under clause (*a*) above, it shall either close the matter or advise the Director to further investigate the matter.

(3) Where the Director is of the prima facie opinion that the member or the firm is not guilty of any misconduct either under the First Schedule or the Second Schedule, he shall place the matter before the Board of Discipline, and the Board of Discipline, -

(c) if it agrees with such opinion of the Director, shall pass order, for closure.

(d) if it disagrees with such opinion of the Director, then it may either proceed under Chapter IV of these rules, if the matter pertains to the First Schedule, or refer the matter to the Committee to proceed under Chapter V of these rules, if the matter pertains to the Second Schedule or both the Schedules, or may advise the Director to further investigate the matter.

(4) The Director shall, after making further investigation as advised by the Board of Discipline under sub-rule (2) or (3) of this rule or by the Committee under sub-rule (2), shall further proceed under this rule.

10. Mode of Sending Notice -

(1) Every notice or letter issued by the Director, Board of Discipline, or the Committee under these rules shall be sent to the member or the firm or any other person, by registered post with acknowledgement due or speed post, except where specified otherwise in any rule.

(2) If any notice or letter is returned unserved with an endorsement to the effect that the addressee had refused to accept the notice or letter, the notice or letter shall be deemed to have been served.

(3) If the notice or letter is returned with an endorsement to the effect that the addressee cannot be found at the address given, the Director shall ask the complainant or any other person who may be in a position to provide another address of the member or firm or person whose address is found to be not correct, and on production of the correct address, a fresh notice or letter shall be issued at such address.

(4) Where the notice or letter is returned under sub-rule (3), it may be served by fixing a copy thereof in some conspicuous place at the professional address or residence of the respondent which was last registered with the Institute or in such other manner as the Board of Discipline may think fit and such service shall be deemed to be sufficient service for the purposes of these rules.

11. **Certain provisions relating to complaint also to be applicable for information relating to misconduct of members -** The procedure laid down for dealing with complaints in sub-rule (6) of rule 3, sub-rules (1), (2), (3) and (4) of rule 5, sub-rules (1), (2), (3) and (5) of rule 8, rule 9 and rule 10 shall also apply to information received by the Director relating to misconduct of members.

12. **Time limit on entertaining complaint or information -** Where the Director is satisfied that there would be difficulty in securing proper evidence of the alleged misconduct, or that the member or firm against whom the information has been received or the complaint has been filed, would find it difficult to lead evidence to defend himself or itself, as the case may be, on account of the time lag, or that changes have taken place rendering the inquiry procedurally inconvenient or difficult, he may refuse to entertain a complaint or information in respect of any misconduct made more than seven years after the same was alleged to have been committed and submit the same to the Board of Discipline for taking decision on it under sub-section (4) of Section 21A of the Act.

CHAPTER IV

BOARD OF DISCIPLINE

13. **Functioning of Board of Discipline -**

(1) All questions which come up before the Board of Discipline shall be decided by a majority of the members present and voting, and in the event of an equality of votes, the Presiding Officer or in his absence, the person presiding, shall have a second or casting vote.

(2) The quorum for any meeting of the Board of Discipline shall be two members.

(3) In the event of the Presiding Officer not being able to attend a meeting of the Board of Discipline, the member of the Council appointed under clause (*b*) of sub-section (1) of Section 21A of the Act shall act as the Presiding Officer.

14. **Procedure to be followed by the Board of Discipline -**

(1) The Board of Discipline shall follow summary disposal procedure in dealing with all cases before it, as laid down in this Chapter.

(2) If the Board of Discipline decides to proceed further under clause (*b*) of sub-rule (2) of rule 9 or under clause (*b*) of sub-rule (3) of rule 9, it shall expeditiously cause to deliver to the respondent and the complaint, a copy each of the following:

(a) prima facie opinion formed by the Director; and

(b) particulars or documents relied upon by the Director, if any, during the course of formulation of prima facie opinion.

(3) The Board of Discipline shall inform the respondent to file a written statement, within such time as may be specified:

Provided that the Board of Discipline may give him additional time for submitting his written statement on application by the respondent on his adducing sufficient reasons to the satisfaction of the Board of Discipline for seeking additional time:

Provided further that such additional time shall not be given more than once and if the respondent still does not submit a written statement, the Board of Discipline shall presume that he has no further submissions to make and shall proceed to decide the case on merits.

(4) The respondent shall send a copy of his written statement, along with supporting documents, to the Director and the complaint within the stipulated time.

(5) The complainant or the Director may, after receipt of the written statement, submit a rejoinder to the Board of Discipline, with a copy to the respondent, along with supporting documents, if any.

(6) The Presiding Officer of the Board of Discipline shall fix a date, hour and place of hearing, which shall not ordinarily be later than 45 days from the date of receipt of prima facie opinion and the Board of Discipline shall cause a notice to be sent of such date, hour and place to the Director, respondent and complainant and require them to appear before it in person to make oral submissions, if any.

Explanation.—For the purpose of this rule, the appearance includes, unless and otherwise directed, appearance by an advocate or through any authorized representative, who may be a Chartered Accountant, Cost Accountant or Company Secretary.

(7) On the date of hearing, if the respondent, in spite of the service of notice, under sub-rule (6), does not appear either in person or through his authorized representative, the Board of Discipline may proceed *ex parte* and pass such orders as it may think fit or direct fresh notice to be served.

(8) The Board of Discipline may, on such terms as it thinks fit, and at any stage of the proceedings, adjourn the hearing:

Provided that such adjournment shall not be given more than once at any stage of the proceedings.

(9) The Board of Discipline shall consider the written representations, including the written statements, rejoinder and supporting documents, and the oral submission, if any made by the Director, the complainant and the respondent, and arrive at a finding on whether the respondent is guilty or not of any professional or other misconduct.

15. Orders of the Board of Discipline.-

(1) On arriving at a finding under sub-rule (9) of rule 14 that the respondent is guilty of professional or other misconduct, the Board of Discipline shall give the respondent an opportunity to be heard before passing any under sub-section (3) of Section 21A of the Act:

Provided that if the respondent does not appear before the Board of Discipline at the time directed to do so when given such an opportunity to be heard, the Board of Discipline shall presume that he has nothing more to represent before it and shall pass orders under sub-section (3) of Section 21A of the Act.

(2) On arriving at a finding under sub-rule (9) of rule 14 that the respondent is not guilty of professional or other misconduct, the Board of Discipline shall pass orders closing the case.

(3) The Board of Discipline shall send, free of charge, to the Director, respondent and the complainant, a certified copy of the final order.

CHAPTER V

DISCIPLINARY COMMITTEE

16. Constitution and functioning of Committee –

(1) The Council may constitute a Committee and more than one Committee, if it considers necessary which may be located in one or more Regional Headquarters:

Provided that at least one Committee shall function at the place where the Directorate is situated.

(2) All questions which come up before the Committee shall be decided by a majority of the members present and voting, and in the event of an equality of votes, the Presiding Officer or in his absence, the person presiding, shall have a second or casting vote.

(3) The quorum for meeting of the Committee shall be three members, of which at least one shall be a member nominated by the Central Government under subsection (1) of Section 21B of the Act.

(4) In the event of the Presiding Officer not being able to attend a meeting of the Committee, the senior-most member amongst the members nominated by the Central Government under sub-section (1) of Section 21B of the Act shall act as the Presiding Officer.

Explanation.– The senior-most member is the member who has been nominated earlier by the Central Government, and in case both the members are nominated on the same date, then the Central Government shall indicate the name of the senior-most member, either at the time of nominating the members or on a written request for the same from the Secretary of the Institute.

(5) The Presiding Officer of the Committee constituted at place where the Directorate is situated, wherever considered appropriate, may transfer a matter from one Committee to another.

(6) The Committee shall, subject to the other provisions of the Act and these rules, regulate its own procedure for matters not covered under this Chapter.

17. Allowance to the members nominated by the Central Government –

(1) The members of the Committee nominated by the Central Government would be paid Rs. 1,000 as allowance for each day of sitting:

Provided that if such a member is holding position under the Central Government or State Government or any statutory authority, he would be not be eligible for any such allowances:

Provided further that the Central Government may revise the allowances from time to time, through notification in the Official Gazette.

Explanation – For the purpose of this rule, holding position under the Central Government shall also include a person holding position under the Comptroller and Auditor General of India, Reserve Bank of India or any other organization under or controlled by Government of India, and holding position under a State Government shall also include holding position in an organization under or controlled by the State Government.

(2) The Presiding Officer and other Members of the Committee, while on tour, shall be entitled to the travelling allowance and daily allowance as admissible to them in their official capacity and in case the member is not a Government Servant, he shall be entitled to the travelling allowance and daily allowance as admissible to an officer holding a post carrying a scale of pay of a Joint Secretary to the Government of India.

18. Procedure to be followed by the Committee –

(1) The Committee shall be guided by the principles of natural justice and shall follow the procedure in dealing with all cases before it, as laid down in this Chapter.

(2) If the Committee decides to proceed further under clause (*b*) of sub-rule (2) of rule 9 or if it receives a reference from Board of Discipline under clause (*b*) of sub-rule (3) of rule 9, it shall expeditiously cause to deliver to the respondent and the complainant, a copy each of the following,—

(a) prima facie opinion formed by the Director; and

(b) particulars or documents relied upon by the Director, if any, during the course of formulation of prima facie opinion.

(3) The Committee shall inform the respondent, as the case may be to file a written statement, within such time as may be specified:

Provided that the Committee may give him additional time for submitting his written statement, on application by the respondent on his adducing sufficient reasons to the satisfaction of the Committee for seeking additional time:

Provided further that such additional time shall not be given more than once and if the respondent still does not submit a written statement, the Committee shall presume that he has no further submissions to make and shall proceed to decide the case on merits.

(4) The respondent shall send a copy of his written statement, along with supporting documents and a list of witnesses, to the Director and the complainant within the stipulated time.

(5) The complainant or the Director may, after receipt of the written statement, submit a rejoinder to the Committee, with a copy to the respondent, along with supporting documents, if any.

(6) The Presiding Officer of the Committee shall fix a date, hour and place of hearing, which shall not ordinarily be later than 45 days from the date of receipt of *prima facie* opinion and the committee shall cause a notice to be sent of such date, hour and place to the Director, respondent and complainant and require them to appear before it in person to make oral submissions, if any.

Explanation – For the purpose of this rule, the appearance includes, unless and otherwise directed, appearance by an advocate or through any authorized representative, who may be a Chartered Accountant, Cost Accountant or Company Secretary.

(7) During the first hearing, the Committee shall read out the charge or charges to the respondent along with the summary of prima facie opinion arrived at by the Director, and ask the respondent whether he pleads guilty to the charge or charges made against him:

Provided that if the respondent does not appear for the first hearing even after one adjournment, the reading out of charge or charges along with the summary of prima facie opinion shall be made in his absence and the case proceeded with in accordance with the provisions of this Chapter.

(8) If the respondent pleads guilty, the Committee shall record the plea and take action as per provisions under rule 19.

(9) If the respondent does not plead guilty, then the Committee shall fix a date for examination of witnesses and production of documents.

(10) The Committee may, on application of the Director, issue notice for appearance to any of his witnesses directing him to attend or to produce any other document or material evidence.

(11) On the date so fixed, the Committee shall proceed to take all such evidence as may be produced by the Director, including oral examination of witnesses and production of documents:

Provided that the Committee may permit the cross-examination of any witness to be deferred until any other witness or witnesses have been examined or recall any witness for further cross-examination.

(12) After the presenting of evidence by the Director is over, the complainant shall be given an opportunity, if present during the hearing, to present any additional evidence after satisfying the Committee that such evidence is relevant and has not been brought forward during the presentation by the Director.

(13) The respondent shall be then called upon to enter upon his defence and produce his evidence.

(14) If the respondent applies to the Committee to issue any notice for compelling attendance of any witness for the purpose of examination or cross-examination, or the production of any document or any material object, the Committee shall issue such notice unless it considers that such application should be refused on the ground that it is made for the purpose of vexation or delay or for defeating the ends of justice and such ground shall be recorded by it in writing.

(15) The witnesses summoned at the instance of the complainant under sub-rule (12) or the respondent under sub-rule (14) shall not be eligible for reimbursement of expenses incurred for attending the hearing.

(16) After evidences have been presented, the Director and the respondent shall present their arguments before the Committee:

Provided that after the Director has presented his argument, if the complainant, provided he is present during the hearing, feels that any vital argument has been left out by the Director, may present the argument, after convincing the Committee of the same.

(17) The Committee shall consider the evidences and arguments produced before it and arrive at a finding on whether the respondent is guilty or not of any professional or other misconduct.

(18) The Committee may, at the request of any of the parties before it or due to other reasons, and on such terms as it thinks fit, and at any stage of the proceedings, adjourn the hearing:

Provided that such adjournment shall not be given more than once at any stage of the proceedings.

Explanation – For the purpose of this rule, inability of the complainant, advocate, authorized representative or witness, or appear shall not be treated as a valid reason for adjournment of a hearing.

19. Orders of the Committee –

(1) On arriving at a finding under sub-rule (8) or sub-rule (17) of rule 18 that the respondent is guilty of professional or other misconduct, the Committee shall give the respondent an opportunity to be heard before passing any order under sub-section (3) of Section 21B of the Act:

Provided that if the respondent does not appear before the Committee at the time directed to do so when given such an opportunity to be heard, the Committee shall presume that he has nothing more to represent before it and shall pass orders under sub-section (3) of Section 21B of the Act.

(2) On arriving at a finding under sub-rule (17) of rule 18 that the respondent is not guilty of professional or other misconduct, the Committee shall pass orders closing the case.

(3) The Committee shall send, free of charge, to the Director, respondent and the complainant, a certified copy of the final order.

CHAPTER VI

MISCELLANEOUS

20. Attendance of hearings by the complainant, respondent and witness –

(1) The complainant and the respondent shall have the right to attend the hearings of the Board of Discipline or the Committee, as the case may be, unless ordered otherwise by the Board of Discipline or Committee, for reasons to be recorded in writing.

(2) The complainant and the respondent shall not be eligible for reimbursement of expenses incurred for attending the hearing.

(3) A witness summoned before the Committee under sub-rule (11) of rule 18 shall be eligible for reimbursement of expenses, as determined through guidelines laid down by the Council.

21. Residuary provision - Matters relating to the procedure of investigation, conduct of cases and allowances to nominated members with respect to which no express provision has been made in these rules shall be referred in each case to the Central Government for its decision and the decision of the Central Government thereon shall be binding.

FORM I

[*See* sub-rule (1) of Rule 3]

1.	Name of the Complainant: (with membership number, if member of Institute of Cost and Works Accountants of India)	....
2.	Name of the member/firm against whom complaint is being made: (with membership number/registration number of the firm, if known)	....
3.	Latest address of the complainant for communication	.... Pin Code: ....
4.	Last available professional address of the member or the firm against whom the complaint is made	.... Pin Code: ....
5.	Particulars of allegation(s) serially numbered together with corresponding clause/part of the relevant Schedule(s), or Particulars of allegation(s) serially numbered together with clause/part of the relevant Schedule(s) under which the alleged acts of commission or omission or both would fall	1. .... 2. .... 3. .... 4. .... 5. ....
6.	Particulars of evidence(s) adduced in support of the allegation(s) made	....
7.	Name(s) of person who have knowledge of the facts of the case	....

Date:

Place: Signature of the Complainant

Verification

I, ..., the Complainant, do hereby declare that what is stated above is true to the best of my information and belief.

Verified today the..............................day of..........................20.........at......

Date:

Place: Signature of the Complainant

9.13 Specimen Question With Answer

Question 1:

Explain whether the following activities amount to professional misconduct:

(a) *A Cost Accountant takes voluntary retirement from his employer and starts practice. He continues his association with his previous employers as an advisor, on a monthly retainer.*

(b) *A practising lawyer specializing in anticipating cases comes to an informal understanding with an independent practising Cost Accountant to assist him in preparing accounting statements to support his cases, and agrees to share his fees on a percentage basis.*

(c) *A Cost Accountant gives a certificate of cost for a product manufactured by an SSI unit owned entirely by his son.*

Answer:

Professional Misconduct:

(a) As the accountant has severed his connection with his previous employer as an employee and acts only in an advisory capacity, which is a legitimate activity of a practising cost accountant, it does not amount to misconduct.

(b) Although the practising cost accountant can accept the assignment for preparing the necessary statements for the antidumping cases for a specified fee, the sharing of total fees on a percentage basis between the lawyer and cost accountant amounts to an informal partnership between them, which is prohibited. Therefore, this practice falls under the definition of misconduct.

(c) The Second Schedule to the Cost and Works Accountants Act, 1959 stipulates that a Cost Accountant in practice shall be deemed to be guilty of professional misconduct if he expresses his opinion on cost or pricing statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest, unless he discloses the interest also in his report. Strictly speaking, a cost accountant issuing a certificate for a unit in which he has no direct interest is in order. However, as in this case the factory is owned by the cost accountant's son it would be prudent on the part of the accountant to desist from issuing such a certificate on moral grounds.

9.14 Self-examination Questions.

1 Enumerate the responsibilities of a cost auditor in regard to –

(a) Profession, and

(b) Ethics.

2 There are certain acts or omissions for which a cost accountant in practice would be liable to professional misconduct including action by a High Court. What are those acts or omissions?

3 Under the Cost and Works Accountants Act, 1959, when is a practising cost accountant liable to be found guilty by misconduct?

4 Discuss the provisions of professional misconduct in relation to Cost Accountant in practice as a part of the "First Schedule" to the Cost and Works Accountants Act, 1959.

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STUDY NOTE - 10

Auditing and Assurance Standards

This Study Note includes:

- Objectives and Functions of CAAB
- Objectives and Fuctions of QRB
- ICWAI as IFAC member
- Steps taken by IAASB to improve the clarity of its standards

10.1 Need for Oversight – an Introduction

10.1.1 The recent corporate collapses in USA and western world have shaken the confidence of the stakeholders in auditors and questions have been frequently raised about the quality of the audit and the feasibility to rely on these audits or audit reports. This has brought the entire profession under the increasing focus regarding the quality of work performed and therefore, the regulators and others stakeholders are calling for more consistent work effort by auditors. These events have not only undermined the public's confidence in the effectiveness of audits and consequential enhanced scrutiny of the work by the auditors, but have also highlighted the need for requirement of new approaches to improve the auditors' effectiveness in detecting material mis-statements in financial statements to regain the credibility lost. Part of the profession's response to the current crisis of confidence involves strengthening the existing auditing standards and auditors' compliance with standards. Auditing standard-setters are also looking to improve work effort consistency by making standards clearer.

10.1.2 It is also true that accounting and auditing standards, while no doubt necessary, cannot by themselves ensure high quality financial reporting to maintain the confidence of the investing public. Audits should, therefore be planned and performed to provide reasonable assurance that financial statements being reported on are free of material mis-statement or fairly presented in accordance with generally accepted accounting principles or the applicable accounting standards. Auditors are effective to the extent that they detect existing material mis-statements and ineffective to the extent that *an* existing material mis-statement remains un-detected during an audit. Ineffective audits increase information risk associated with financial statements, making it more likely that users will suffer losses as a consequence of relying on materially mis-stated information. Therefore, risk and control are fundamental to assurance practice today.

10.1.3 In addition to above, the role of an auditor today is expanding beyond the traditional financial-statement audit to offer services that also improve the quality of information, or its context for decision-making. New types of assurance services are being developed and offered during this era of corporate governance with increasing responsibilities and accountabilities of the management especially audit committees. These services, which are also known as assurance services are expanding on the audit function, while retaining important concepts and objectives such as independence and improving information for decision-making. Assurance can be broadly defined to include engagements such as attestation services performed by independent parties and assurance needed by a company's management. Management needs assurance that, for example, information systems and data are secure, rights to intellectual property are protected or the operating objectives are being achieved etc. Cost Auditors or Internal Auditors often provide the assurance service for some of these resources to assure the management that organizational objectives are being met or that legal rights to intellectual property are protected. It was felt that if these activities are not subject to any oversight; these may lead to further deterioration of the creditability of the professionals.

10.2 Lack of Clarity in Accounting Statements:

10.2.1 It is sometimes, felt that the existing accounting techniques may not sufficient for the information needs of all the stakeholders. The Balance Sheet or the Profit and Loss account is often found lacking in disclosing the real revenue earning capability or potential of any organisation. There are many areas of the business, which are very important from the business point of view. However, there is no uniform and reasonable accounting method to reflect their true value in the business Balance Sheet. Accounting for leases is one of such complex problems currently facing the financial accounting standard setters and practitioners. Intellectual properties of any organisation like copyrights and patents etc., which are reported in the books of accounts as intangible assets is yet another area.

10.2.2 Intellectual property, which is also known as intellectual capital or knowledge, is the primary source of revenue earnings for the companies engaged in sectors like software, pharmaceuticals, recordings and publications. Similarly, other intellectual assets like knowledge and experience of managers etc. has value to the firm but such value is not quantified and reported in the financial statements. Therefore, the financial value of the intangible assets as are quantified and reported on a company's Balance Sheet can differ dramatically from the actual revenue-producing value of that asset to the firm. A simple example would be the financial value of the patents held by pharmaceutical company or a software company or value of copy-rights held by any publisher. These assets often have very low financial-statement value as compared with revenue-generating value as much of the knowledge assets that drive financial performance for today's companies are not formally measured and reported. So Balance-Sheet may not reflect the true worth of the business to that extent.

10.2.3 One more intangible asset, which is often the primary determinant of a firm's financial performance is its reputation or brand image. Firms with strong brand reputations generate higher unit volume sales and can command premium prices and profit margins. Firms whose reputation for quality or reliability has been compromised suffer lost unit sales and lower revenue and profit margins, both causing poorer financial performance. These intangible assets are often not captured in the financial Balance-Sheet or if captured, these are often reflected at a very un-realistic value due to lack of appropriate cost accounting techniques. However, these actual values become very critical during mergers, amalgamations or buy – outs etc. of these firms. It is, therefore very pertinent that these assets are valued at realistic value.

10.3 Assurance Services

10.3.1 Advances in information technology have dramatically increased companies' reliance on computerized information systems to conduct operations and to gather and report performance information both internally and externally. Maintaining operations and reliably reporting performance information requires 'assurance', for example, that information system controls function effectively and database is kept secure. This 'Assurance' on information system reliability and database security is very important to management, auditors as well as all other stakeholders.

10.3.2 'Assurance Services' have been defined as "independent professional services that improve the quality of information, or its context, for decision makers." This broad concept includes audit and attestation services. These assurance services are distinct from the consulting services despite certain similarities. Assurance services focus primarily on improving the information rather than on providing advice or installing systems. These are much more comprehensive than just a required reporting obligation. It includes all types of information, whether financial or non-financial. It can be about past events or conditions or even about ongoing processes or systems (such as internal controls). It can also be direct (information about a product) or indirect (information about someone else's assertion about a product). It can be internal or external to the organisation. There is also no limit to the type of improvement. The assuror can improve the information's reliability, relevance or context. Some of the likely assurance services include:

- Assessment of ethics-related risks and vulnerabilities
- Controls over and risk related to investments
- Adequacy of controls and policies for derivatives
- Fairness of inventory valuation
- Valuation of intangible assets
- Optimum product mix to ensure maximisation of profits
- Information systems security reviews
- Assessment of risk of accumulation, distribution and storage of digital information
- Fraud and illegal acts risk assessment
- Scope for cost reduction
- Optimum pricing of products
- Internal audit quality assurance
- Customer satisfaction surveys—reports/validations
- Compliance with royalty agreements
- Identification of key factors to monitor
- ISO 9000 certification
- Environmental report
- Efficiency in operations compared to benchmark based on peers in the industry
- Cost competitiveness of the unit in this era of globalization
- Assurance that systems are designed and operate in a manner that provides reliable information or operate according to accepted criteria.

10.3.3 We can see that management accountants especially cost auditors can be very effective in providing many of the aforesaid assurance services. Key inputs are already available with them during the conduct of cost audit. It is, therefore very pertinent that assurance standards are brought out by the institute to ensure that there is no conflict of interest between their duties and responsibilities as a cost auditor and those as an assurance provider.

10.3.4 As already stated above, the Assurance engagements are designed to enhance intended users' degree of confidence about the outcome of the evaluation or measurement of a subject matter against criteria. The International Framework for Assurance Engagements (the Assurance Framework) issued by the International Auditing and Assurance Standards Board describes the elements and objectives of an assurance engagement, and identifies engagements to which International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply.

10.3.5 In case of assurance engagement, it is in the public interest that members of assurance teams, firms and, when applicable, network firms be independent of assurance clients. This is necessary as the professional accountant in public practice expresses a conclusion in assurance engagement designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. IFAC has therefore, issued Code of Ethics for Professional Accountants regarding Independence in Assurance Engagements. This has been reproduced at Appendix – E. As already stated above, ICWAI is duty bound to implement this code of ethics for its practicing members (Appendix – C).

10.4 The Cost Audit and Assurance Standards Board (CAAB)

10.4.1 The Institute of Cost and Works Accountants of India (ICWAI) is committed to the goal of enabling the cost and management accounting profession in India to provide services of high quality in the public interest as per the international standards. ICWAI has developed and promulgated technical standards and other professional literature to realize this goal. The ICWAI being one of the founder members of the IFAC, the standards are being developed and promulgated by the Cost Audit & Assurance Board (CAAB) under the authority of the council of ICWAI are in conformity with the corresponding International Standards issued by the International Auditing and Assurance Standards Board (IAASB), established by IFAC.

10.4.2 The primary objectives of CAAB may be summarized as follows:

- To identify the areas in which Standards on Quality Control and Engagement Standards are required to be developed after reviewing the existing and emerging audit practices worldwide;
- To serve the public interest by formulating and setting high-quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the auditing and assurance profession.
- To demonstrate to the regulators, investors, business community, interested third parties and the wider public our commitment to upholding and developing professional standards that command public confidence and to provide comfort and assurance to users of financial statements, regulators and third parties.
- To establish appropriate quality assurance standards and guidelines in relation to audit practice of the firms that are considered essential in the interest of the profession, in the public interest and to comply with the requirements of ICWAI's professional requirements as well as Statements of Membership Obligation (SMO)-l on Quality Assurance issued by the International Federation of Accountants (IFAC). The SMOs clarify and strengthen IFAC's membership obligations and seek to enhance the performance of accountants worldwide.

- To provide support and guidance to help audit firms to develop and improve their practices.
- To take up a program of practice review which applies to all practicing members in India who hold a Certificate of Practice (COP) of ICWAI.

10.4.3 The council of ICWAI is developing and issuing the Indian Cost Audit & Assurance Standards on Auditing (ICAAS) consisting of following standards through the Cost Audit & Assurance Board (CAAB):

(a) Standards on Cost Auditing and Standards on Review Engagements to be applied in auditing and reporting on historical financial information;

(b) Standards on Assurance Engagements to be applied in assurance engagements dealing with information other than historical financial information;

(c) Standards on Related Services to be applied in related services engagements as may be defined by the ICWAI;

(d) Standards on Quality Control to be applied for all services falling within the Engagement Standards as described in points (a), (b) and (c) above.

10.4.4 The basic objective of the ICAAS is to establish standards on the principles that the cost auditor should include in his plan to conduct an effective cost audit in an efficient manner. However, the ICWAI is yet to fix the date of mandatory applicability of these ICAAS. The CAAB has been presently entrusted with the task of establishing a Quality Control Framework to provide written guidelines to ensure quality control in respect of audits and other professional services performed by the firms. Cost Audit & Assurance Board (CAAB) is also expected to provide members in practice with a framework of quality assurance principles to help them assess and develop their practices, and by offering technical support and advice, where necessary.

10.5 Quality Review Board (*QRB):*

10.5.1 As already stated above, there has been growing demand for high quality assurance, consistency and greater transparency in the functioning of profession. A need for over sight board was being felt, which would contribute to public confidence in the integrity and enhancing the quality of work done by the members of the Institute. Therefore provision of a "Quality Review Board" has been incorporated into the Cost and Works Accountant Act 1959 to review the quality of services provided by the Cost Accountants and making recommendations for improvement. Section 29A of the Cost and Works Accountants Act 1959 provides for establishment of 'Quality Review Board' consisting of a chairperson and four other members. Out of there four members of the Board, two members shall be nominated by the council and other two members shall be nominated by the Central Government. Section 29-B of the Act relates to the functions of the Board. It provides that the Board shall perform the following functions:

a) to make recommendations to the council with regard to the quality of services provided by the members of the Institute;

b) to guide the members of the institute to improve the quality of services, provided by the members of the institute including cost adviser services; and

c) To review the quality of services and adherence to the various statutory and other regulatory requirements.

10.5.2 This constitution of 'Quality Review Board' is therefore, aimed at maintenance as well as enhancement of quality of attestation services or cost audit services and to provide guidance to members to improve their performance and adhere to various statutory and regulatory requirements. The quality review process is mainly focused on:

- Compliance with technical standards
- Quality of reporting
- Office system and procedures
- Training programmes for staff concerned including appropriate infrastructure.

10.5.3 The detailed procedure for meetings of the Board and procedures to be followed by the Board etc have been prescribed under 'The Cost and Works Accountants Procedures of Meetings of Quality Review Board and Terms and Conditions of Service and Allowances of the Chairperson and Members of the Board Rules 2006" (Appendix – B). The initial constitution of the Board has been notified vide Gazette Notification S. O. No. 1693(E) dated 3rd October 2007 (Appendix – A). These rules provide that not more than six months shall elapse between any two meetings of the Board and the quorum for transaction of any business at a meeting of the Board shall be of three members, of which at least one must be nominated by the Central Government under sub-section (3) of Section 29A of the Act. Rule 3(5) of the said rules provide that all questions which come up before any meeting of the Board shall be decided by a majority of the members present and voting. In case of equality of votes, the chairperson or in his absence, the member presiding shall have a second or casting vote. Rule 6 of the said rules provides that the Board, in the discharge of its functions may:

(a) on its own or through any specialized arrangement set up under the Institute, evaluate and review the quality of work and services provided by the members of the Institute in such manner as it may decide;

(b) lay down the procedure or evaluation criteria to evaluate various services being provided by the members of the Institute and to select, in such manner and form as it may decide, the individuals and firms rendering such services for review;

(c) call for information from the Institute, the Council or its Committees, members, clients of members or other persons or organizations in such form and manner as it may decide, and may also give a hearing to them;

(d) invite experts to provide expert/technical advice or opinion or analysis or any matter or issue which the Board may feel relevant for the purpose of assessing the quality of work and services offered by the members of the Institute;

(e) make recommendations to the Council to guide the members of the Institute to improve their professional competence and qualifications, quality of work and services offered and adherence to various statutory and other regulatory requirements and other matters related thereto.

10.6 Review Procedure to be Followed by the Quality Review Board:

10.6.1 The term 'evaluate and review the quality of work and services provided by the members of the institute' is a new concept, being introduced in the institute and may broadly involve the review of work done by one Cost Accountant by another Cost Accountant of similar standing. The purpose is to provide guidance to the members to improve their performance and quality. Board may have to decide about periodicity and procedure to select the practice units. The practice units are generally selected on the basis of representative random sample basis. The review is usually carried out by the reviewers empanelled by the Board on the basis of their experience and qualification. However it may be clarified here that the practice units under review do not incur any liability under the code of ethics as prescribed under the Cost and Works Accountants Act 1959. This immunity clause ensures that such reviews are for the purpose of enhancing quality of professional work and that they have no relationship what so ever with any disciplinary or any other regularly mechanism.

10.6.2 This immunity is very necessary as otherwise no Cost Accountant may like to get his work reviewed by another Cost Accountant on one pretext or the other. The reviews begin with the assumption that professionals work professionally and end with an enhancement of the attributes of professionalism. The review would focus on adequacy of laid down procedures and not on the opinion arrived by the practice unit. Generally strict confidentiality provisions apply to all those involved in Quality Review Process. In short, Quality Review Process is an excellent tool of self-regulation with the basic objective of enhancing the audit quality. While reviewing the practice unit, the following issues need to be reviewed:

a) Independence

b) Professional Skills and Standards

c) Expert Consultation

d) Documentation System

e) Staff Supervision and Development.

10.7 ICWAI as IFAC Member

10.7.1 The Institute of Cost and Works Accountants of India is one of the founder members of the International Federation of Accountants (IFAC). As already stated in Study Note 9, the mission of the IFAC is "the worldwide development and enhancement of an accountancy profession with harmonized standards, able to provide services of consistently high quality in the public interest." In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing and assurance standards for use around the world. The ICWAI being a member of the International Federation of Accountants (IFAC), the Auditing and Assurance Standards developed and promulgated by the ICWAI are required to be in harmony, to the extent possible in the light of the conditions prevailing in India, with the corresponding International Standards on Auditing, International Standards on Review Engagements, International Standards on Assurance Engagements, International Standards on Related Services or International Standards on Quality

Control, issued by the International Auditing and Assurance Standards Board (IAASB) of the IFAC (Appendix – C). IFAC also issues policy positions on topics where the profession's expertise is most relevant.

10.7.2 IFAC has long recognized the need for a globally harmonized framework to meet the increasingly international demands that are placed on the accountancy profession. IFAC's standard-setting boards follow a due process that supports the development of high quality standards in the public interest in a transparent, efficient, and effective manner. These standard-setting boards all have Consultative Advisory Groups, which provide public interest perspectives and include public members. IFAC's Public Interest Activity Committees (PIACs) – the International Auditing and Assurance Standards Board, International Accounting Education Standards Board, International Ethics Standards Board for Accountants, and the Compliance Advisory Panel – are subject to oversight by the Public Interest Oversight Board (PIOB). IFAC has also issued Auditing and Assurance Standards, which are adopted by all the members institutes from different countries.

10.7.3 IFAC regulations also require that the audit firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances. In view of the present day requirements for upholding the image and dignity of the profession as a whole and for more close monitoring of the quality control standards of its practicing members, The Institute, being a member body of the International Federation of Accountants (IFAC) and is committed to follow the international standards in addition to its own standards.

10.8 Steps Taken by the International Auditing and Assurance Standards Board (IAASB) to Improve the Clarity of its Standards (Clarity Project):

10.8.1 The International Auditing and Assurance Standards Board (IAASB) sets high quality international auditing and assurance standards in serving the public interest. The IAASB recognizes that standards need to be understandable, clear and capable of consistent application. These aspects of clarity serve to enhance the quality and uniformity of practice worldwide. The IAASB reviewed the drafting conventions used in its International Standards during the year 2003 seeking to improve its standards. The objective of the review was to identify ways to improve the clarity, and thereby the consistent application, of International Standards issued by the IAASB. The IAASB began a comprehensive program in the year 2004 to enhance the clarity of ISAs. This program involved the application of new drafting conventions to all ISAs, either as part of a substantive revision or through a limited redrafting to reflect the new conventions and matters of clarity generally.

10.8.2 The IAASB has issued amendments to the Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface). This document establishes the conventions to be used by the IAASB in drafting future International Standards on Auditing (ISAs) and the obligations of auditors who follow those Standards. Improvements arising from the amended Preface broadly comprise:

- Identifying the auditor's overall objective when conducting an audit in accordance with ISAs, setting an objective in each ISA, and establishing an obligation on the auditor in relation to those objectives;

- Clarifying the obligations imposed on auditors by the requirements of the ISAs and the language used to communicate such requirements;
- Eliminating any possible ambiguity about the requirements an auditor needs to fulfill; such possible ambiguity arose from the use of the present tense in the current ISAs; and
- Improving the overall readability and understandability of the ISAs through structural and drafting improvements, including presenting the requirements and application and other explanatory material in separate sections within the ISAs.

10.8.3 The IAASB plans to complete the project by the end of 2008. This plan distinguishes between revision and redrafting. The IAASB currently has 32 ISAs in issue. The redrafted or revised and redrafted ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The detailed progress of the project is indicated in Appendix – D i.e., Extracts from the “Background information on the Clarity Project of IFAC”.

10.9 Appendix – A

REGD. NO. D.L.-33004/99

The Gazette of India

EXTRAORDINARY

PART II – Section 3 – Sub-section (ii)

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MINISTRY OF CORPORATE AFFAIRS

NOTIFICATION

New Delhi, the 3rd October, 2007

S.O.1963(E). – In exercise of the powers conferred by Section 29A of the Cost and Works Accountants Act, 1959 (23 of 1959), the Central Government hereby establishes a Quality Review Board consisting of the following persons, namely :-

1. Sh. U.C. Nahta, Chairperson
   Regional Director (Eastern Region),
   Nizam Palace, II MSO Building,
   3rd Floor, 234/4, A.J.C. Bose Road,
   Kolkata

2. Shri B.B. Goel, Adviser (Cost), Member
   Ministry of Corporate Affairs,
   New Delhi

3. Shri Ashok Kumar Agarwal, Member
   Fellow Chartered Accountant,
   Flat No. 3-A, White House,
   10, Bhagwan Dass Road,
   New Delhi-110001

Nominees of the Council :

4. Sh V.Kalaynaraman, Member
   Past President,
   Institute of Cost and
   Works Accountants of India

5. Sh. Dhananjay V.Joshi, Member
   Past President, Insititute
   of Cost and Works
   Accountants of India

2. The terms and conditions of service and allowances of the Chairperson and Members of the Quality Review Board shall be governed by the Cost and Works Accountants Procedures of meetings of Quality Review Board, and Terms and Conditions of Service and Allowance of Chairperson and Members of the Board, Rules, 2006.

3. This notification shall take effect from the date of publication in the Official Gazette.

[F.No.5/2/2007-C.L.-V]

JITESH KHOSLA, Jt. Secy.

10.10 APPENDIX – B

The Cost and Works Accountants Procedures of Meetings of Quality Review Board and Terms and Conditions of Service and allowances of the Chairperson and members of the Board Rules, 2006.

MINISTRY OF COMPANY AFFAIRS

NOTIFICATION

New Delhi, the 27th November, 2006

G.S.R. 734(E). – In exercise of the powers conferred by clause (e) and (f) of subsection (2) of Section 38A of, read with Section 29C and sub-section (1) of Section 29D of the Cost and Works Accountants Act, 1959 (23 of 1959), the Central Government hereby makes the following rules namely:-

1. Short title and commencement: -

(1) These Rules may be called the Cost and Works Accountants Procedures of Meetings of Quality Review Board, and Terms and Conditions of Service and allowances of the Chairperson and members of the Board Rules, 2006.

(2) They shall come into force on the date of their publication in the Official Gazette.

2. Definitions: -

(1) In these Rules, unless the context otherwise requires -

(a) "Act" means the Cost and Works Accountants Act, 1959;

(b) "Board" means the Quality Review Board formed under sub-section (1) of Section 29A of the Act;

(c) "Council" means the Council constituted under Section 9 of the Act;

(d) "Institute" means the Institute of Cost and Works Accountants of India set up under the Act.

(2) Words and expressions used but not defined in these Rules and defined in the Act shall have the same meaning as assigned to them in the Act.

3. Procedure for Meetings of the Board: -

(1) All meetings of the Board shall, ordinarily, be held at the headquarters of the Institute.

(2) The date and time of any meeting shall be fixed by the Chairperson:

Provided that a notice of not less than 15 days before the scheduled date of every such meeting shall be given by the Chairperson or any person so authorized by him to the other members of the Board:

Provided further that the Chairperson, for reasons to be recorded in writing, may call for a meeting at a shorter notice:

Provided also that not more than six months shall elapse between any two meetings.

(3) The quorum for transaction of any business at a meeting of the Board shall be of three members, of which at least one must be nominated by the Central Government under Sub-section (3) of Section 29A of the Act.

(4) The Chairperson shall chair all the meetings of the Board:

Provided that in the absence of Chairperson, the members shall elect any of the members present on the day of the meeting to chair the meeting.

(5) All questions which come up before any meeting of the Board shall be decided by a majority of the members present and voting, and in the event of an equality of votes, the Chairperson or in his absence, the member presiding, shall have a second or casting vote.

4. **Transaction of Business: -** The business of the Board shall ordinarily be transacted at a meeting of the Board.

5. **Agenda for the Board meeting: -**

(1) The agenda for a meeting of the Board shall be decided by the Chairperson.

(2) Any matter referred to it by the Central Government or the Council shall be included in the agenda for the meeting of the Board within time limits specified, if any, in such a reference.

(3) The Chairperson may, in appropriate cases, circulate the agenda note and related papers on any issue among members of the Board for resolution by circulation.

Provided that if three members of the Board require that any question be decided at a meeting, the Chairperson shall withdraw the papers from circulation and have the question determined at a meeting of the Board.

(4) A decision taken by the circulation of the papers shall be communicated to all the members and shall be noted at the next meeting of the Board.

6. **Procedures to be followed by the Board: -** In the discharge of its functions, the Board may:

(a) on its own or through any specialized arrangement set up under the Institute, evaluate and review the quality of work and services provided by the members of the Institute in such manner as it may decide;

(b) lay down the procedure or evaluation criteria to evaluate various services being provided by the members of the Institute and to select, in such manner and form as it may decide, the individuals and firms rendering such services for review;

(c) call for information from the Institute, the Council or its Committees, members, clients of members or other persons or organizations in such form and manner as it may decide, and may also give a hearing to them;

(d) invite experts to provide expert/technical advice or opinion or analysis or any matter or issue which the Board may feel relevant for the purpose of assessing the quality of work and services offered by the members of the Institute;

(e) make recommendations to the Council to guide the members of the Institute to improve their professional competence and qualifications, quality of work and services offered and adherence to various statutory and other regulatory requirements and other matters related thereto.

7. **Assistance to the Board: -** The Institute shall set up a specialized technical unit to-

   (a) provide secretarial assistance, as required, to the Board in the discharge of its functions;

   (b) to assist the Board in carrying out review of quality of services provided by the Members.

8. **Terms and conditions of service of the Chairperson and Members of the Board:-**

   (1) The tenure of the Chairperson and Members of the Board shall be four years.

   (2) The Chairperson and other members of the Board shall be part-time members.

   (3) No Chairperson or member of the Board shall be removed or withdrawn except as provided under Rule 10.

9. **Allowances: -**

   (1) The Chairperson and other Members shall be entitled to traveling and daily allowances as admissible to them in their official capacity, and in case, the member is not a Government Servant, he will be entitled to the travelling allowance and daily allowance as admissible to an officer holding a post carrying a scale of pay of a Joint Secretary to the Government of India for attending meetings of the Board at the headquarters of the Institute if their place of residence is different from the headquarters of the Institute.

   (2) The Chairperson and other Members of the Board whose place of residence is the same as the venue of the meeting of the Board shall be provided local conveyance or allowance for the local journeys to be performed in connection with the meetings of the Board.

   (3) The Chairperson and other Members of the Board, while on tour, shall be entitled to travelling and daily allowances at the above rates.

10. **Resignation, Removal and filling up of casual vacancy: -**

   (1) The Chairperson and each Member of the Board shall cease to remain the Chairperson or Member, as the case may be, in case of his resignation or removal.

   (2) The Chairperson or a Member of the Board may resign his office by a notice in writing under his hand addressed to the Central Government which shall be effective from the date of resignation.

   (3) The Central Government may remove a person from the post of Chairperson or Member, if

      (a) he has become physically or mentally incapable of acting as the Chairperson or a Member, as the case may be;

      (b) he has not attended three consecutive meetings of the Board, without leave of absence;

      (c) he, being the Chairperson, has not called a meeting of the Board for more than six months;

      (d) he, in the opinion of the Central Government, is unable to discharge his function or perform his duties; or

      (e) he has been held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

   (4) A casual vacancy in the Board shall be filled by the Central Government, from out of the category in which such vacancy occurs.

11. Residuary provision: - Matters relating to the terms and conditions of services and allowances of the Chairperson and other members of the Board, the place of meetings and the procedure to be adopted in meetings of the Board, with respect to which no express provisions has been made in these rules shall be referred in each case to the Central Government for its decision and the decision of the Central Government thereon shall be binding on the Board, the Chairperson and other members.

[F.No.5/27/2006/CL-V]

JITESH KHOSLA, Jt.Secy.

10.11 Appendix - C

Extracts from the Background information on the International Federation of Accountants:

Auditing and Assurance Services

The International Auditing and Assurance Standards Board (IAASB) develops ISAs and International Standards on Review Engagements, which deal with the audit and review of historical financial information; and International Standards on Assurance Engagements, which deal with assurance engagements other than the audit or review of historical financial information. The IAASB also develops related practice statements. These standards and statements serve as the benchmark for high quality auditing and assurance standards and statements worldwide. They establish standards and provide guidance for auditors and other professional accountants, giving them the tools to cope with the increased and changing demands for reports on financial information, and provide guidance in specialized areas.

In addition, the IAASB develops quality control standards for firms and engagement teams in the practice areas of audit, assurance and related services.

IFAC Member Body Compliance Program

As part of the Member Body Compliance Program, IFAC members and associates (mostly national professional institutes) are required to demonstrate how they have used best endeavors, subject to national laws and regulations, to implement the standards issued by IFAC and the International Accounting Standards Board. The program, which is overseen by IFAC's Compliance Advisory Panel, also seeks to determine how members and associates have met their obligations with respect to quality assurance and investigation and disciplinary programs for their members as set out in IFAC's Statements of Membership Obligations (SMOs). As part of the Compliance Program, members and associates are required to complete a self-assessment regarding the SMO requirements and, where areas for improvement are identified, to develop action plans to address those areas. The SMOs serve as the foundation of the Compliance Program and provide clear benchmarks to current and potential member bodies to assist them in ensuring high quality performance by professional accountants.

10.12 Appendix - D

Extracts from the "Background information on the CLARITY PROJECT of THE INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD"

Clarity and High Quality International Standards

In serving the public interest, the International Auditing and Assurance Standards Board (IAASB) sets high quality international auditing and other assurance standards. The IAASB recognizes that standards need to be understandable, clear and capable of consistent application. These aspects of clarity serve to enhance the quality and uniformity of practice worldwide.

In seeking to improve its standards, in 2003 the IAASB reviewed the drafting conventions used in its International Standards. The objective of the review was to identify ways to improve the clarity, and thereby the consistent application, of International Standards on Auditing (ISAs).

In 2004, the IAASB began a comprehensive program to enhance the clarity of ISAs. This program involves the application of new drafting conventions to all ISAs, either as part of a substantive revision or through a limited redrafting to reflect the new conventions and matters of clarity generally.

Amended Preface

The IAASB has issued amendments to the Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface). The Preface establishes the new conventions to be used in drafting ISAs and the obligations of auditors who follow those Standards. Improvements arising from the amended Preface broadly comprise:

- Identifying the auditor's overall objective when conducting an audit in accordance with ISAs, setting an objective in each ISA, and establishing an obligation on the auditor in relation to those objectives;
- Clarifying the obligations imposed on auditors by the requirements of the ISAs and the language used to communicate such requirements;
- Eliminating any possible ambiguity about the requirements an auditor needs to fulfill (such possible ambiguity arose from the use of the present tense in the current ISAs); and
- Improving the overall readability and understandability of the ISAs through structural and drafting improvements, including presenting the requirements and application and other explanatory material in separate sections within the ISAs.

Plan for Completing the Project

The IAASB established a plan for completing the project by the end of 2008. This plan distinguishes revision and redrafting. The IAASB currently has 32 ISAs in issue. Of these:

- 11 are under full revision and will be issued in the clarity form (for purposes of the handbook, they are referred to as "Revised and Redrafted");
- Nine have been revised in the last few years and are in no need of further revision, but will be redrafted in the clarity form (referred to as "Redrafted"); and
- The other 12 have not been recently revised, but are considered acceptable; they will be redrafted in the clarity form without revision for any other matters (also referred to as "Redrafted").

The plan responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect, while completing the Clarity project within a reasonable time. It also minimizes the time the IAASB will spend on the clarification of the older ISAs and ensures that the IAASB can turn its attention to other projects as soon as practicable. These other projects may include the full revision of some of the older ISAs if the clarity redrafting exercise, or the IAASB's consultation on its future work program, highlights a need for this.

Effective Date

The redrafted or revised and redrafted ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009.

Implementation Considerations

It is important that all those with responsibility for implementation activities consider the final ISAs as early as practicable. National standards setters, legislators and others involved in setting standards have been following the development of the ISAs and contributing to the process by commenting on exposure drafts. They will, therefore, be well placed to consider adoption or convergence plans that maximize the implementation period for auditors. IFAC member bodies and auditors, who have similarly been following the process, will want to consider what continuing professional development courses or other training materials need to be developed. Auditors will also need to consider the extent to which the new requirements within the ISAs call for amendments to current audit programs and procedures.

The IAASB is releasing the final ISAs as they are approved, and after the Public Interest Oversight Board has confirmed that due process has been followed in the development of each Standard. The IAASB believes that publication of the ISAs in this way will assist in their translation, adoption and implementation. The IAASB accepts that there is a possibility of conforming amendments being necessary to released ISAs as other ISAs are redrafted or revised and redrafted, although this process will be completed before publication of the set of final ISAs in late 2008. Any such amendments are not expected to change the substance of the ISAs already approved, although they may have a small effect on their content.

Progress to Date

At December 31, 2007, the IAASB has released the following final ISAs:

- ISA 230 (Redrafted), "Audit Documentation"
- ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"
- ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance"
- ISA 300 (Redrafted), "Planning an Audit of Financial Statements"
- ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"
- ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks"
- ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"
- ISA 600 (Revised and Redrafted), "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)"
- ISA 720 (Redrafted), "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements"

At December 31, 2007, the IAASB has approved the following final ISAs. These ISAs are awaiting confirmation by the Public Interest Oversight Board that due process has been followed in their development. They will be released after such confirmation has been received:

- ISA 560 (Redrafted), "Subsequent Events"
- ISA 580 (Revised and Redrafted), "Written Representations"

At December 31, 2007 the following exposure drafts of proposed redrafted or revised and redrafted ISAs have been issued. These ISAs have not yet been completed as final Standards:

- ISA 200 (Revised and Redrafted), "Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing"
- ISA 210 (Redrafted), "Agreeing the Terms of Audit Engagements"
- ISA 220 (Redrafted), "Quality Control for an Audit of Financial Statements" and International Standard on Quality Control (ISQC) 1 (Redrafted), "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements"
- ISA 250 (Redrafted), "The Auditor's Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements"
- ISA 265, "Communicating Deficiencies in Internal Control"
- ISA 320 (Revised and Redrafted), "Materiality in Planning and Performing an Audit"
- ISA 402 (Revised and Redrafted), "Audit Considerations Relating to an Entity Using a Third Party Service Organization"
- ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified during the Audit"
- ISA 500 (Redrafted), "Considering the Relevance and Reliability of Audit Evidence"
- ISA 501 (Redrafted), "Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures"
- ISA 505 (Revised and Redrafted), "External Confirmations"
- ISA 510 (Redrafted), "Initial Audit Engagements—Opening Balances"
- ISA 520 (Redrafted), "Analytical Procedures"
- ISA 530 (Redrafted), "Audit Sampling"
- ISA 550 (Revised and Redrafted), "Related Parties"
- ISA 570 (Redrafted), "Going Concern"
- ISA 610 (Redrafted), "The Auditor's Consideration of the Internal Audit Function"
- ISA 620 (Revised and Redrafted), "Using the Work of an Auditor's Expert"
- ISA 700 (Redrafted), "The Independent Auditor's Report on General Purpose Financial Statements"
- ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report"
- ISA 706 (Revised and Redrafted), "Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor's Report"
- ISA 710 (Redrafted), "Comparative Information—Corresponding Figures and Comparative Financial Statements"
- ISA 800 (Revised and Redrafted), "Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement"
- ISA 805 (Revised and Redrafted), "Engagements to Report on Summary Financial Statements"

10.13 Appendix - E

Extracts from Code of Ethics for Professional Accountants – Section 290 (Revised) : Independence – Assurance Engagements:

SECTION 290

Independence—Assurance Engagements

290.1 In the case of an assurance engagement it is in the public interest and, therefore, required by this Code of Ethics, that members of **assurance teams**, firms and, when applicable, **network firms** be independent of assurance clients.

290.2 Assurance engagements are designed to enhance intended users' degree of confidence about the outcome of the evaluation or measurement of a subject matter against criteria. The International Framework for Assurance Engagements (the Assurance Framework) issued by the International Auditing and Assurance Standards Board describes the elements and objectives of an assurance engagement, and identifies engagements to which International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply. For a description of the elements and objectives of an assurance engagement reference should be made to the Assurance Framework.

290.3 As further explained in the Assurance Framework, in an assurance engagement the professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

290.4 The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. The term "subject matter information" is used to mean the outcome of the evaluation or measurement of subject matter. For example:

- The recognition, measurement, presentation and disclosure represented in the **financial statements** (subject matter information) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as International Financial Reporting Standards, (criteria) to an entity's financial position, financial performance and cash flows (subject matter).
- An assertion about the effectiveness of internal control (subject matter information) results from applying a framework for evaluating the effectiveness of internal control, such as COSO or CoCo, (criteria) to internal control, a process (subject matter).

290.5 Assurance engagements may be assertion-based or direct reporting. In either case they involve three separate parties: a public accountant in public practice, a responsible party and intended users.

290.6 In an assertion-based assurance engagement, which includes a **financial statement audit engagement**, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

290.7 In a direct reporting assurance engagement the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report.

290.8 Independence requires:

Independence of Mind

The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

Independence in Appearance

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

290.9 The use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

290.10 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest.

A Conceptual Approach to Independence

290.11 Members of assurance teams, firms and network firms are required to apply the conceptual framework contained in Section 100 to the particular circumstances under consideration. In addition to identifying relationships between the firm, network firms, members of the assurance team and the assurance client, consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client create threats to independence.

290.12 The examples presented in this section are intended to illustrate the application of the conceptual framework and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances that may create threats to independence. Consequently, it is not sufficient for a member of an assurance team, a firm or a network firm merely to comply with the examples presented, rather they should apply the framework to the particular circumstances they face.

290.13 The nature of the threats to independence and the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level differ depending on the characteristics of the individual assurance engagement: whether it is a financial statement audit engagement or another type of assurance engagement; and in the latter case, the purpose, subject matter information and intended users of the report. A firm should, therefore, evaluate the relevant circumstances, the nature of the assurance engagement and the threats to independence in deciding whether it is appropriate to accept or continue an engagement, as well as the nature of the safeguards required and whether a particular individual should be a member of the assurance team.

Networks and Network Firms

290.14 An entity that belongs to a network might be a firm, which is defined in this Code as a sole practitioner, partnership or corporation of professional accountants and an entity that controls or is controlled by such parties, or the entity might be another type of entity, such as a consulting practice or a professional law practice. The independence requirements in this section that apply to a network firm apply to any entity that meets the definition of a network firm irrespective of whether the entity itself meets the definition of a firm.

290.15 If a firm is considered to be a network firm, the firm is required to be independent of the financial statement audit clients of the other firms within the network. In addition, for assurance clients that are not financial statement audit clients, consideration should be given to any threats the firm has reason to believe may be created by financial interests in the client held by other entities in the network or by relationships between the client and other entities in the network.

290.16 To enhance their ability to provide professional services, firms frequently form larger structures with other firms and entities. Whether these larger structures create a network depends upon the particular facts and circumstances and does not depend on whether the firms and entities are legally separate and distinct. For example, a larger structure may be aimed only at facilitating the referral of work, which in itself does not meet the criteria necessary to constitute a network. Alternatively, a larger structure might be such that it is aimed at co-operation and the firms share a common brand name, a common system of quality control, or significant professional resources and consequently is considered to be a network.

290.17 The judgment as to whether the larger structure is a network should be made in light of whether a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that the entities are associated in such a way that a network exists. This judgment should be applied consistently throughout the network.

290.18 Where the larger structure is aimed at co-operation and it is clearly aimed at profit or cost sharing among the entities within the structure, it is considered to be a network. However, the sharing of immaterial costs would not in itself create a network. In addition, if the sharing of costs is limited only to those costs related to the development of audit methodologies, manuals, or training courses, this would not in itself create a network. Further, an association between a firm and an otherwise unrelated entity to jointly provide a service or develop a product would not in itself create a network.

290.19 Where the larger structure is aimed at cooperation and the entities within the structure share common ownership, control or management, it is considered to be a network. This could be achieved by contract or other means.

290.20 Where the larger structure is aimed at co-operation and the entities within the structure share common quality control policies and procedures, it is considered to be a network. For this purpose common quality control policies and procedures would be those designed, implemented and monitored across the larger structure.

290.21 Where the larger structure is aimed at co-operation and the entities within the structure share a common business strategy, it is considered to be a network. Sharing a common business strategy involves an agreement by the entities to achieve common strategic objectives. An entity is not considered to be a network firm merely because it co-operates with another entity solely to respond jointly to a request for a proposal for the provision of a professional service.

290.22 Where the larger structure is aimed at co-operation and the entities within the structure share the use of a common brand name, it is considered to be a network. A common brand name includes common initials or a common name. A firm is considered to be using a common brand name if it includes, for example, the common brand name as part of, or along with, its firm name, when a partner of the firm signs an assurance report.

290.23 Even though a firm does not belong to a network and does not use a common brand name as part of its firm name, it may give the appearance that it belongs to a network if it makes reference in its stationery or promotional materials to being a member of an association of firms. Accordingly, a firm should carefully consider how it describes any such memberships in order to avoid the perception that it belongs to a network.

290.24 If a firm sells a component of its practice, the sales agreement sometimes provides that, for a limited period of time, the component may continue to use the name of the firm, or an element of the name, even though it is no longer connected to the firm. In such circumstances, while the two entities may be practicing under a common name, the facts are such that they do not belong to a larger structure aimed at co-operation and are, therefore, not network firms. Those entities should carefully consider how to disclose that they are not network firms when presenting themselves to outside parties.

290.25 Where the larger structure is aimed at co-operation and the entities within the structure share a significant part of professional resources, it is considered to be a network. Professional resources include:

- Common systems that enable firms to exchange information such as client data, billing, and time records;
- Partners and staff;
- Technical departments to consult on technical or industry specific issues, transactions or events for assurance engagements;
- Audit methodology or audit manuals; and
- Training courses and facilities.

290.26 The determination of whether the professional resources shared are significant, and therefore the firms are network firms, should be made based on the relevant facts and circumstances. Where the shared resources are limited to common audit methodology or audit manuals, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be considered to be significant. The same applies to a common training endeavor. Where, however, the shared resources involve the exchange of people or information, such as where staff are drawn from a shared pool, or a common technical department is created within the larger structure to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared resources are significant.

Assertion-Based Assurance Engagements

Financial Statement Audit Engagements

290.27 Financial statement audit engagements are relevant to a wide range of potential users; consequently, in addition to independence of mind, independence in appearance is of particular significance. Accordingly, for financial statement audit clients, the members of the assurance team, the firm and network firms are required to be independent of the financial statement audit client. Such independence requirements include prohibitions regarding certain relationships between members of the assurance team and directors, officers and employees of the client in a position to exert direct and significant influence over the subject matter information (the financial statements). Also, consideration should be given to whether threats to independence are created by relationships with employees of the client in a position to exert direct and significant influence over the subject matter (the financial position, financial performance and cash flows).

Other Assertion-Based Assurance Engagements

290.28 In an assertion-based assurance engagement where the client is not a financial statement audit client, the members of the assurance team and the firm are required to be independent of the assurance client (the responsible party, which is responsible for the subject matter information and may be responsible for the subject matter). Such independence requirements include prohibitions regarding certain relationships between members of the assurance team and directors, officers and employees of the client in a position to exert direct and significant influence over the subject matter information. Also, consideration should be given to whether threats to independence are created by relationships with employees of the client in a position to exert direct and significant influence over the subject matter of the engagement. Consideration should also be given to any threats that the firm has reason to believe may be created by network firm interests and relationships.

290.29 In the majority of assertion-based assurance engagements, that are not financial statement audit engagements, the responsible party is responsible for the subject matter information and the subject matter. However, in some engagements the responsible party may not be responsible for the subject matter. For example, when a professional accountant in public practice is engaged to perform an assurance engagement regarding a report that an environmental consultant has prepared about a company's sustainability practices, for distribution to intended users, the environmental consultant is the responsible party for the subject matter information but the company is responsible for the subject matter (the sustainability practices).

290.30 In those assertion-based assurance engagements that are not financial statement audit engagements, where the responsible party is responsible for the subject matter information but not the subject matter the members of the assurance team and the firm are required to be independent of the party responsible for the subject matter information (the assurance client). In addition, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

Direct Reporting Assurance Engagements

290.31 In a direct reporting assurance engagement the members of the assurance team and the firm are required to be independent of the assurance client (the party responsible for the subject matter).

Restricted Use Reports

290.32 In the case of an assurance report in respect of a non-financial statement audit client expressly restricted for use by identified users, the users of the report are considered to be knowledgeable as to the purpose, subject matter information and limitations of the report through their participation in establishing the nature and scope of the firm's instructions to deliver the services, including the criteria against which the subject matter are to be evaluated or measured. This knowledge and the enhanced ability of the firm to communicate about safeguards with all users of the report increase the effectiveness of safeguards to independence in appearance. These circumstances may be taken into account by the firm in evaluating the threats to independence and considering the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level. At a minimum, it will be necessary to apply the provisions of this section in evaluating the independence of members of the assurance team and their immediate and close family. Further, if the firm had a material financial interest, whether direct or indirect, in the assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Limited consideration of any threats created by network firm interests and relationships may be sufficient.

Multiple Responsible Parties

290.33 In some assurance engagements, whether assertion-based or direct reporting, that are not financial statement audit engagements, there might be several responsible parties. In such engagements, in determining whether it is necessary to apply the provisions in this section to each responsible party, the firm may take into account whether an interest or relationship between the firm, or a member of the assurance team, and a particular responsible party would create a threat to independence that is other than clearly insignificant in the context of the subject matter information. This will take into account factors such as:

- The materiality of the subject matter information (or the subject matter) for which the particular responsible party is responsible; and
- The degree of public interest associated with the engagement.

If the firm determines that the threat to independence created by any such interest or relationship with a particular responsible party would be clearly insignificant it may not be necessary to apply all of the provisions of this section to that responsible party.

Other Considerations

290.34 The threats and safeguards identified in this section are generally discussed in the context of interests or relationships between the firm, network firms, members of the assurance team and the assurance client. In the case of a financial statement audit client that is a listed entity, the firm and any network firms are required to consider the interests and relationships that involve that client's related entities. Ideally those entities and the interests and relationships should be identified in advance. For all other assurance clients, when the assurance team has reason to believe that a **related entity** of such an assurance client is relevant to the evaluation of the firm's independence of the client, the assurance team should consider that related entity when evaluating independence and applying appropriate safeguards.

290.35 The evaluation of threats to independence and subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a firm, a network firm or a member of the assurance team knows, or could reasonably be expected to know, of circumstances or relationships that might compromise independence. There may be occasions when the firm, a network firm or an individual inadvertently violates this section. If such an inadvertent violation occurs, it would generally not compromise independence with respect to an assurance client provided the firm has appropriate quality control policies and procedures in place to promote independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied.

290.36 Throughout this section, reference is made to significant and clearly insignificant threats in the evaluation of independence. In considering the significance of any particular matter, qualitative as well as quantitative factors should be taken into account. A matter should be considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

Objective and Structure of this Section

290.37 The objective of this section is to assist firms and members of assurance teams in:

(a) Identifying threats to independence;

(b) Evaluating whether these threats are clearly insignificant; and

(c) In cases when the threats are not clearly insignificant, identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level.

Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable. In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.

290.38 This section concludes with some examples of how this conceptual approach to independence is to be applied to specific circumstances and relationships. The examples discuss threats to independence that may be created by specific circumstances and relationships (paragraphs 290.100 onwards). Professional judgment is used to determine the appropriate safeguards to eliminate threats to independence or to reduce them to an acceptable level. In certain examples, the threats to independence are so significant the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement. In other examples, the threat can be eliminated or reduced to an acceptable level by the application of safeguards. The examples are not intended to be all-inclusive.

290.39 Certain examples in this section indicate how the framework is to be applied to a financial statements audit engagement for a listed entity. When a member body chooses not to differentiate between listed entities and other entities, the examples that relate to financial statement audit engagements for listed entities should be considered to apply to all financial statement audit engagements.

290.40 When threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the assurance engagement, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.

290.41 The evaluation of the significance of any threats to independence and the safeguards necessary to reduce any threats to an acceptable level, takes into account the public interest. Certain entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Examples of such entities may include listed companies, credit institutions, insurance companies, and pension funds. Because of the strong public interest in the financial statements of listed entities, certain paragraphs in this section deal with additional matters that are relevant to the financial statement audit of listed entities. Consideration should be given to the application of the framework in relation to the financial statement audit of listed entities to other financial statement audit clients that may be of significant public interest.

290.42 Audit committees can have an important corporate governance role when they are independent of client management and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There should be regular communications between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities regarding relationships and other matters that might, in the firm's opinion, reasonably be thought to bear on independence.

290.43 Firms should establish policies and procedures relating to independence communications with audit committees, or others charged with governance of the client. In the case of the financial statement audit of listed entities, the firm should communicate orally and in writing at least annually, all relationships and other matters between the firm, network firms and the financial statement audit client that in the firm's professional judgment may reasonably be thought to bear on independence. Matters to be communicated will vary in each circumstance and should be decided by the firm, but should generally address the relevant matters set out in this section.

Engagement Period

290.44 The members of the assurance team and the firm should be independent of the assurance client during the period of the assurance engagement. The period of the engagement starts when the assurance team begins to perform assurance services and ends when the assurance report is issued, except when the assurance engagement is of a recurring nature. If the assurance engagement is expected to recur, the period of the assurance engagement ends with the notification by either party that the professional relationship has terminated or the issuance of the final assurance report, whichever is later.

290.45 In the case of a financial statement audit engagement, the engagement period includes the period covered by the financial statements reported on by the firm. When an entity becomes a financial statement audit client during or after the period covered by the financial statements that the firm will report on, the firm should consider whether any threats to independence may be created by:

- Financial or business relationships with the audit client during or after the period covered by the financial statements, but prior to the acceptance of the financial statement audit engagement; or

- Previous services provided to the audit client.

Similarly, in the case of an assurance engagement that is not a financial statement audit engagement, the firm should consider whether any financial or business relationships or previous services may create threats to independence.

290.46 If a non-assurance service was provided to the financial statement audit client during or after the period covered by the financial statements but before the commencement of professional services in connection with the financial statement audit and the service would be prohibited during the period of the audit engagement, consideration should be given to the threats to independence, if any, arising from the service. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards may include:

- Discussing independence issues related to the provision of the non-assurance service with those charged with governance of the client, such as the audit committee;
- Obtaining the client's acknowledgement of responsibility for the results of the non-assurance service;
- Precluding personnel who provided the non-assurance service from participating in the financial statement audit engagement; and
- Engaging another firm to review the results of the non-assurance service or having another firm re-perform the non-assurance service to the extent necessary to enable it to take responsibility for the service.

290.47 A non-assurance service provided to a non-listed financial statement audit client will not impair the firm's independence when the client becomes a listed entity provided:

(a) The previous non-assurance service was permissible under this section for non-listed financial statement audit clients;

(b) The service will be terminated within a reasonable period of time of the client becoming a listed entity, if they are impermissible under this section for financial statement audit clients that are listed entities; and

(c) The firm has implemented appropriate safeguards to eliminate any threats to independence arising from the previous service or reduce them to an acceptable level.

Application of Framework to Specific Situations

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Introduction

290.100 The following examples describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and the safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level in each circumstance. The examples are not all inclusive. In practice, the firm, network firms and the members of the assurance team will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards, including the safeguards in paragraphs 200.12-200.15 can be applied to satisfactorily address the threats to independence.

290.101 Some of the examples deal with financial statement audit clients while others deal with assurance engagements for clients that are not financial statement audit clients. The examples illustrate how safeguards should be applied to fulfill the requirement for the members of the assurance team, the firm and network firms to be independent of a financial statement audit client, and for the members of the assurance team and the firm to be independent of an assurance client that is not a financial statement audit client. The examples do not include assurance reports to a non-financial statement audit client expressly restricted for use by identified users. As stated in paragraph 290.32 for such engagements, members of the assurance team and their immediate and close family are required to be independent of the assurance client. Further, the firm should not have a material financial interest, direct or indirect, in the assurance client.

290.102 The examples illustrate how the framework applies to financial statement audit clients and other assurance clients. The examples should be read in conjunction with paragraph 290.33 which explain that, in the majority of assurance engagements, there is one responsible party and that responsible party comprises the assurance client. However, in some assurance engagements there are two responsible parties. In such circumstances, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

290.103 Interpretation 2005-01 to this section provides further guidance on the application of the independence requirements contained in this section to assurance engagements that are not financial statement audit engagements.

Financial Interests

290.104 A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).

290.105 When evaluating the type of financial interest, consideration should be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or the financial interest held (e.g., a mutual fund, unit trust or similar intermediary vehicle) to those where the individual has control over the financial interest (e.g., as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to independence, it is important to consider the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy. When control exists, the financial interest should be considered direct. Conversely, when the holder of the financial interest has no ability to exercise such control the financial interest should be considered indirect.

Provisions Applicable to all Assurance Clients

290.106 If a member of the assurance team, or their immediate family member, has a **direct financial interest**, or a material **indirect financial interest**, in the assurance client, the self-interest threat created would be so significant the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:

(a) Dispose of the direct financial interest prior to the individual becoming a member of the assurance team;

(b) Dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the assurance team; or

(c) Remove the member of the assurance team from the assurance engagement.

290.107 If a member of the assurance team, or their immediate family member receives, by way of, for example, an inheritance, gift or, as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards should be applied to eliminate the threat or reduce it to an acceptable level:

(a) Disposing of the financial interest at the earliest practical date; or

(b) Removing the member of the assurance team from the assurance engagement.

During the period prior to disposal of the financial interest or the removal of the individual from the assurance team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant to review the work done, or otherwise advise as necessary.

290.108 When a member of the assurance team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. In evaluating the significance of any threat, consideration should be given to the nature of the relationship between the member of the assurance team and the close family member and the materiality of the financial interest. Once the significance of the threat has been evaluated, safeguards should be considered and applied as necessary. Such safeguards might include:

- The close family member disposing of all or a sufficient portion of the financial interest at the earliest practical date;
- Discussing the matter with those charged with governance, such as the audit committee;

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team with the close family relationship or otherwise advise as necessary; or
- Removing the individual from the assurance engagement.

290.109 When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest should only be held when:

(a) The member of the assurance team, an immediate family member of the member of the assurance team, and the firm are not beneficiaries of the trust;

(b) The interest held by the trust in the assurance client is not material to the trust;

(c) The trust is not able to exercise significant influence over the assurance client; and

(d) The member of the assurance team or the firm does not have significant influence over any investment decision involving a financial interest in the assurance client.

290.110 Consideration should be given to whether a self-interest threat may be created by the financial interests of individuals outside of the assurance team and their immediate and close family members. Such individuals would include:

- Partners, and their immediate family members, who are not members of the assurance team;
- Partners and managerial employees who provide non-assurance services to the assurance client; and
- Individuals who have a close personal relationship with a member of the assurance team.

Whether the interests held by such individuals may create a self-interest threat will depend upon factors such as:

- The firm's organizational, operating and reporting structure; and
- The nature of the relationship between the individual and the member of the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Where appropriate, policies to restrict people from holding such interests;
- Discussing the matter with those charged with governance, such as the audit committee; or
- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done or otherwise advise as necessary.

290.111 An inadvertent violation of this section as it relates to a financial interest in an assurance client would not impair the independence of the firm, the network firm or a member of the assurance team when:

(a) The firm, and the network firm, have established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client;

(b) The firm, and the network firm, promptly notify the professional that the financial interest should be disposed of; and

(c) The disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.

290.112 When an inadvertent violation of this section relating to a financial interest in an assurance client has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Provisions Applicable to Financial Statement Audit Clients

290.113 If a firm, or a network firm, has a direct financial interest in a financial statement audit client of the firm the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

290.114 If a firm, or a network firm, has a material indirect financial interest in a financial statement audit client of the firm a self-interest threat is also created. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.115 If a firm, or a network firm, has a material financial interest in an entity that has a controlling interest in a financial statement audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only actions appropriate to permit the firm to perform the engagement would be for the firm, or the network firm, either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.116 If the retirement benefit plan of a firm, or network firm, has a financial interest in a financial statement audit client a self-interest threat may be created. Accordingly, the significance of any such threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

290.117 If other partners, including partners who do not perform assurance engagements, or their immediate family, in the **office** in which the **engagement partner** practices in connection with the financial statement audit hold a direct financial interest or a material indirect financial interest in that audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such partners or their immediate family should not hold any such financial interests in such an audit client.

290.118 The office in which the engagement partner practices in connection with the financial statement audit is not necessarily the office to which that partner is assigned. Accordingly, when the engagement partner is located in a different office from that of the other members of the assurance team, judgment should be used to determine in which office the partner practices in connection with that audit.

290.119 If other partners and managerial employees who provide non-assurance services to the financial statement audit client, except those whose involvement is clearly insignificant, or their immediate family, hold a direct financial interest or a material indirect financial interest in the audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such personnel or their immediate family should not hold any such financial interests in such an audit client.

290.120 A financial interest in a financial statement audit client that is held by an immediate family member of (a) a partner located in the office in which the engagement partner practices in connection with the audit, or (b) a partner or managerial employee who provides non-assurance services to the audit client is not considered to create an unacceptable threat provided it is received as a result of their employment rights (e.g., pension rights or share options) and, where necessary, appropriate safeguards are applied to reduce any threat to independence to an acceptable level.

290.121 A self-interest threat may be created if the firm, or the network firm, or a member of the assurance team has an interest in an entity and a financial statement audit client, or a director, officer or controlling owner thereof also has an investment in that entity. Independence is not compromised with respect to the audit client if the respective interests of the firm, the network firm, or member of the assurance team, and the audit client, or director, officer or controlling owner thereof are both immaterial and the audit client cannot exercise significant influence over the entity. If an interest is material, to either the firm, the network firm or the audit client, and the audit client can exercise significant influence over the entity, no safeguards are available to reduce the threat to an acceptable level and the firm, or the network firm, should either dispose of the interest or decline the audit engagement. Any member of the assurance team with such a material interest should either:

(a) Dispose of the interest;

(b) Dispose of a sufficient amount of the interest so that the remaining interest is no longer material; or

(c) Withdraw from the audit.

Provisions Applicable to Non-Financial Statement Audit Assurance Clients

290.122 If a firm has a direct financial interest in an assurance client that is not a financial statement audit client the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, disposal of the financial interest would be the only action appropriate to permit the firm to perform the engagement.

290.123 If a firm has a material indirect financial interest in an assurance client that is not a financial statement audit client a self-interest threat is also created. The only action appropriate to permit the firm to perform the engagement would be for the firm to either dispose of the indirect interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.124 If a firm has a material financial interest in an entity that has a controlling interest in an assurance client that is not a financial statement audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The only action appropriate to permit the firm to perform the engagement would be for the firm either to dispose of the financial interest in total or to dispose of a sufficient amount of it so that the remaining interest is no longer material.

290.125 When a restricted use report for an assurance engagement that is not a financial statement audit engagement is issued, exceptions to the provisions in paragraphs 290.106-290.110 and 290.122-290.124 are set out in 290.32.

Loans and Guarantees

290.126 A loan, or a guarantee of a loan, to the firm from an assurance client that is a bank or a similar institution, would not create a threat to independence provided the loan, or guarantee, is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional professional accountant from outside the firm, or network firm, to review the work performed.

290.127 A loan, or a guarantee of a loan, from an assurance client that is a bank or a similar institution, to a member of the assurance team or their immediate family would not create a threat to independence provided the loan, or guarantee, is made under normal lending procedures, terms and requirements. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances.

290.128 Similarly, deposits made by, or brokerage accounts of, a firm or a member of the assurance team with an assurance client that is a bank, broker or similar institution would not create a threat to independence provided the deposit or account is held under normal commercial terms.

290.129 If the firm, or a member of the assurance team, makes a loan to an assurance client, that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

290.130 Similarly, if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

290.131 The examples in paragraphs 290.126–290.130 relate to loans and guarantees between the firm and an assurance client. In the case of a financial statement audit engagement, the provisions should be applied to the firm, all network firms and the audit client.

Close Business Relationships with Assurance Clients

290.132 A close business relationship between a firm or a member of the assurance team and the assurance client or its management, or between the firm, a network firm and a financial statement audit client, will involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:

- Having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client.
- Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties.
- Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.

In the case of a financial statement audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm, the network firm and the audit client, no safeguards could reduce the threat to an acceptable level. In the case of an assurance client that is not a financial statement audit client, unless the financial interest is immaterial and the relationship is clearly insignificant to the firm and the assurance client, no safeguards could reduce the threat to an acceptable level. Consequently, in both these circumstances the only possible courses of action are to:

(a) Terminate the business relationship;

(b) Reduce the magnitude of the relationship so that the financial interest is immaterial and the relationship is clearly insignificant; or

(c) Refuse to perform the assurance engagement.

Unless any such financial interest is immaterial and the relationship is clearly insignificant to the member of the assurance team, the only appropriate safeguard would be to remove the individual from the assurance team.

290.133 In the case of a financial statement audit client, business relationships involving an interest held by the firm, a network firm or a member of the assurance team or their immediate family in a closely held entity when the audit client or a director or officer of the audit client, or any group thereof, also has an interest in that entity, do not create threats to independence provided:

(a) The relationship is clearly insignificant to the firm, the network firm and the audit client;

(b) The interest held is immaterial to the investor, or group of investors; and

(c) The interest does not give the investor, or group of investors, the ability to control the closely held entity.

290.134 The purchase of goods and services from an assurance client by the firm (or from a financial statement audit client by a network firm) or a member of the assurance team would not generally create a threat to independence providing the transaction is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Eliminating or reducing the magnitude of the transaction;
- Removing the individual from the assurance team; or
- Discussing the issue with those charged with governance, such as the audit committee.

Family and Personal Relationships

290.135 Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual's responsibilities on the assurance engagement, the closeness of the relationship and the role of the family member or other individual within the assurance client. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level.

290.136 When an immediate family member of a member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement, or was in such a position during any period covered by the engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team. The closeness of the relationship is such that no other safeguard could reduce the threat to independence to an acceptable level. If application of this safeguard is not used, the only course of action is to withdraw from the assurance engagement. For example, in the case of an audit of financial statements, if the spouse of a member of the assurance team is an employee in a position to exert direct and significant influence over the preparation of the audit client's accounting records or financial statements, the threat to independence could only be reduced to an acceptable level by removing the individual from the assurance team.

290.137 When an immediate family member of a member the assurance team is an employee in a position to exert direct and significant influence over the subject matter of the engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- The position the immediate family member holds with the client; and
- The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Removing the individual from the assurance team;
- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the immediate family member; or
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

290.138 When a close family member of a member of the assurance team is a director, an officer, or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement, threats to independence may be created. The significance of the threats will depend on factors such as:

- The position the close family member holds with the client; and
- The role of the professional on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Removing the individual from the assurance team;
- Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; or
- Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

290.139 In addition, self-interest, familiarity or intimidation threats may be created when a person who is other than an immediate or close family member of a member of the assurance team has a close relationship with the member of the assurance team and is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement. Therefore, members of the assurance team are responsible for identifying any such persons and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.

290.140 Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member of the assurance team and a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement. Therefore partners and employees of the firm are responsible for identifying any such relationships and for consulting in accordance with firm procedures. The evaluation of the significance of any threat created and the safeguards appropriate to eliminate the threat or reduce it to an acceptable level will include considering matters such as the closeness of the relationship, the interaction of the firm professional with the assurance team, the position held within the firm, and the role of the individual within the assurance client.

290.141 An inadvertent violation of this section as it relates to family and personal relationships would not impair the independence of a firm or a member of the assurance team when:

(a) The firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;

(b) Either the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and

(c) Additional care is given to reviewing the work of the professional.

290.142 When an inadvertent violation of this section relating to family and personal relationships has occurred, the firm should consider whether any safeguards should be applied. Such safeguards might include:

- Involving an additional professional accountant who did not take part in the assurance engagement to review the work done by the member of the assurance team; or
- Excluding the individual from any substantive decision-making concerning the assurance engagement.

Employment with Assurance Clients

290.143 A firm or a member of the assurance team's independence may be threatened if a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, a member of the assurance team's independence may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future.

290.144 If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

(a) The position the individual has taken at the assurance client.

(b) The amount of any involvement the individual will have with the assurance team.

(c) The length of time that has passed since the individual was a member of the assurance team or firm.

(d) The former position of the individual within the assurance team or firm.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary; or

- Quality control review of the assurance engagement.

In all cases, all of the following safeguards are necessary to reduce the threat to an acceptable level:

(a) The individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence.

(b) The individual does not continue to participate or appear to participate in the firm's business or professional activities.

290.145 A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that he or she is to, or may, join the assurance client some time in the future. This threat can be reduced to an acceptable level by the application of all of the following safeguards:

- Policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client.
- Removal of the individual from the assurance engagement.

In addition, consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

Recent Service with Assurance Clients

290.146 To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-interest, self-review and familiarity threats. This would be particularly true when a member of the assurance team has to report on, for example, subject matter information he or she had prepared or elements of the financial statements he or she had valued while with the assurance client.

290.147 If, during the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter information of the assurance engagement, the threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the assurance team.

290.148 If, prior to the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to exert direct and significant influence over the subject matter information of the assurance engagement, this may create self-interest, self-review and familiarity threats. For example, such threats would be created if a decision made or work performed by the individual in the prior period, while employed by the assurance client, is to be evaluated in the current period as part of the current assurance engagement. The significance of the threats will depend upon factors such as:

- The position the individual held with the assurance client;
- The length of time that has passed since the individual left the assurance client; and

- The role the individual plays on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Involving an additional professional accountant to review the work done by the individual as part of the assurance team or otherwise advise as necessary; or
- Discussing the issue with those charged with governance, such as the audit committee.

Serving as an Officer or Director on the Board of Assurance Clients

290.149 If a partner or employee of the firm serves as an officer or as a director on the board of an assurance client the self-review and self-interest threats created would be so significant no safeguard could reduce the threats to an acceptable level. In the case of a financial statement audit engagement, if a partner or employee of a network firm were to serve as an officer or as a director on the board of the audit client the threats created would be so significant no safeguard could reduce the threats to an acceptable level. Consequently, if such an individual were to accept such a position the only course of action is to refuse to perform, or to withdraw from the assurance engagement.

290.150 The position of Company Secretary has different implications in different jurisdictions. The duties may range from administrative duties such as personnel management and the maintenance of company records and registers, to duties as diverse as ensuring that the company complies with regulations or providing advice on corporate governance matters. Generally this position is seen to imply a close degree of association with the entity and may create self-review and advocacy threats.

290.151 If a partner or employee of the firm or a network firm serves as Company Secretary for a financial statement audit client the self-review and advocacy threats created would generally be so significant, no safeguard could reduce the threat to an acceptable level. When the practice is specifically permitted under local law, professional rules or practice, the duties and functions undertaken should be limited to those of a routine and formal administrative nature such as the preparation of minutes and maintenance of statutory returns.

290.152 Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

Long Association of Senior Personnel with Assurance Clients

General Provisions

290.153 Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team;
- The role of the individual on the assurance team;
- The structure of the firm; and

- The nature of the assurance engagement.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- Rotating the senior personnel off the assurance team;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary; or
- Independent internal quality reviews.

Financial Statement Audit Clients that are Listed Entities

290.154 Using the same engagement partner or the same individual responsible for the **engagement quality control review** on a financial statement audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the financial statement audit of a listed entity and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly in respect of the financial statement audit of listed entities:

(a) The engagement partner and the individual responsible for the engagement quality control review should be rotated after serving in either capacity, or a combination thereof, for a pre-defined period, normally no more than seven years; and

(b) Such an individual rotating after a pre-defined period should not participate in the audit engagement until a further period of time, normally two years, has elapsed.

290.155 When a financial statement audit client becomes a listed entity the length of time the engagement partner or the individual responsible for the engagement quality control review has served the audit client in that capacity should be considered in determining when the individual should be rotated. However, the person may continue to serve as the engagement partner or as the individual responsible for the engagement quality control review for two additional years before rotating off the engagement.

290.156 While the engagement partner and the individual responsible for the engagement quality control review should be rotated after such a predefined period, some degree of flexibility over timing of rotation may be necessary in certain circumstances. Examples of such circumstances include:

- Situations when the person's continuity is especially important to the financial statement audit client, for example, when there will be major changes to the audit client's structure that would otherwise coincide with the rotation of the person's; and
- Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard.

In all such circumstances when the person is not rotated after such a predefined period equivalent safeguards should be applied to reduce any threats to an acceptable level.

290.157 When a firm has only a few people with the necessary knowledge and experience to serve as engagement partner or individual responsible for the engagement quality control review on a financial statement audit client that is a listed entity, rotation may not be an appropriate safeguard. In these circumstances the firm should apply other safeguards to reduce the threat to an acceptable level. Such safeguards would include involving an additional professional accountant who was not otherwise associated with the assurance team to review the work done or otherwise advise as necessary. This individual could be someone from outside the firm or someone within the firm who was not otherwise associated with the assurance team.

Provision of Non-Assurance Services to Assurance Clients

290.158 Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from having these firms, which have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The greater the knowledge of the assurance client's business, the better the assurance team will understand the assurance client's procedures and controls, and the business and financial risks that it faces. The provision of non-assurance services may, however, create threats to the independence of the firm, a network firm or the members of the assurance team, particularly with respect to perceived threats to independence. Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services. In some cases it may be possible to eliminate or reduce the threat created by application of safeguards. In other cases no safeguards are available to reduce the threat to an acceptable level.

290.159 The following activities would generally create self-interest or self-review threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threats to an acceptable level:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so.
- Determining which recommendation of the firm should be implemented.
- Reporting, in a management role, to those charged with governance.

290.160 The examples set out in paragraphs 290.166–290.205 are addressed in the context of the provision of non-assurance services to an assurance client. The potential threats to independence will most frequently arise when a non-assurance service is provided to a financial statement audit client. The financial statements of an entity provide financial information about a broad range of transactions and events that have affected the entity. The subject matter information of other assurance services, however, may be limited in nature. Threats to independence, however, may also arise when a firm provides a non-assurance service related to the subject matter information, of a non-financial statement audit assurance engagement. In such cases, consideration should be given to the significance of the firm's involvement with the subject matter information, of the engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the engagement should be declined. When the non-assurance service is not related to the subject matter information, of the non-financial statement audit assurance engagement, the threats to independence will generally be clearly insignificant.

290.161 The following activities may also create self-review or self-interest threats:

- Having custody of an assurance client's assets.
- Supervising assurance client employees in the performance of their normal recurring activities.
- Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Making arrangements so that personnel providing such services do not participate in the assurance engagement;
- Involving an additional professional accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team; or
- Other relevant safeguards set out in national regulations.

290.162 New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all situations when providing non-assurance services to an assurance client might create threats to independence and of the different safeguards that might eliminate these threats or reduce them to an acceptable level. In general, however, a firm may provide services beyond the assurance engagement provided any threats to independence have been reduced to an acceptable level.

290.163 The following safeguards may be particularly relevant in reducing to an acceptable level threats created by the provision of non-assurance services to assurance clients:

- Policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions.
- Discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee.
- Policies within the assurance client regarding the oversight responsibility for provision of non-assurance services by the firm.
- Involving an additional professional accountant to advise on the potential impact of the non-assurance engagement on the independence of the member of the assurance team and the firm.
- Involving an additional professional accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement.
- Obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm.
- Disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged.

- Making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.

290.164 Before the firm accepts an engagement to provide a non-assurance service to an assurance client, consideration should be given to whether the provision of such a service would create a threat to independence. In situations when a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate safeguards can be applied to eliminate the threat or reduce it to an acceptable level.

290.165 The provision of certain non-assurance services to financial statement audit clients may create threats to independence so significant that no safeguard could eliminate the threat or reduce it to an acceptable level. However, the provision of such services to a related entity, division or discrete financial statement item of such clients may be permissible when any threats to the firm's independence have been reduced to an acceptable level by arrangements for that related entity, division or discrete financial statement item to be audited by another firm or when another firm re-performs the non-assurance service to the extent necessary to enable it to take responsibility for that service.

Preparing Accounting Records and Financial Statements

290.166 Assisting a financial statement audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.

290.167 It is the responsibility of financial statement audit client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include:

- Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the financial statement audit client;
- Authorizing or approving transactions; and
- Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

290.168 The audit process involves extensive dialogue between the firm and management of the financial statement audit client. During this process, management requests and receives significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for financial statement audit clients are an appropriate means to promote the fair presentation of the financial statements. The provision of such advice does not generally threaten the firm's independence. Similarly, the financial statement audit process may involve assisting an audit client in resolving account reconciliation problems, analyzing and accumulating information for regulatory reporting, assisting in the preparation of consolidated financial statements (including the translation of local statutory accounts to comply with group accounting policies and the transition to a different reporting framework such as International Financial Reporting Standards), drafting disclosure items, proposing adjusting journal entries and providing assistance and advice in the preparation of local statutory accounts of subsidiary entities. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence.

General Provisions

290.169 The examples in paragraphs 290.170–290.173 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter information of an audit engagement of the firm. This notion may be equally applicable in situations when the subject matter information of the assurance engagement is not financial statements. For example, a self-review threat would be created if the firm developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information. Consequently, the firm should evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

Financial Statements Audit Clients that are Not Listed Entities

290.170 The firm, or a network firm, may provide a financial statement audit client that is not a listed entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:

- Recording transactions for which the audit client has determined or approved the appropriate account classification;
- Posting coded transactions to the audit client's general ledger;
- Preparing financial statements based on information in the trial balance; and
- Posting the audit client approved entries to the trial balance.

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Making arrangements so such services are not performed by a member of the assurance team;
- Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client;
- Requiring the source data for the accounting entries to be originated by the audit client;
- Requiring the underlying assumptions to be originated and approved by the audit client; or
- Obtaining audit client approval for any proposed journal entries or other changes affecting the financial statements.

Financial Statement Audit Clients that are Listed Entities

290.171 The provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, on behalf of a financial statement audit client that is a listed entity, may impair the independence of the firm or network firm, or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services, except in emergency situations and when the services fall within the statutory audit mandate, could reduce the threat created to an acceptable level. Therefore, a firm or a network firm should not, with the limited exceptions below, provide such services to a listed entity that is a financial statement audit client.

290.172 The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of a financial statement audit client that is a listed entity would not be seen as impairing independence with respect to the audit client provided that the following conditions are met:

(a) The services do not involve the exercise of judgment.

(b) The divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client, or the services provided are collectively immaterial to the division or subsidiary.

(c) The fees to the firm, or network firm, from such services are collectively clearly insignificant.

If such services are provided, all of the following safeguards should be applied:

(a) The firm, or network firm, should not assume any managerial role nor make any managerial decisions.

(b) The audit client should accept responsibility for the results of the work.

(c) Personnel providing the services should not participate in the audit.

Emergency Situations

290.173 The provision of accounting and bookkeeping services to financial statement audit clients in emergency or other unusual situations, when it is impractical for the audit client to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:

(a) The firm, or network firm, does not assume any managerial role or make any managerial decisions;

(b) The audit client accepts responsibility for the results of the work; and

(c) Personnel providing the services are not members of the assurance team.

Valuation Services

290.174 A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

290.175 A self-review threat may be created when a firm or network firm performs a valuation for a financial statement audit client that is to be incorporated into the client's financial statements.

290.176 If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the financial statement audit engagement.

290.177 Performing valuation services for a financial statement audit client that are neither separately, nor in the aggregate, material to the financial statements, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary;
- Confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
- Obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm; and
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

In determining whether the above safeguards would be effective, consideration should be given to the following matters:

(a) The extent of the audit client's knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgment.

(b) The degree to which established methodologies and professional guidelines are applied when performing a particular valuation service.

(c) For valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned.

(d) The reliability and extent of the underlying data.

(e) The degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved.

(f) The extent and clarity of the disclosures in the financial statements.

290.178 When a firm, or a network firm, performs a valuation service for a financial statement audit client for the purposes of making a filing or return to a tax authority, computing an amount of tax due by the client, or for the purpose of tax planning, this would not create a significant threat to independence because such valuations are generally subject to external review, for example by a tax authority.

290.179 When the firm performs a valuation that forms part of the subject matter information of an assurance engagement that is not a financial statement audit engagement, the firm should consider any self-review threats. If the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

Provision of Taxation Services to Financial Statement Audit Clients

290.180 In many jurisdictions, the firm may be asked to provide taxation services to a financial statement audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.

Provision of Internal Audit Services to Financial Statement Audit Clients

290.181 A self-review threat may be created when a firm, or network firm, provides internal audit services to a financial statement audit client. Internal audit services may comprise an extension of the firm's audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.

290.182 Services involving an extension of the procedures required to conduct a financial statement audit in accordance with International Standards on Auditing would not be considered to impair independence with respect to the audit client provided that the firm's or network firm's personnel do not act or appear to act in a capacity equivalent to a member of audit client management.

290.183 When the firm, or a network firm, provides assistance in the performance of a financial statement audit client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by client management and the internal audit activities themselves.

290.184 Performing a significant portion of the financial statement audit client's internal audit activities may create a self-review threat and a firm, or network firm, should consider the threats and proceed with caution before taking on such activities. Appropriate safeguards should be put in place and the firm, or network firm, should, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.

290.185 Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:

(a) The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;

(b) The audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;

(c) The audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;

(d) The audit client is responsible for evaluating and determining which recommendations of the firm should be implemented;

(e) The audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and

(f) The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.

290.186 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

Provision of IT Systems Services to Financial Statement Audit Clients

290.187 The provision of services by a firm or network firm to a financial statement audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.

290.188 The self-review threat is likely to be too significant to allow the provision of such services to a financial statement audit client unless appropriate safeguards are put in place ensuring that:

(a) The audit client acknowledges its responsibility for establishing and monitoring a system of internal controls;

(b) The audit client designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;

(c) The audit client makes all management decisions with respect to the design and implementation process;

(d) The audit client evaluates the adequacy and results of the design and implementation of the system; and

(e) The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.

290.189 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

290.190 The provision of services by a firm, or network firm, to a financial statement audit client which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may also create a self-review threat. The significance of the threat, if any, should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

290.191 The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to create a threat to independence provided that firm or network firm personnel do not perform management functions.

Temporary Staff Assignments to Financial Statement Audit Clients

290.192 The lending of staff by a firm, or network firm, to a financial statement audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the firm's or network firm's personnel will not be involved in:

(a) Making management decisions;

(b) Approving or signing agreements or other similar documents; or

(c) Exercising discretionary authority to commit the client.

Each situation should be carefully analyzed to identify whether any threats are created and whether appropriate safeguards should be implemented. Safeguards that should be applied in all circumstances to reduce any threats to an acceptable level include:

- The staff providing the assistance should not be given audit responsibility for any function or activity that they performed or supervised during their temporary staff assignment; and
- The audit client should acknowledge its responsibility for directing and supervising the activities of firm, or network firm, personnel.

Provision of Litigation Support Services to Financial Statement Audit Clients

290.193 Litigation support services may include activities such as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.

290.194 A self-review threat may be created when the litigation support services provided to a financial statement audit client include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements. The significance of any threat created will depend upon factors such as:

- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned; and
- The nature of the engagement.

The firm, or network firm, should evaluate the significance of any threat created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to perform the service; or
- The involvement of others, such as independent experts.

290.195 If the role undertaken by the firm or network firm involved making managerial decisions on behalf of the financial statement audit client, the threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm or network firm should not perform this type of service for an audit client.

Provision of Legal Services to Financial Statement Audit Clients

290.196 Legal services are defined as any services for which the person providing the services must either be admitted to practice before the Courts of the jurisdiction in which such services are to be provided, or have the required legal training to practice law. Legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, litigation, mergers and acquisition advice and support and the provision of assistance to clients' internal legal departments. The provision of legal services by a firm, or network firm, to an entity that is a financial statement audit client may create both self-review and advocacy threats.

290.197 Threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entities' financial statements. The safeguards set out in paragraph 290.162 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances when the threat to independence cannot be reduced to an acceptable level the only available action is to decline to provide such services or withdraw from the financial statement audit engagement.

290.198 The provision of legal services to a financial statement audit client which involve matters that would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.

290.199 There is a distinction between advocacy and advice. Legal services to support a financial statement audit client in the execution of a transaction (e.g., contract support, legal advice, legal due diligence and restructuring) may create self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Such a service would not generally impair independence, provided that:

(a) Members of the assurance team are not involved in providing the service; and

(b) In relation to the advice provided, the audit client makes the ultimate decision or, in relation to the transactions, the service involves the execution of what has been decided by the audit client.

290.200 Acting for a financial statement audit client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the financial statements of the audit client would create advocacy and self-review threats so significant no safeguard could reduce the threat to an acceptable level. Therefore, the firm should not perform this type of service for a financial statement audit client.

290.201 When a firm is asked to act in an advocacy role for a financial statement audit client in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the financial statements of the audit client, the firm should evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client; or
- Using professionals who are not members of the assurance team to perform the service.

290.202 The appointment of a partner or an employee of the firm or network firm as General Counsel for legal affairs to a financial statement audit client would create self-review and advocacy threats that are so significant no safeguards could reduce the threats to an acceptable level. The position of General Counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, no member of the firm or network firm should accept such an appointment for a financial statement audit client.

Recruiting Senior Management

290.203 The recruitment of senior management for an assurance client, such as those in a position to affect the subject matter information of the assurance engagement, may create current or future self-interest, familiarity and intimidation threats. The significance of the threat will depend upon factors such as:

- The role of the person to be recruited; and
- The nature of the assistance sought.

The firm could generally provide such services as reviewing the professional qualifications of a number of applicants and provide advice on their suitability for the post. In addition, the firm could generally produce a short-list of candidates for interview, provided it has been drawn up using criteria specified by the assurance client.

The significance of the threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. In all cases, the firm should not make management decisions and the decision as to whom to hire should be left to the client.

Corporate Finance and Similar Activities

290.204 The provision of corporate finance services, advice or assistance to an assurance client may create advocacy and self-review threats. In the case of certain corporate finance services, the independence threats created would be so significant no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an assurance client's shares is not compatible with providing assurance services. Moreover, committing the assurance client to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level. In the case of a financial statement audit client the provision of those corporate finance services referred to above by a firm or a network firm would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level.

290.205 Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate strategies, assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria, and providing structuring advice and assisting a client in analyzing the accounting effects of proposed transactions. Safeguards that should be considered include:

- Policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
- Using professionals who are not members of the assurance team to provide the services; and
- Ensuring the firm does not commit the assurance client to the terms of any transaction or consummate a transaction on behalf of the client.

Fees and Pricing

Fees—Relative Size

290.206 When the total fees generated by an assurance client represent a large proportion of a firm's total fees, the dependence on that client or client group and concern about the possibility of losing the client may create a self-interest threat. The significance of the threat will depend upon factors such as:

- The structure of the firm; and
- Whether the firm is well established or newly created.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Discussing the extent and nature of fees charged with the audit committee, or others charged with governance;
- Taking steps to reduce dependency on the client;
- External quality control reviews; and
- Consulting a third party, such as a professional regulatory body or another professional accountant.

290.207 A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Policies and procedures to monitor and implement quality control of assurance engagements; and
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary.

Fees—Overdue

290.208 A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally the payment of such fees should be required before the report is issued. The following safeguards may be applicable:

- Discussing the level of outstanding fees with the audit committee, or others charged with governance.
- Involving an additional professional accountant who did not take part in the assurance engagement to provide advice or review the work performed.

The firm should also consider whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed.

Pricing

290.209 When a firm obtains an assurance engagement at a significantly lower fee level than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless:

(a) The firm is able to demonstrate that appropriate time and qualified staff are assigned to the task; and

(b) All applicable assurance standards, guidelines and quality control procedures are being complied with.

Contingent Fees

290.210 Contingent fees are fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them.

290.211 A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter information of the assurance engagement.

290.212 A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. If the amount of the fee for a non-assurance engagement was agreed to, or contemplated, during an assurance engagement and was contingent on the result of that assurance engagement, the threats could not be reduced to an acceptable level by the application of any safeguard. Accordingly, the only acceptable action is not to accept such arrangements. For other types of contingent fee arrangements, the significance of the threats created will depend on factors such as:

- The range of possible fee amounts;
- The degree of variability;

- The basis on which the fee is to be determined;
- Whether the outcome or result of the transaction is to be reviewed by an independent third party; and
- The effect of the event or transaction on the assurance engagement.

The significance of the threats should be evaluated and, if the threats are other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threats to an acceptable level. Such safeguards might include:

- Disclosing to the audit committee, or others charged with governance, the extent and nature of fees charged;
- Review or determination of the final fee by an unrelated third party; or
- Quality and control policies and procedures.

Gifts and Hospitality

290.213 Accepting gifts or hospitality from an assurance client may create self-interest and familiarity threats. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality.

Actual or Threatened Litigation

290.214 When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created. The relationship between client management and the members of the assurance team must be characterized by complete candor and full disclosure regarding all aspects of a client's business operations. The firm and the client's management may be placed in adversarial positions by litigation, affecting management's willingness to make complete disclosures and the firm may face a self-interest threat. The significance of the threat created will depend upon such factors as:

- The materiality of the litigation;
- The nature of the assurance engagement; and
- Whether the litigation relates to a prior assurance engagement.

Once the significance of the threat has been evaluated the following safeguards should be applied, if necessary, to reduce the threats to an acceptable level:

(a) Disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;

(b) If the litigation involves a member of the assurance team, removing that individual from the assurance team; or

(c) Involving an additional professional accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the assurance engagement.

Section 290 Interpretations

These interpretations are directed towards the application of the IFAC *Code of Ethics for Professional Accountants* to the topics of the specific queries received. Those subject to the regulations of other authoritative bodies, such as the US Securities and Exchange Commission, may wish to consult with them for their positions on these matters.

Interpretation 2003-01

The Provision of Non-Assurance Services to Assurance Clients

The *Code of Ethics for Professional Accountants* addresses the issue of the provision of non assurance services to assurance clients in paragraphs 290.158–290.205 inclusive. The Code does not currently include any transitional provisions relating to the requirements set out in these paragraphs however the Ethics Committee has concluded that it is appropriate to allow a transitional period of one year, during which existing contracts to provide non assurance services for assurance clients may be completed if additional safeguards are put in place to reduce any threat to independence to an insignificant level. This transitional period commences on December 31, 2004 (or from the date of implementation of the Code for members of those IFAC member bodies which have adopted an earlier implementation date).

Interpretation 2003-02

Lead Engagement Partner Rotation for Audit Clients that are Listed Entities

The *Code of Ethics for Professional Accountants* addresses the issue of engagement partner rotation for financial statement audit clients that are listed entities in paragraphs 290.154–290.157.

The paragraphs state that in the financial statement audit of a listed entity the engagement partner should be rotated after serving in that capacity for a pre-defined period, normally no more than seven years. They also state that some degree of flexibility in timing of rotation may be necessary in certain circumstances. The Ethics Committee believes that the implementation (or early adoption) of the Code constitutes an example of a circumstance in which some degree of flexibility over timing of rotation may be necessary.

The Code does not currently include any transitional provisions relating to these requirements. However, the Ethics Committee has concluded that it is appropriate to allow a transitional period of two years. Consequently, on implementation or early adoption of the Code, while the length of time the engagement partner has served the financial statement audit client in that capacity should be considered in determining when rotation should occur, the partner may continue to serve as the engagement partner for two additional years from the date of implementation (or early adoption) before rotating off the engagement. In such circumstances, the additional requirements of paragraph 290.157 to apply equivalent safeguards in order to reduce any threats to an acceptable level should be followed.

Interpretation 2005-01

Application of Section 290 to Assurance Engagements that are Not Financial Statement Audit Engagements

This interpretation provides guidance on the application of the independence requirements contained in Section 290 to assurance engagements that are not financial statement audit engagements.

This interpretation focuses on the application issues that are particular to assurance engagements that are not financial statement audit engagements. There are other matters noted in Section 290 that are relevant in the consideration of independence requirements for all assurance engagements. For example, paragraph 290.28 states that consideration should be given to any threats the firm has reason to believe may be created by network firms' interests and relationships. Similarly, paragraph 290.34 states that for assurance clients, that are other than listed entity financial statement audit clients, when the assurance team has reason to believe that a related entity of such an assurance client is relevant to the evaluation of the firm's independence of the client, the assurance team should consider that related entity when evaluating independence and applying appropriate safeguards. These matters are not specifically addressed in this interpretation.

As explained in the International Framework for Assurance Engagements issued by the International Auditing and Assurance Standards Board, in an assurance engagement, the professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

Assertion-Based Assurance Engagements

In an assertion-based assurance engagement, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

In an assertion-based assurance engagement independence is required from the responsible party, which is responsible for the subject matter information and may be responsible for the subject matter.

In those assertion-based assurance engagements where the responsible party is responsible for the subject matter information but not the subject matter, independence is required from the responsible party. In addition, consideration should be given to any threats the firm has reason to believe may be created by interests and relationships between a member of the assurance team, the firm, a network firm and the party responsible for the subject matter.

Direct Reporting Assurance Engagements

In a direct reporting assurance engagement, the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report.

In a direct reporting assurance engagement independence is required from the responsible party, which is responsible for the subject matter.

Multiple Responsible Parties

In both assertion-based assurance engagements and direct reporting assurance engagements there may be several responsible parties. For example, a public accountant in public practice may be asked to provide assurance on the monthly circulation statistics of a number of independently owned newspapers. The assignment could be an assertion based assurance engagement where each newspaper measures its circulation and the statistics are presented in an assertion that is available to the intended users. Alternatively, the assignment could be a direct reporting assurance engagement, where there is no assertion and there may or may not be a written representation from the newspapers.

In such engagements, when determining whether it is necessary to apply the provisions in Section 290 to each responsible party, the firm may take into account whether an interest or relationship between the firm, or a member of the assurance team, and a particular responsible party would create a threat to independence that is other than clearly insignificant in the context of the subject matter information. This will take into account:

- The materiality of the subject matter information (or the subject matter) for which the particular responsible party is responsible; and
- The degree of public interest that is associated with the engagement.

If the firm determines that the threat to independence created by any such relationships with a particular responsible party would be clearly insignificant it may not be necessary to apply all of the provisions of this section to that responsible party.

Example

The following example has been developed to demonstrate the application of Section 290. It is assumed that the client is not also a financial statement audit client of the firm, or a network firm.

A firm is engaged to provide assurance on the total proven oil reserves of 10 independent companies. Each company has conducted geographical and engineering surveys to determine their reserves (subject matter). There are established criteria to determine when a reserve may be considered to be proven which the professional accountant in public practice determines to be suitable criteria for the engagement.

The proven reserves for each company as at December 31, 20X0 were as follows:

	Proven oil reserves thousands barrels
Company 1	5,200
Company 2	725
Company 3	3,260
Company 4	15,000
Company 5	6,700
Company 6	39,126
Company 7	345
Company 8	175
Company 9	24,135
Company 10	9,635
Total	**104,301**

The engagement could be structured in differing ways:

Assertion-Based Engagements

A1 Each company measures its reserves and provides an assertion to the firm and to intended users.

A2 An entity other than the companies measures the reserves and provides an assertion to the firm and to intended users.

Direct Reporting Engagements

D1 Each company measures the reserves and provides the firm with a written representation that measures its reserves against the established criteria for measuring proven reserves. The representation is not available to the intended users.

D2 The firm directly measures the reserves of some of the companies.

Application of Approach

A1 Each company measures its reserves and provides an assertion to the firm and to intended users.

There are several responsible parties in this engagement (companies 1-10). When determining whether it is necessary to apply the independence provisions to all of the companies, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant. This will take into account factors such as:

- The materiality of the company's proven reserves in relation to the total reserves to be reported on; and
- The degree of public interest associated with the engagement. (Paragraph 290.33.)

For example, Company 8 accounts for 0.16% of the total reserves, therefore a business relationship or interest with Company 8 would create less of a threat than a similar relationship with Company 6, which accounts for approximately 37.5% of the reserves.

Having determined those companies to which the independence requirements apply, the assurance team and the firm are required to be independent of those responsible parties which would be considered to be the assurance client (paragraph 290.33).

A2 An entity other than the companies measures the reserves and provides an assertion to the firm and to intended users.

The firm would be required to be independent of the entity that measures the reserves and provides an assertion to the firm and to intended users (paragraph 290.30). That entity is not responsible for the subject matter and so consideration should be given to any threats the firm has reason to believe may be created by interests/relationships with the party responsible for the subject matter (paragraph 290.30). There are several parties responsible for subject matter in this engagement (Companies 1-10) As discussed in example A1 above, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant.

D1 Each company provides the firm with a representation that measures its reserves against the established criteria for measuring proven reserves. The representation is not available to the intended users.

There are several responsible parties in this engagement (Companies 1-10). When determining whether it is necessary to apply the independence provisions to all of the companies, the firm may take into account whether an interest or relationship with a particular company would create a threat to independence that is other than clearly insignificant. This will take into account factors such as:

- The materiality of the company's proven reserves in relation to the total reserves to be reported on; and
- The degree of public interest associated with the engagement. (paragraph 290.33).

For example Company 8 accounts for 0.16% of the reserves, therefore a business relationship or interest with Company 8 would create less of a threat than a similar relationship with Company 6 that accounts for approximately 37.5% of the reserves.

Having determined those companies to which the independence requirements apply, the assurance team and the firm are required to be independent of those responsible parties which would be considered to be the assurance client (paragraph 290.33).

D2 The firm directly measures the reserves of some of the companies.

The application is the same as in example D1.

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