FINAL : PAPER - 19

COST AND MANAGEMENT AUDIT

FINAL

STUDY NOTES

The Institute of Cost Accountants of India
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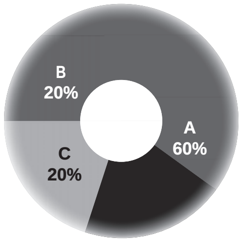
Syllabus

PAPER 19: COST AND MANAGEMENT AUDIT (CMAD)

Syllabus Structure

The syllabus comprises the following topics and study weightage:

A	Cost and Management Audit	60%
B	Internal Audit and Operational Audit	20%
C	Case Study on Performance Analysis	20%



ASSESSMENT STRATEGY

There will be written examination (including case study / caselet analysis) paper of three hours

OBJECTIVE

To promote the knowledge of Cost and Management Accountancy to provide educational facilities for training of budding professionals for excelling in the field of management accounting. To promote the decision-making skills and administrative competence relevant to management accounting and corporate management in general.

Learning Aims

The syllabus aims to test the student's ability to:

- Focus on basic cost information, appropriately computed cost centre wise, system based cost data support for decision-making processes
- Ensure uniformity and maintain cost records as per Generally Accepted Cost Accounting Principles
- Tabulate the cost information and construct the system thus evolved for gainful operation and use in the strategy making for measuring productivity, profitability, etc.
- Prepare cost audit report in compliance with statutory obligations
- Understand the usefulness of cost audit and interpret for stakeholders view
- Discuss the concepts of management audit and demonstrate its usefulness
- Evaluate the performance of an organization through cost accounting records and cost audit reports
- Recommend desired course of action for optimal utilization of scarce resources which can lead to improve the productivity and profitability of an organization

Skill Set required

Level C: Requiring skill levels of knowledge, comprehension, application, analysis, synthesis and evaluation.

Section A : Cost and Management Audit	**60%**
1. Companies (Cost Records and Audit) Rules, 2014 [in lieu of CARR and CAR]	
2. Cost Accounting Standards	
3. Cost Auditing Standards [CAAS – renamed as Cost Auditing Standards as per Section 148(3) of Companies Act, 2013]	
4. Cost Auditor – appointment and related issues	
5. Management Reporting under Cost Audit	
Section B: Internal Audit and Operational Audit	**20%**
6. Internal Audit and Operational Audit	
Section C: Case Study on Performance Analysis	**20%**

SECTION A: COST AND MANAGEMENT AUDIT [60 MARKS]

1. **Companies (Cost Records and Audit) Rules, 2014**

   (in lieu of Cost Accounting Record Rules, 2011 & Cost Audit Report Rules, 2011)

2. **Cost Accounting Standards**

3. **Cost Auditing Standards**

   (in lieu of Cost Audit & Assurance Standards)

4. **Cost audit, appointment of cost auditor**

   (a) Nature and scope of cost audit

   (b) Provisions under Companies Act relating to maintenance of Cost Records and Cost Audit

   (c) Cost auditor-appointment, rights and responsibilities

   (d) Structuring the cost audit

   (e) Product-group Classification

5. **Management Reporting under Cost Audit**

   (a) Management Reporting issues under Cost Audit

Section B: Internal Audit and Operational Audit [20 marks]

6. **Internal audit and operational audit**

   (a) Concept of internal and operational audit

   (b) Internal Audit–techniques and procedures

   (c) Internal Audit Report

   (d) Operational Audit–techniques and procedures

   (e) Operational audit report

   (f) Special report for banks, shareholders, employees etc

   (g) Evaluation of internal control system, budgetary control system, inventory control system, management information system

   (h) Management Audit–concepts, procedures

Section C: Case Study on Performance Analysis – based on information as per Companies (Cost Records and Audit) Rules, 2014 [20 marks]

FORM OF THE PERFORMANCE APPRAISAL REPORT

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Study Note - 1

COST AUDIT

This Study Note includes

1.1 Cost Audit – Basics
1.2 Origin of Cost Audit
1.3 Genesis of Cost Audit in India
1.4 Relevance of Cost Audit
1.5 Objectives of Cost Audit
1.6 Cost Records and Cost Audit – as per Companies Act, 2013
1.7 Companies (Cost Records and Audit) Rules, 2014

1.1 COST AUDIT - BASICS

Cost Audit involves an examination of cost books, cost accounts, cost statements and subsidiary and prime documents with a view to satisfying the auditor that these represent true and fair view of the cost of production. This includes the examination of the appropriateness of Cost Accounting system.

The term cost audit has been defined by the Institute as "Cost audit is an independent examination of cost and other related information in respect of a product or group of products of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon".

The Institute of Cost 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.

1.2 ORIGIN OF COST AUDIT

In India, methods and techniques of cost accounting and audit of cost accounts can be traced back to pre-independence era when a large number of firms were given contracts by the Government of India on cost plus basis. The Government then started verifying and investigating into the cost structure of such firms. This trend continued on a large scale during World War II that led to the recognition of cost as a distinct concept not only in India but also in the industrial economies of the world. A phenomenon of cost consciousness started taking shape in the country and the Institute of Cost and Works Accountants of India was set up in 1944 with the objectives of promoting, regulating, and developing the profession of cost accountancy in the country.

The Institute of Cost and Works Accountants of India (now The Institute of Cost Accountants of India) was later incorporated as a statutory body by an Act of Parliament in 1959. In moving the Cost and Works Accountants Bill for reference to the Joint Committee, the Deputy Minister of Commerce and Industry explained the nature and purpose of cost accounting as follows (Lok Sabha Debates, Vol. XXIV, dated 20th December, 1958, pp. 6608-09):

"Cost accounting is a function entirely different from general or financial accounting. Cost accountancy covers a wide range of subjects, with special emphasis on cost accounting, factory organization and management, engineering techniques, and knowledge of the working of the factories. The cost accountant performs services involving pricing of goods, preparation, verification, certification of cost accounts and related statements, or recording presentation or certification of cost facts or data. In a manufacturing concern, he works out the economical cost of production and evaluates its progress at each stage of production. In mass production enterprises, he points out wastage of manpower due to overstaffing or inefficient organization and indicates the output, the capacity of the machines and labour, the stock position, the movement of stores and weakness in the production process. The systematic determination of cost in every single and distinct process of manufacturing provides a continuous check on the margin of waste in the processing of raw and semi-finished materials, on the utilisation of machinery installed, on manpower expended and the percentage of rejection of finished products. This pinpoints also the particular process in which defects and deficiencies exist, thereby enabling immediate remedial measure being taken. Costing, in short, aims at making the organization efficient and economical, by providing the minimum of labour and material and getting the full capacity of the machine output. The cost accountant, therefore, is concerned solely and mainly with the internal economy of the industry, and renders services essential to the day-to-day management of the undertaking."

1.3 GENESIS OF COST AUDIT IN INDIA

In the mid-fifties, famous case of corporate frauds in Dalmia-Jain companies virtually jolted the then Government. It resulted in the Government appointing Vivian Bose Commission and later the Dutta Commission and Daphtary-Sastri Committee. These Commissions/ Committees observed inadequacies in the then existing system of financial accounting and audit and also in the then existing system of corporate disclosures. They recommended a more effective system of cost accounting and cost audit, to supplement the financial accounting and auditing practices.

Further, in the initial phase of industrial development of the country, there was an acute shortage of goods & materials, as well as, majority of inputs and resources for the production/manufacture of various capital & consumer goods. In the face of scarcity and shortage of almost all the inputs, products and services, Government had to resort to a policy of permits and licensing. A mechanism of Cost audit and maintenance of structured cost data were considered as important instruments in the hands of the regulatory authorities to monitor, control and regulate the efficient use of scarce resources and inputs so made available and monitor cost of production and administer prices. Thus, Cost Audit as a unique feature of corporate management in India, emerged.

1.4 RELEVANCE OF COST AUDIT

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 the Companies Act, 1956 was to meet the Government requirements for regulating the price mechanism in some core industries. 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.

The liberalization of the economy and consequential globalization has further enhanced the need for authentic data.

The Expert committee formed by the Government of India to study the Cost Audit scenario in the country, highlighted the following benefits of cost information:

- Cost Information enables the organization to structure the cost, understand it and use it for communicating with the stakeholders.
- Costing is an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It informs how profits and value are created, and how efficiently and effectively

operational processes transform input into output. It contributes to the data input on economy level parameters like resources efficiency, waste management, resources allocation policies etc.

❖ Costing includes product, process, and resource-related information covering the functions of the organization and its value chain. Costing information can be used to appraise actual performance in the context of implemented strategies.

❖ Good practice in costing should support a range of both regular and non-routine decisions when designing products and services to
  - meet customer expectations and profitability targets;
  - assist in continuous improvements in resources utilisation; and
  - guide product mix and investment decisions.

❖ Working from a common data source (or a single set of sources) also helps to ensure that output reports for different audiences are reconcilable with each other.

❖ Integrating databases and information systems can help to provide useful costing information more efficiently as well as reducing source data manipulation.

As per International Federation of Accountants (IFAC), the general principles of costing and the design of costing systems in this Guidance are generally applicable to all types of organization. For example, cost information is an equally important driver of performance information and reporting in public and not-for-profit organizations. However, some jurisdictions apply legislative expectations on performance. These legislative mandates require reporting entities to develop and report cost information on a consistent and regular basis. Rules in some jurisdictions prescribe the calculation of unit costs to (a) allow comparisons between public authorities, and (b) establish the performance of specific activities.

Cost audits help to ascertain whether an organization's cost accounting records are so maintained as to give a true and fair view of the cost of production, processing, manufacturing, and mining of a product. Therefore, cost audits can be used to the benefit of management, consumers and shareholders by (a) helping to identify weaknesses in cost accounting systems, and (b) to help drive down costs by detecting wastage and inefficiencies. Cost audits are also of assistance to governments in helping to formulate tariff and taxation policies.

The Expert Group noted that the Indian economy has to migrate from the current status to the top end position of the global competitiveness index in a short/medium time span. In a paper published by Mr. P.L. Joshi (University of Bahrain in 2001) based on a survey of firms in India on adoption of management accounting techniques it has been stated that, "Indian managements are generally conservative in adopting to new techniques of management accounting." Considering the maturity levels of cost and management accounting in Indian economy caused by the legacy of protected environment, we have a long way to traverse without the luxury of time. We do not have the luxury of a long experience curve for this to happen and need to work out the strategies including policy intervention which will position cost and management accounting as a soft infrastructure towards building national competitiveness. We can look at the following maturity levels for devising a strategy:

Base Level	:	Plethora of legacy practices of cost accounting/ management
Level II	:	A National standard level of cost accounting discipline
Level III	:	A self driven level of world class cost/management accounting

The Expert Group was of the view that migrating through above levels should be at great speed and especially Level II will require statutory drive through standard cost accounting practices for the entire corporate sector. Once an enterprise crosses Level II into Level III it will be in a mode of voluntary adoption of all cost and management accounting guidelines to be issued by professional bodies either for internal financial management or for external reporting.

Hence, the Expert Group recommended phased introduction of cost accounting and cost audit framework in all companies to achieve the highest levels of competitiveness

The Group strongly believed that the Indian economy is at a maturity level of II. Therefore, instead of strict rules and laws, Indian industry needs directions, principles and guidance from the Government. At this maturity level, the Group felt that the industry should be given more freedom and flexibility and ultimately, over a period of time, the industry will achieve sufficient maturity level where driving force will be self discipline rather than any law of the Government. Till Indian industry reaches at the highest level of maturity, there is a need for compliance & monitoring mechanism in all fundamental parameters of economic activities.

The group also recognized that there is a major focus shift from the corporate governance to the enterprise governance. IFAC too, has started recognizing the need for adequate cost information and reporting framework to the governing body of enterprises for risk-management and decision making needed to enhance the stakeholders' value. IFAC has also very clearly highlighted the usage of such framework in the functioning of government and other public agencies. It is significantly clear that government regulation has to come to stay in the global economy. The international bodies, concerned with economic activities, like WTO, European Union etc. have emphasized the need for regulation in one form or other. At present, the regulatory bodies have prescribed their own formats in which the companies are required to submit the necessary cost information. In the absence of accurate and reliable cost data at the end of the companies/utilities, the regulatory bodies cannot discharge their statutory responsibilities in, say, fixing the correct tariff and other charges. They take the certified cost data in the prescribed formats from the companies/service providers. Such data is generated from the companies costing systems and if they are not well designed and implemented, even the certified copies may not provide relevant and reliable data to the regulatory bodies on which they base their decisions. Hence, it is highly mandated and imperative to ensure that the companies are maintaining proper records of costing through well designed costing accounting system and get these records duly audited/certified from an independent cost expert.

1.5 OBJECTIVES OF COST AUDIT

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.

- 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.

1.6 COST RECORDS AND COST AUDIT – AS PER COMPANIES ACT, 2013

As per section 2(13) of Companies Act, 2013, "books of account" includes records maintained in respect of—

(i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;

(ii) all sales and purchases of goods and services by the company;

(iii) the assets and liabilities of the company; and

(iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section;

Books of account, etc., to be kept by company [Section 128]

(1) Every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting:

Provided that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within seven days thereof, file with the Registrar a notice in writing giving the full address of that other place:

Provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

(2) Where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place referred to in sub-section (1).

(3) The books of account and other books and papers maintained by the company within India shall be open for inspection at the registered office of the company or at such other place in India by any director during business hours, and in the case of financial information, if any, maintained outside the country, copies of such financial information shall be maintained and produced for inspection by any director subject to such conditions as may be prescribed:

Provided that the inspection in respect of any subsidiary of the company shall be done only by the person authorised in this behalf by a resolution of the Board of Directors.

(4) Where an inspection is made under sub-section (3), the officers and other employees of the company shall give to the person making such inspection all assistance in connection with the inspection which the company may reasonably be expected to give.

(5) The books of account of every company relating to a period of not less than eight financial years immediately preceding a financial year, or where the company had been in existence for a period less than eight years, in respect of all the preceding years together with the vouchers relevant to any entry in such books of account shall be kept in good order:

Provided that where an investigation has been ordered in respect of the company under Chapter XIV, the Central Government may direct that the books of account may be kept for such longer period as it may deem fit.

(6) If the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person of a company charged by the Board with the duty of complying with the provisions of this section, contravenes such provisions, such managing director, whole-time director in charge of finance, Chief Financial officer or such other person of the company shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees or with both.

Central Government to Specify Audit of Items of Cost in respect of certain Companies [Section 148]

(1) The Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

Provided that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

(2) If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.

(3) The audit under sub-section (2) shall be conducted by a Cost Accountant in practice who shall be appointed by the Board on such remuneration as may be determined by the members in such manner as may be prescribed.

Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards.

Explanation.— For the purposes of this sub-section, the expression "cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government.

(4) An audit conducted under this section shall be in addition to the audit conducted under section 143.

(5) The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

Provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

(6) A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared in pursuance of a direction under sub-section (2) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.

(7) If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company under sub-section (6), the Central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

(8) If any default is made in complying with the provisions of this section,—

(a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147;

(b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.

1.7 COMPANIES (COST RECORDS AND AUDIT) RULES, 2014

The salient features are as follows:

- The Companies are required to maintain Cost Records if turnover exceeds ₹ 35 crores or more during immediately preceding Financial Year in respect of the products and services specified;
- The Companies (Cost Records and Audit) Rules, 2014 has categorised the entities into Regulated Sector and Unregulated Sectors;
- The entities falling under the Regulated sectors having overall annual turnover of ₹ 50 crores or more and the aggregate turnover of the individual products or services of ₹ 25 crores or more have to get their Cost Records Audited;
- Six sectors are brought under the Regulated category namely Telecommunication services; Power generation, Transmission, Distribution and Supply; Petroleum products; Drugs and Pharmaceuticals; Fertilisers; Sugar and Industrial alcohol;
- The entities falling under the Unregulated category viz. Business of plastics and polymers, glass, electrical, textiles, milk powder businesses, etc., having annual turnover of ₹ 100 crores or more and the aggregate turnover of the individual products or services of ₹ 35 crores or more have to get their Cost Records Audited;
- Exemptions are provided to Companies whose revenue from exports, in foreign exchange, exceeds 75% of total revenue and Companies operating from Special Economic Zones.

[This is explained in details in Study Note 2]

Study Note - 2

COMPANIES (COST RECORDS & AUDIT) RULES, 2014 & GUIDANCE NOTE ON COST ACCOUNTING STANDARDS

This Study Note includes

Section – A

2.1 Companies (Cost Records & Audit) Rules, 2014

Section – B

2.2 Guidance Note on Cost Accounting Standard on Cost of Production for Captive Consumption (CAS-4)

2.3 Guidance Note on Cost Accounting Standard on Material Cost (CAS-6)

2.4 Guidance Note on Cost Accounting Standard on Employee Cost (CAS-7)

2.5 Guidance Note on Cost Accounting Standard on Cost of Utilities (CAS-8)

2.6 Guidance Note on Cost Accounting Standard on Packing Material Cost (CAS-9)

2.7 Guidance Note on Cost Accounting Standard on Administrative Overheads (CAS-11)

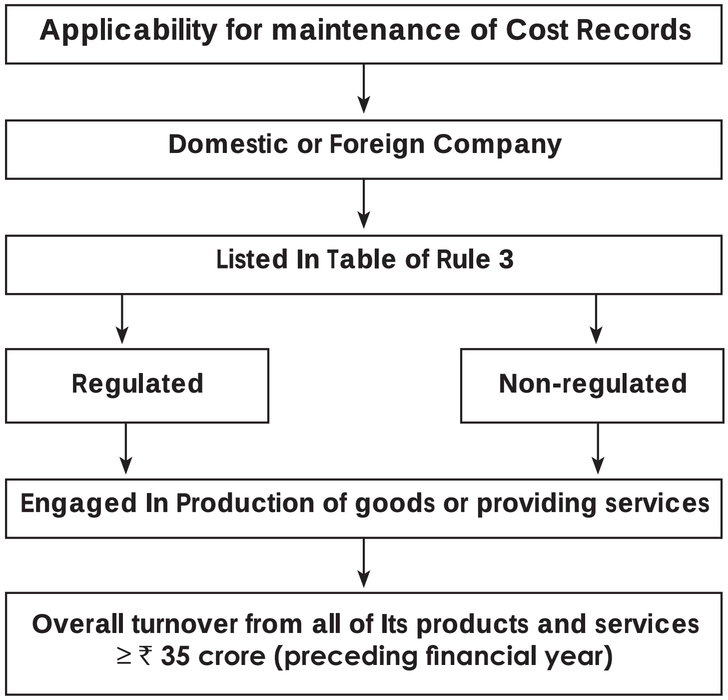
SECTION - A

2.1 COMPANIES (COST RECORDS & AUDIT) RULES, 2014

An analysis through – diagrammatic representation

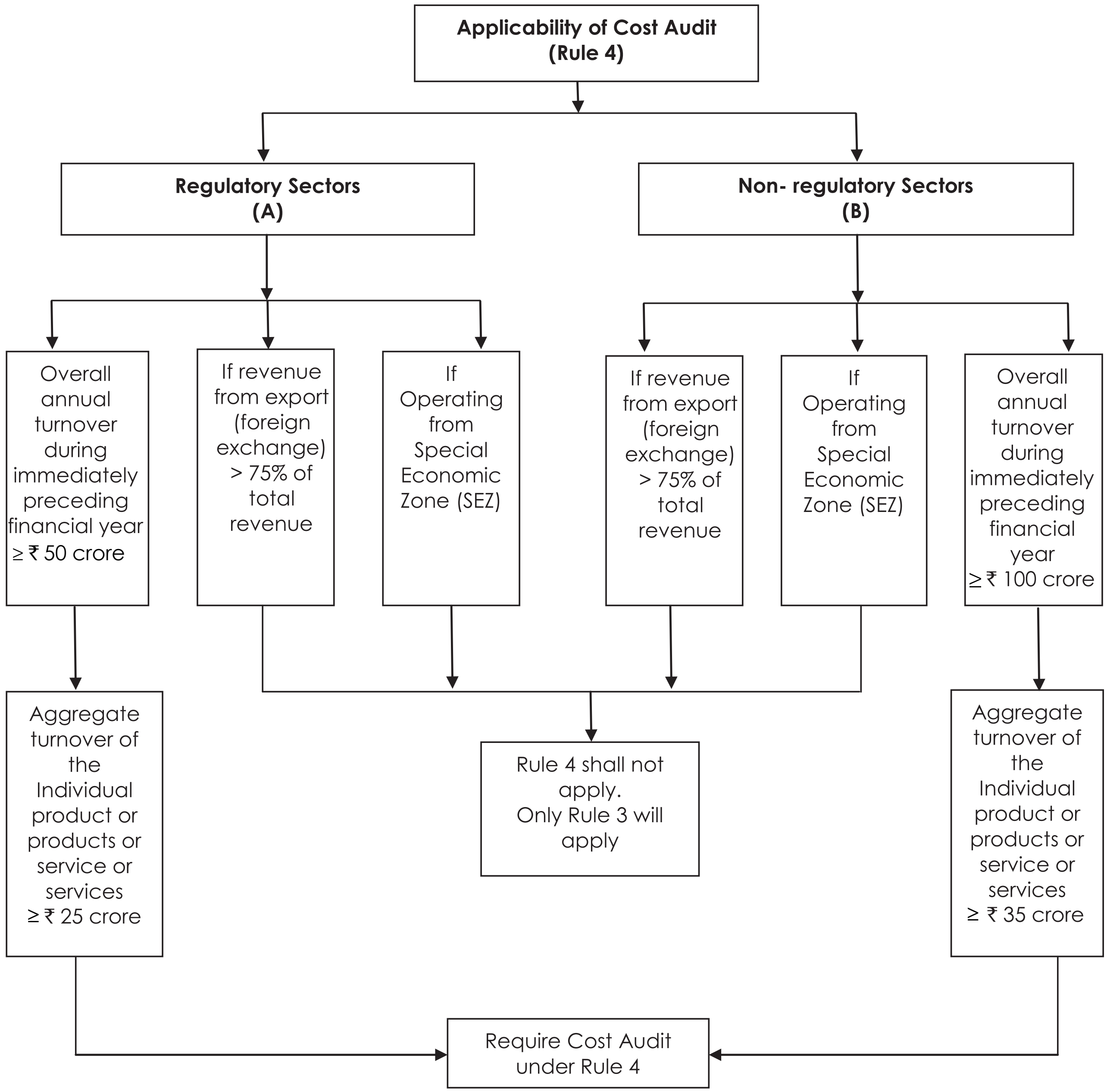
Rules/Forms	Summary
Rule 1: Short title and commencement	**(1)** These rules may be called the Companies (Cost Records and Audit) Rules, 2014. **(2)** They shall come into force on the date of publication in the Official Gazette i.e. 30.06.2014.
Rule 2: Definitions	In these rules, defined various points - **(a)** Act; **(aa)** Central Excise Tariff Act Heading; **(b)** Cost Accountant in practice; **(c)** cost auditor **(d)** cost audit report; **(e)** cost records; **(f)** form; **(g)** institute; **(h)** all other words and expressions used in these rules but not defined, and defined in the Act or in the Companies (Specification of Definition Details) Rules, 2014 shall have the same meanings as assigned to them in the Act or in the said rules.
Rule-3: Application of Cost Records	Two categories (regulated sectors and non-regulated sectors) have been retained and a general threshold of turnover of ₹ 35 crores or more has been prescribed for companies covered. Micro enterprise or a small enterprise as per MSMED Act, 2006 have been taken out of the purview.

Rule 3: Diagrammatic Representation

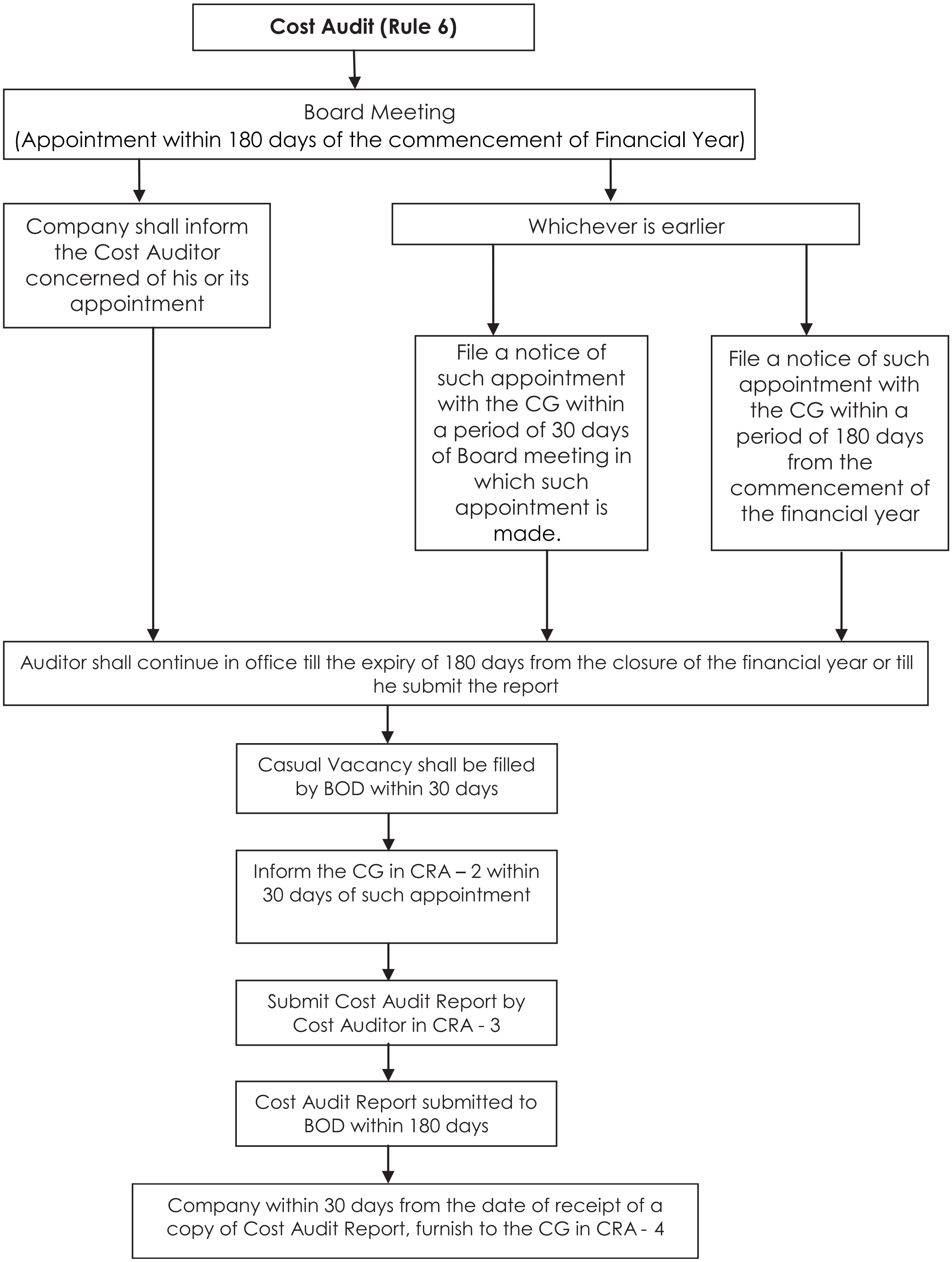


Rule-4: Applicability for Cost Audit	Even for regulated sectors like Telecommunication, Electricity, Petroleum and Gas, Drugs and Pharma, Fertilizers and Sugar, Cost audit requirement has been made subject to a turnover based threshold of ₹ 50 crores for all product and services and ₹ 25 crores for individual product or services. For Non-regulated sector the threshold is ₹ 100 crores and ₹ 35 crores respectively.

Rule 4: Diagrammatic Representation



Rule-5: Maintenance of Cost Records	The requirement to maintain cost records in Form CRA-1 have been postponed to Financial Year 2015-16 for the following companies in some non-regulated sectors, namely; Coffee and Tea, Milk Powder and Electricals and electronic machinery.
Rule-6: Cost Audit	Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal to be filled by the Board of Directors within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within thirty days of such appointment of cost auditor.


Cost Audit (Rule 6)
Board Meeting
(Appointment within 180 days of the commencement of Financial Year)
Company shall inform the Cost Auditor concerned of his or its appointment
Whichever is earlier
File a notice of such appointment with the CG within a period of 30 days of Board meeting in which such appointment is made.
File a notice of such appointment with the CG within a period of 180 days from the commencement of the financial year
Auditor shall continue in office till the expiry of 180 days from the closure of the financial year or till he submit the report
Casual Vacancy shall be filled by BOD within 30 days
Inform the CG in CRA – 2 within 30 days of such appointment
Submit Cost Audit Report by Cost Auditor in CRA - 3
Cost Audit Report submitted to BOD within 180 days
Company within 30 days from the date of receipt of a copy of Cost Audit Report, furnish to the CG in CRA - 4

CRA-1: Forms in which cost records shall be maintained **[Pursuant to rule 5(1)]**	The form CRA-1 prescribes the form in which cost records shall be maintained. The form categorises the requirement of maintaining proper details as per 30 headings. The headings are as follows: **(1)** Material Cost, **(2)** Employee Cost, **(3)** Utilities, **(4)** Direct Expenses, **(5)** Repair and Maintenance, **(6)** Fixed Assets and Depreciation, **(7)** Overheads, **(8)** Administrative Overheads, **(9)** Transportation Cost, **(10)** Royalty and Technical Know-how, **(11)** Research and Development expenses, **(12)** Quality Control Expenses, **(13)** Pollution Control Expenses, **(14)** Service Department Expenses, **(15)** Packing Expenses, **(16)** Interest and Financing Charges, **(17)** Any other item of Cost, **(18)** Capacity Determination, **(19)** Work-in-progress and finished stock, **(20)** Captive Consumption, **(21)** By-Products and Joint Products, **(22)** Adjustment of Cost Variances, **(23)** Reconciliation of Cost and Financial Accounts, **(24)** Related Party Transactions, **(25)** Expenses or Incentives on Exports, **(26)** Production records, **(27)** Sales records, **(28)** Cost Statements, **(29)** Statistical Records, **(30)** Records of Physical Verification.
CRA-2: Form of intimation of appointment of cost auditor by the company to **Central Government** **[Pursuant to rule 6(2) & (3A)]**	**(1)** Corporate Identity number (CIN) or foreign company registration number (FCRN) of the company **(2)** General Information **(3)** Product(s)/Service(s) to which Cost Audit relates **(4)** Details of all the Cost Auditor(s) appointed **(5)** Financial year to be covered under the Cost Audit **(6)** Details of previous Cost Auditor which has not been reappointed **(7)** Attachments - Copy of the Board resolution of the company - Optional attachment - if any
CRA-3: Form of Cost Audit Report **[Pursuant to rule 6(4)]**	Clause (vii) have been added to auditor's report as under: Detailed unit-wise and product/service-wise cost statements and schedules thereto In respect of the product/services under reference of the company duly audited and certified by me/us are/are not kept in the company.

<table>
<tr>
<td>Annexure to Cost Audit Report</td>
<td>Annexure has been reclassified into four parts as under:

Part-A
General Information,
General Details of Cost Auditors,
Cost Accounting Policy,
Product/Service Details –for the company as a whole.

Part-B For Manufacturing Sector
Quantitative Information,
Abridged Cost Statement,
Details of Materials Consumed,
Details of Utilities Consumed,
Details of Industry Specific Operating Expenses.

Part-C For Service Sector
Quantitative Information,
Abridged Cost Statement,
Details of Materials Consumed,
Details of Utilities Consumed,
Details of Industry Specific Operating Expenses.

Part-D
Product and Service Profitability Statement,
Profit Reconciliation,
Value Addition and Distribution of Earnings,
Financial Position and Ratio Analysis,
Related Party Transactions,
Reconciliation of Indirect taxes.</td>
</tr>
<tr>
<td>CRA – 4: Form for filing Cost Audit Report with the Central Government

[Pursuant to rule 6(6)]</td>
<td>(1) Corporate identity number (CIN) or foreign company Registration number (FCRN) of the company
(2) General Information
(3) Corporate identity number (CIN) or foreign company Registration number (FCRN) of the company
(4) Details of Industries/Sectors/Product(s)/Service(s) (CETA headling level, wherever applicable as per Rules for Regulated and Non-regulated sector) for which the Cost Audit Report is being submitted
(5) Details of Industries/Sectors/Product(s)/Service(s) (CETA headling level, wherever applicable as per Rules for Regulated and Non-regulated sector) not covered in the Cost Audit Report
(6) Details of the cost auditor(s) appointed
(7) Details of observation of the Cost Audit report
(8) Attachment
- XBRL document in respect of the cost audit report and Company's information and explanation on every Qualification and reservation contained therein
- Optional attachment, if any.</td>
</tr>
</table>

Detailed Rule as per pronouncement by the MCA, GOI is reproduce for reference:-

The Companies (Cost Records and Audit) Rules, 2014 came into force on 30th June, 2014. These rules were amended on 31st December' 2014 giving effect to Rule 2, 3, 4, 5, 6, 7 and Form CRA 1 & CRA 3. It was further amended on 12th June'2015 to giving effect on Form CRA 2 & CRA 4.

Represented hereunder the existing provisions as applicable, after considering amendments till date, as mentioned above:

1. Short title and commencement [Rule 1]

(1) These rules may be called the Companies (Cost Records and Audit) Rules, 2014.

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

2. Definitions [Rule 2]

In these rules, unless the context otherwise requires -

(a) "Act" means the Companies Act, 2013 (18 of 2013);

(aa) "Central Excise Tariff Act Heading" means the heading as referred to in the Additional Notes in the First Schedule to the Central Excise Tariff Act, 1985 [5 of 1986];

(b) "Cost Accountant in practice" means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959), who holds a valid certificate of practice under sub-section (1) of section 6 of that Act and who is deemed to be in practice under sub-section (2) of section 2 thereof, and includes a firm or limited liability partnership of cost accountants;

(c) "cost auditor" means a Cost Accountant in practice, as defined in clause (b), who is appointed by the Board;

(d) "cost audit report" means the report duly audited and signed by the cost auditor including attachment, annexure, qualifications or observations etc. to cost audit report;

(e) "cost records" means books of account relating to utilisation of materials, labour and other items of cost as applicable to the production of goods or provision of services as provided in section 148 of the Act and these rules;

(f) "form" means a form annexed to these rules;

(g) "institute" means the Institute of Cost Accountants of India constituted under the Cost and Works Accountants Act, 1959 (23 of 1959);

(h) all other words and expressions used in these rules but not defined, and defined in the Act or in the Companies (Specification of Definition Details) Rules, 2014 shall have the same meanings as assigned to them in the Act or in the said rules.

3. Application of Cost Records [Rule 3]

For the purposes of sub-section (1) of section 148 of the Act, the class of companies, including foreign companies defined in clause (42) of section 2 of the Act engaged in the production of the goods or providing services, specified in the Table below, having an overall turnover from all its products and services of rupees thirty five crore or more during the immediately preceding financial year, shall include cost records for such products or services in their books of account, namely:-

Table of Rule 3

(A) Regulated Sectors

S. No.	Industry/ Sector/ Product/ Service	CETA Heading (wherever applicable)
1.	Telecommunication services made available to users by means of any transmission or reception of signs, signals, writing, images and sounds or intelligence of any nature (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India under the Telecom Regulatory Authority of India Act, 1997 (24 of I997);	Not applicable.
2.	Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003 (36 of 2003), other than for captive generation (referred to in the Electricity Rules, 2005);	…………
3.	Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board under the Petroleum and Natural Gas Regulatory Board Act, 2006 (19 of 2006);	2709 to 2715;
4.	Drugs and pharmaceuticals;	2901 to 2942; 3001 to 3006.
5.	Fertilisers;	3102 to 3105.
6.	Sugar and industrial alcohol;	1701; 1703; 2207.

(B) Non- regulated Sectors

S. No.	Industry/ Sector/ Product/ Service	CETA Heading (wherever applicable)
1.	Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items; **Explanation -** For the purposes of this sub-clause, any company which is engaged in any item or items supplied exclusively for use under this clause, shall be deemed to be covered under these rules.	8401 to 8402; 8801 to 8805; 8901 to 8908.
2.	Turbo jets and turbo propellers;	8411
3.	Arms and ammunitions;	3601 to 3603; 9301 to 9306.

4.	Propellant powders; prepared explosives (other than propellant powders); safety fuses; detonating fuses; percussion or detonating caps; igniters; electric detonators;	3601 to 3603
5.	Radar apparatus, radio navigational aid apparatus and radio remote control apparatus;	8526
6	Tanks and other armoured fighting vehicles, motorised, whether or not fitted with weapons and parts of such vehicles, that are funded (investment made in the company) to the extent of ninety per cent. or more by the Government or Government agencies;	8710
7.	Port services of stevedoring, pilotage, hauling, mooring, re-mooring, hooking, measuring, loading and unloading services rendered by a Port in relation to a vessel or goods regulated by the Tariff Authority for Major Ports under section 111 of the Major Port Trusts Act, 1963 (38 of 1963);	Not applicable.
8.	Aeronautical services of air traffic management, aircraft operations, ground safety services, ground handling, cargo facilities and supplying fuel rendered by airports and regulated by the Airports Economic Regulatory Authority under the Airports Economic Regulatory Authority of India Act, 2008 (27 of 2008);	Not applicable.
9.	Steel;	7201 to 7229; 7301 to 7326
10.	Roads and other infrastructure projects corresponding to para No. (1) (a) as specified in Schedule VI of the Companies Act, 2013;	Not applicable.
11.	Rubber and allied products being regulated by the Rubber Board constituted under the Rubber Act, 1947 (XXIV of 1947).	4001 to 4017
12.	Coffee and tea;	0901 to 0902
13.	Railway or tramway locomotives, rolling stock, railway or tramway fixtures and fittings, mechanical (including electro mechanical) traffic signalling equipment's of all kind;	8601 to 8608.
14.	Cement;	2523; 6811 to 6812
15.	Ores and Mineral products;	2502 to 2522; 2524 to 2526; 2528 to 2530; 2601 to 2617
16.	Mineral fuels (other than Petroleum), mineral oils etc.;	2701 to 2708

17.	Base metals;	7401 to 7403; 7405 to 7413; 7419;7501 to 7508; 7601 to 7614; 7801 to 7802; 7804; 7806; 7901 to 7905; 7907; 8001; 8003; 8007; 8101 to 8113.
18.	Inorganic chemicals, organic or inorganic compounds of precious metals, rare-earth metals of radioactive elements or isotopes, and Organic Chemicals;	2801 to 2853; 2901 to 2942; 3801 to 3807; 3402 to 3403; 3809 to 3824.
19.	Jute and Jute Products;	5303, 5310
20.	Edible Oil;	1507 to 1518
21.	Construction Industry as per para No. (5) (a) as specified in Schedule VI of the Companies Act 2013 (18 of 2013)	Not applicable.
22.	Health services, namely functioning as or running hospitals, diagnostic centres, clinical centres or test laboratories;	Not applicable.
23.	Education services, other than such similar services falling under philanthropy or as part of social spend which do not form part of any business.	Not applicable.
24.	Milk power;	0402
25.	Insecticides;	3808
26.	Plastics and polymers;	3901 to 3914; 3916 to 3921; 3925
27.	Tyres and tubes;	4011 to 4013
28.	Paper;	4801 to 4802.
29.	Textiles;	5004 to 5007; 5106 to 5113; 5205 to 5212; 5303; 5310; 5401 to 5408; 5501 to 5516
30.	Glass;	7003 to 7008; 7011; 7016
31.	Other machinery;	8403 to 8487
32.	Electricals or electronic machinery;	8501 to 8507; 8511 to 8512; 8514 to 8515; 8517; 8525 to 8536; 8538 to 8547.

33.	Production, import and supply or trading of following medical devices, namely:- **(i)** Cardiac stents; **(ii)** Drug eluting stents; **(iii)** Catheters; **(iv)** Intra ocular lenses; **(v)** Bone cements; **(vi)** Heart valves; **(vii)** Orthopaedic implants; **(viii)** Internal prosthetic replacements; **(ix)** Scalp vein set; **(x)** Deep brain stimulator; **(xi)** Ventricular peripheral shud; **(xii)** Spinal implants; **(xiii)** Automatic impalpable cardiac deflobillator; **(xiv)** Pacemaker (temporary and permanent); **(xv)** Patent ductus arteriosus, atrial septal defect and ventricular septal defect closure device; **(xvi)** Cardiac re-synchronize therapy ; **(xvii)** Urethra spinicture devices; **(xviii)** Sling male or female **(xix)** Prostate occlusion device; and **(xx)** Urethral stents:	9018 to 9022

Provided that nothing contained in serial number 33 shall apply to foreign companies having only liaison offices.

Provided further that nothing contained in this rule shall apply to a company which is classified as a micro enterprise or a small enterprise including as per the turnover criteria under sub-section (9) of section 7 of the Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006).

4. Applicability for Cost Audit [Rule 4]

(1) Every company specified in item (A) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees fifty crore or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees twenty five crore or more.

(2) Every company specified in item (B) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees one hundred crore or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees thirty five crore or more.

(3) The requirement for cost audit under these rules shall not apply to a company which is covered in rule 3, and –

- **(i)** whose revenue from exports, in foreign exchange, exceed, seventy five per cent of its total revenue; or
- **(ii)** which is operating from a special economic zone."

5. Maintenance of Records [Rule 5]

(1) Every company under these rules including all units and branches thereof, shall, in respect of each of its financial year commencing on or after the 1st day of April, 2014, maintain cost records in **form CRA-1**.

Provided that in case of company covered in serial number 12 and serial numbers 24 to 32 of item (B) of rule 3, the requirement under this rule shall apply in respect of each of its financial year commencing on or after 1st day of April, 2015.

(2) The cost records referred to in sub-rule (1) shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

(3) The cost records shall be maintained in such manner so as to enable the company to exercise, as far as possible, control over the various operations and costs to achieve optimum economies in utilisation of resources and these records shall also provide necessary data which is required to be furnished under these rules.

6. Cost Audit [Rule 6]

(1) The category of companies specified in rule 3 and the thresholds limits laid down in rule 4, shall within one hundred and eighty days of the commencement of every financial year, appoint a cost auditor.

(2) Every company referred to in sub-rule (1) shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in **Form CRA-2**, alongwith the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

(3) Every cost auditor appointed as such shall continue in such capacity till the expiry of one hundred and eighty days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

(3A) Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within thirty days of such appointment of cost auditor.

(4) Every cost auditor, who conducts an audit of the cost records of a company, shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in **Form CRA-3**.

(5) Every cost auditor shall forward his report to the Board of Directors of the company within a period of one hundred and eighty days from the closure of the financial year to which the report relates and the Board of directors shall consider and examine such report particularly any reservation or qualification contained therein.

(6) Every company covered under these rules shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in **Form CRA-4** alongwith fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

(7) The provisions of sub-section (12) of section 143 of the Act and the relevant rules made thereunder shall apply *mutatis mutandis* to a cost auditor during performance of his functions under section 148 of the Act and these rules.

Annexure

FORM CRA-1

(Pursuant to Rule 5(1) of the Companies (Cost Records and Audit) Rules, 2014)

Particulars relating to the Items of Costs to be included in the Books of Accounts

1. Material Costs.-

(a) Proper records shall be maintained showing separately all receipts, issues and balances both in quantities and cost of each item of raw material required for the production of goods or rendering of services under reference.

(b) The material receipt shall be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities, that can be quantified with reasonable accuracy at the time of acquisition.

(c) Finance costs incurred in connection with the acquisition of materials shall not form part of material cost.

(d) Self-manufactured materials or captive consumption shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads.

(e) Spares which are specific to an item of equipment shall not be taken to inventory, but shall be capitalized with the cost of the specific equipment. Cost of capital spares or insurance spares whether procured with the equipment or subsequently, shall be amortised over a period not exceeding the useful life of the equipment.

(f) Normal loss or spoilage of material prior to reaching the factory or at places where the services are provided shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.

(g) Losses due to shrinkage or evaporation and gain due to elongation or absorption of moisture etc., before the material is received shall be absorbed in material cost to the extent they are normal with corresponding adjustment in the quantity.

(h) The forex component of imported material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the material cost.

(i) Any demurrage or detention charges, or penalty levied by transport or other authorities shall not form part of the cost of materials.

(j) Subsidy or Grant or Incentive and any such payment received or receivable with respect to any material shall be reduced from cost for ascertainment of the cost of the cost object to which such amounts are related.

(k) Issues shall be valued using appropriate assumptions on cost flow, e.g. First-in-First-out, Last-in-First-out, Weighted Average Rate. The method of valuation shall be followed on a consistent basis

(l) Where materials are accounted at standard cost, the price variances related to materials shall be treated as part of material cost.

(m) Any abnormal cost shall be excluded from the material cost.

(n) Wherever, material costs include transportation costs, determination of costs of transportation shall be governed by Para No. 9 on Determination of Cost of Transportation.

(o) Self-manufactured components and sub-assemblies or captive consumption shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads.

(p) The material cost of normal scrap or defectives which are rejects shall be included in the material cost of goods manufactured. The material cost of actual scrap or defectives, not exceeding the normal shall be adjusted in the material cost of good production. Material Cost of abnormal scrap or defectives shall not be included in material cost but treated as loss after giving credit to the realisable value of such scrap or defectives.

(q) Material costs shall be directly traced to a Cost object to the extent it is economically feasible or shall be assigned to the cost object on the basis of material quantity consumed or similar identifiable measure and valued as per above principles.

(r) Where the material costs are not directly traceable to the cost object, the same shall be assigned on a suitable basis like technical estimates.

(s) Where a material is processed or part manufactured by a third party according to specifications provided by the buyer, the processing or manufacturing charges payable to the third party shall be treated as part of the material cost.

(t) Wherever part of the manufacturing operations or activity is subcontracted, the subcontract charges related to materials shall be treated as direct expenses and assigned directly to the cost object.

(u) The cost of indirect materials shall be assigned to the various Cost objects based on a suitable basis such as actual usage or technical norms or a similar identifiable measure.

(v) The cost of materials like catalysts, dies, tools, moulds, patterns etc., which are relatable to production over a period of time shall be amortized over the production units benefited by such cost.

(w) The cost of indirect material with life exceeding one year shall be included in cost over the useful life of the material.

2. Employee Cost

(a) Proper records shall be maintained in respect of employee costs in such a manner as to enable the company to book these expenses cost centre wise or department wise with reference to goods or services under reference and to furnish necessary particulars. Where the employees work in such a manner that it is not possible to identify them with any specific cost centre or service centre or department, the employees cost shall be apportioned to the cost centre or service centres or departments on equitable and reasonable basis and applied consistently.

(b) Employee cost shall be ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all the benefits.

(c) Bonus whether payable as a statutory minimum or on a sharing of surplus shall be treated as part of employee cost. Ex gratia payable in lieu of or in addition to bonus shall also be treated as part of the employee cost.

(d) Remuneration payable to Managerial Personnel including Executive Directors on the Board and other officers of a corporate body under a statute shall be considered as part of the employee cost of the year under reference whether the whole or part of the remunerate is computed as a percentage of profits. Remuneration paid to non executive directors shall not form part of employee cost but shall form part of administrative overheads.

(e) Separation costs related to voluntary retirement, retrenchment, termination and other related matters shall be amortised over the period benefitting from such costs.

(f) Employee cost shall not include imputed costs.

(g) Cost of Idle time is ascertained by the idle hours multiplied by the hourly rate applicable to the idle employee or a group of employees.

(h) Where employee cost is accounted at standard cost, variances due to normal reasons related to employee cost shall be treated as part of employee cost. Variances due to abnormal reasons shall be treated as part of abnormal cost.

(i) Any subsidy, grant, incentive or any such payment received or receivable with respect to any employee cost shall be reduced for ascertainment of cost of the cost object to which such amounts are related.

(j) Any abnormal cost where it is material and quantifiable shall not form part of the employee cost.

(k) Penalties, damages paid to statutory authorities or other third parties shall not form part of the employee cost.

(l) The cost of free housing, free conveyance and any other similar benefits provided to an employee shall be determined at the total cost of all resources consumed in providing such benefits.

(m) Any recovery from the employee towards any benefit provided, namely, housing shall be reduced from the employee cost.

(n) Any change in the cost accounting principles applied for the determination of the employee cost shall be made only if it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.

(o) Where the employee services are traceable to a cost object, such employees' cost shall be assigned to the cost object on the basis such as time consumed or number of employees engaged or other related basis or similar identifiable measure.

(p) While determining whether a particular employee cost is chargeable to a separate cost object, the principle of materiality shall be adhered to.

(q) Where the employee costs are not directly traceable to the cost object, the same shall be assigned on suitable basis like estimates of time based on time study.

(r) The amortised separation costs related to voluntary retirement, retrenchment, and termination or other related matters for the period shall be treated as indirect cost and assigned to the cost objects in an appropriate manner provided that unamortized amount related to discontinue operations, shall not be treated as employee cost.

(s) Recruitment costs, training cost and other such costs shall be treated as overheads and dealt with accordingly.

(t) Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime.

(u) Idle time cost shall be assigned direct to the cost object or treated as overheads depending on the economic feasibility and the specific circumstances causing such idle time.

3. Utilities

(a) Proper records shall be maintained showing the quantity and cost of each major utility such as power, water, steam, effluent treatment and other related utilities produced and consumed by the different cost centres in such detail as to have particulars for each utility separately.

(b) Each type of utility shall be treated as a distinct cost object.

(c) Cost of utilities purchased shall be measured at cost of purchase including duties and taxes, transportation cost, insurance and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified with reasonable accuracy at the time of acquisition.

(d) Cost of self-generated utilities for own consumption shall comprise direct material cost, direct employee cost, direct expenses and factory overheads.

(e) In case of utilities generated for the purpose of inter unit transfers, the distribution cost incurred for such transfers shall be added to the cost of utilities determined as above.

(f) Cost of utilities generated for the intercompany transfers shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost and share of administrative overheads.

(g) Cost of utilities generated for the sale to outside parties shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost, share of administrative overheads and marketing overheads. The sale value of such utilities shall also include the margin.

(h) Finance costs incurred in connection with the utilities shall not form part of cost of utilities

(i) The cost of utilities shall include the cost of distribution of such utilities. The cost of distribution shall consist of the cost of delivery of utilities up to the point of consumption.

(j) Cost of utilities shall not include imputed costs.

(k) Where cost of utilities is accounted at standard cost, the price variances related to utilities shall be treated as part of cost of utilities and the portion of usage variances due to normal reasons shall be treated as part of cost of utilities Usage variances due to abnormal reasons shall be treated as part of abnormal cost.

(l) Any subsidy or grant or incent.ve or any such payment received or receivable with respect to any cost of utilities shall be reduced for ascertainment of the cost to which such amounts are related.

(m) The cost of production and distribution of utilities shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost. Cost of a Stand-by Utility shall include the committed costs of maintaining such a utility.

(n) Any abnormal cost where it is material and quantifiable shall not form part of the cost of utilities

(o) Penalties damages paid to statutory authorities or other third parties shall not form part of the cost of utilities.

(p) Credits or recoveries relating to the utilities including cost of utilities provided to outside parties material and quantifiable, shall be deducted from the total cost of utility to arrive at the net cost of ‘utility.

(q) Any change in the cost accounting principles applied for the measurement of the cost of utilities shall be made only if. it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an organization.

(r) While assigning cost of utilities, traceabi.ity to a cost object in an economically feasible manner shall be the guiding principle.

(s) Where the cost of utilities is not directly traceable to cost object, it shall be assigned on the most appropriate basis.

(t) The most appropriate basis of distribution of cost of a utility to the departments consuming services is to be derived from usage parameters.

4. Direct Expenses

(a) Proper records shall be maintained in respect of direct expenses in such a manner as to enable the company to book these expenses cost centre wise or cost object or department wise with reference to goods or services under reference and to furnish necessary particulars.

(b) Direct expenses incurred for the use of bought out resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable there to net of trade discounts, rebates, taxes and duties refundable or to be credited.

(c) Other direct expenses shall be determined on the basis of amount incurred, in connection therewith.

(d) Direct expenses paid or incurred in lump- sum or which are in the nature of ‘one- time’ payment, shall be amortised on the basis of the estimated output or benefit to be derived from such direct expenses.

(e) If an item of direct expenses does not meet the test of materiality, it can be treated as part of overheads.

(f) Finance costs incurred in connection with the self- generated or procured resources shall not form part of direct expenses. Direct expenses shall not include imputed costs.

(g) Where direct expenses are accounted at standard cost, variances due to normal reasons shall be treated as part of the direct expenses. Variances due to abnormal reasons shall not form part of the direct expenses.

(h) Any subsidy or grant or incentive or any such payment received or receivable with respect to any direct expenses shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

(i) Any abnormal portion of the direct expenses where it is material and quantifiable shall not form part of the direct expenses.

(j) Penalties, damages paid to statutory authorities or other third parties shall not form part of the direct expenses.

(k) Credits recoveries relating to the direct expenses, material and quantifiable, shall be deducted to arrive at the net direct expenses.

(l) Any change in the cost accounting principles applied for the measurement of the direct expenses shall be made only if, it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.

(m) Direct expenses that are directly traceable to the cost object shall be assigned to that cost object.

5. Repairs and Maintenance.-

(a) Proper records showing the expenditure incurred by the workshop, tool room and on repairs and maintenance in the various cost centres or departments shall be maintained under different heads.

(b) Repairs and maintenance cost shall be the aggregate of direct and indirect cost relating to repairs and maintenance activity. Direct cost shall include the cost of materials, consumable stores, spares, manpower, equipment usage, utilities and other identifiable resources consumed in such activity! Indirect cost shall include the cost of resources common to various repairs and maintenance activities such as manpower, equipment usage and other costs allocable to such activities.

(c) Cost of in-house repairs and maintenance activity shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such activity.

(d) Cost of repairs and maintenance activity carried out by outside contractors inside the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other costs incurred by the entity for such jobs.

(e) Cost of repairs and maintenance jobs carried out by contractor at its premises shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited. This cost shall also include the cost of other resources provided to the contractors.

(f) Cost of repairs and maintenance jobs carried out by outside contractors shall include charges made by the contractor and cost of own materials, consumable stores, spares, manpower, equipment usage, utilities and other costs used in such jobs.

(g) Each type of repairs and maintenance shall be treated as a distinct activity, if material and identifiable.

(h) Cost of repairs and maintenance activity shall be measured for each major asset category separately.

(i) Cost of spares replaced which do not enhance the future economic benefits from the existing asset beyond its previously assessed standard of performance shall be included under repairs and maintenance cost.

(j) High value spare, when replaced by a new spare and is reconditioned, which is expected to result in future economic benefits, the same shall be taken into stock. Such a spare shall be valued at an amount that measures its service potential in relation to a new spare which amount shall not exceed the cost of reconditioning the spare. The difference between the total of the cost of the new spare and the reconditioning cost and the value of the reconditioned spare shall be treated as repairs and maintenance cost.

(k) The cost of major overhaul shall be amortised on a rational basis.

(l) Finance costs Incurred in connection with the repairs and maintenance activities shall not form part of Repairs and maintenance costs.

(m) Repairs and maintenance costs shall not include imputed costs.

(n) Price variances related to repairs and maintenance, where standard costs are in use, shall be treated as part of repairs and maintenance cost. The portion of usage variances attributable to normal reasons shall be treated as part of repairs and maintenance cost. Usage variances attributable to abnormal reasons shall be excluded from repairs and maintenance cost.

(o) Subsidy or Grant or Incentive or amount of similar nature received or receivable with respect to repairs and maintenance activity, if any, shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

(p) Any repairs and maintenance cost resulting from some abnormal circumstances, namely, major fire, explosion, flood and similar events, if material and quantifiable, shall not form part of the repairs and maintenance cost.

(q) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the repairs and maintenance cost.

(r) Credits or recoveries relating to the repairs and maintenance activity, material and quantifiable, shall be deducted to arrive at the net repairs and maintenance cost.

(s) Any change in the cost accounting principles applied for the measurement of the repairs and maintenance cost shall be made only if, it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.

(t) Repairs and maintenance costs shall be traced to a cost object to the extent economically feasible.

(u) Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following the principles of (1) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost and (2) Benefits received - overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

(v) If the repairs and maintenance cost (including the share of the cost of reciprocal exchange of services) is shared by several cost objects, the related cost shall be measured as an aggregate and distributed among the cost objects.

6. Fixed Assets and depreciation.-

(a) Proper and adequate records shall be maintained for assets used for production of goods or rendering of services under reference in respect of which depreciation has to be provided for These records shall, inter-alia, indicate grouping of assets under each good or service, the cost of acquisition of each item of asset including installation charges, date of acquisition and rate of depreciation.

(b) Depreciation and amortisation shall be measured based on the depreciable amount and the useful life. The residual value of an intangible asset shall be assumed to be zero unless:

(i) there is a commitment by a third party to purchase the asset at the end of its useful life, or

(ii) there is an active market for the asset and:

a. residual value can be determined by reference to that market; and

b. it is probable that such a market will exist at the end of the asset's useful life.

c. The residual value of a fixed asset shall be considered as zero if the entity is unable to estimate the same with reasonable accuracy.

(c) The minimum amount of depreciation to be provided shall not be less than the amount calculated as per principles and methods as prescribed by any law or regulations applicable to the entity and followed by it.

(d) In case of regulated industry the amount of depreciation shall be the same as prescribed by the concerned regulator.

(e) While estimating the useful life of a depreciable asset, consideration shall be given to the following factors:

(i) Expected physical wear and tear;

(ii) Obsolescence; and

(iii) Legal or other limits on the use of the asset.

(f) The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset.

(g) If the contractual or other legal rights are conveyed for a limited term that can be renewed the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. The useful life of a re-acquired right recognised as an intangible asset in a business combination is the remaining contractual period of the contract in which the right was granted and shall not include renewal periods.

(h) The useful life of an intangible asset, in any situation, shall not exceed 10 years from the date it is available for use.

(i) Depreciation shall be considered from the time when a depreciable asset is first put into use An asset which is used only when the need arises but is always held ready for use. Example: fire extinguisher, stand by generator, safety equipment shall be considered to be an asset in use Depreciable assets shall be considered to be put into use when commercial production of goods and services commences.

(j) Depreciation on an asset which is temporarily retired from production of goods and services shall be considered as abnormal cost for the period when the asset is not in use.

(k) Depreciation of any addition or extension to an existing depreciable asset which becomes an integral part of that asset shall be based on the remaining useful life of that asset.

(l) Depreciation of any addition or extension to an existing depreciable asset which retains a separate identity and is capable of being used after the expiry of the useful life of that asset shall be based on the estimated useful life of that addition or extension.

(m) The impact of higher depreciation due to revaluation of assets shall not be assigned to cost object.

(n) Impairment loss on assets shall be excluded from cost of production.

(o) The method of depreciation used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

(p) An entity can use any of the methods of depreciation to assign depreciable amount of an asset on a systematic basis over its useful life, namely, Straight-line method; Diminishing balance method; and Units of production method, etc.

(q) The method of amortisation of intangible asset shall reflect the pattern in which the economic benefits accrue to entity.

(r) The methods and rates of depreciation applied shall be reviewed at least annually and, if there has been a change in the expected pattern of consumption or loss of future economic benefits, the method applied shall be changed to reflect the changed pattern.

(s) Spares purchased specifically for a particular asset, or class of assets, and which would become redundant if that asset or class of asset was retired or use of that asset was discontinued, shall form part of that asset. The depreciable amount of such spares shall be allocated over the useful life of the asset.

(t) Cost of small assets shall be written off in the period in which they were purchased as per the accounting policy of the entity.

(u) Depreciation of an asset shall not be considered in case cumulative depreciation exceeds the original cost of the asset, net of residual value.

(v) Where depreciation for an addition of an asset is measured on the basis of the number of days for which the asset was used for the preparation and presentation of financial statements, depreciation of the asset for assigning to cost of object shall be measured in relation to the period, the asset actually utilized.

(w) Depreciation shall be traced to the cost object to the extent economically feasible.

(x) Where the depreciation is not directly traceable to cost object, it shall be assigned based on either of the following two principles; namely

(i) **Cause and Effect -** Cause is the process or operation or activity and effect is the incurrence of cost and

(ii) **Benefits received -** overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

7. Overheads

(a) Proper records shall be maintained for various items of indirect expenses comprising overheads pertaining to goods or services under reference. These expenses shall be analysed, classified and grouped according to functions.

(b) Overheads representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited.

(c) Overheads other than those referred to above shall be determined on the basis of cost incurred in connection therewith.

(d) Any abnormal cost where it Is material and quantifiable shall not form part of the overheads.

(e) Finance costs incurred In connection with procured or self-generated resources shall not form part of overheads.

(f) Overheads shall not include imputed cost.

(g) Overhead variances attributable to normal reasons shall be treated as part of overheads. Overhead variances attributable to abnormal reasons shall be excluded from overheads.

(h) Any subsidy or grant or incentive or amount of similar nature received or receivable with respect to overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

(i) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the overheads.

(j) Credits or recoveries relating to the overheads, material and quantifiable, shall be deducted from the total overhead to arrive at the net overheads. Where the recovery exceeds the total overheads, the balance recovery shall be treated as other income.

(k) Any change in the cost accounting principles applied for the measurement of the overheads shall be made only if, it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an entity.

(l) While assigning overheads, traceability to a cost object in an economically feasible manner shall be the guiding principle. The cost which can be traced directly to a cost object shall be directly assigned.

(m) Overheads shall be classified according to functions, viz., works, administration, selling and distribution, head office, corporate etc.

(n) Assignment of overheads to the cost objects shall be based on either of the following two principles; **(1) Cause and Effect -** Cause is the process or operation or activity and effect is the incurrence of cost and **(2) Benefits received -** overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

(o) The variable production overheads shall be absorbed to products or services based on actual capacity utilisation.

(p) The fixed production overheads shall be absorbed based on the normal capacity.

(q) Assignment of Administration Overheads shall be in accordance with para No. 8.

(r) Marketing overheads that can be identified to a product or service shall be assigned to that product or service.

(s) Marketing overheads that cannot be identified to a product or service shall be assigned to the products or services on the most appropriate basis.

8. Administrative Overheads

(a) Administrative overheads shall be the aggregate of cost of resources consumed in activities relating to general management and administration of an organisation.

(b) In case of leased assets, if the lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a financial lease, the finance cost portion shall be segregated and treated as part of finance costs.

(c) The cost of software (developed in house, purchased, licensed or customised), including up-gradation cost shall be amortised over its estimated useful life.

(d) The cost of administrative services procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited.

(e) Any subsidy or grant or incentive or any amount of similar nature received or receivable with respect to any Administrative overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

(f) Administrative overheads shall not include any abnormal administrative cost.

(g) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the administrative overheads.

(h) Credits or recoveries relating to the administrative overheads including those rendered without any consideration, material and quantifiable, shall be deducted to arrive at the net administrative overheads.

(i) Any change in the cost accounting principles applied for the measurement of the administrative overheads shall be made only if it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.

(j) While assigning administrative overheads, traceability to a cost object in an economically feasible manner shall be the guiding principle.

(k) Assignment of administrative overheads to the cost objects shall be based on either of the following two principles; namely: -

- **(i)** Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost.
- **(ii)** Benefits received - overheads are to be apportioned to the various cost objects in proportion to the benefit received by them.

9. Transportation Cost

(a) 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. Abnormal costs relating to transportation, if any, are to be identified and recorded for exclusion of computation of average transportation cost.

(b) 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.

(c) 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 and other related details.

(d) Records shall be maintained separately for inward and outward transportation cost specifying the details particulars of goods despatched, name of supplier or recipient, amount of freight etc.

(e) 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 or sold for both home consumption and export.

(f) Records for transportation cost from factory to depot and thereafter shall be maintained separately.

(g) Records for transportation cost for carrying any material or product to job-workers place and back shall be maintained separately so as include the same in the transaction value of the product.

(h) Records for transportation cost for goods involved exclusively for trading activities shall be maintained separately and the same shall not be included for claiming any deduction for calculating assessable value excisable goods cleared for home consumption.

(i) Records of transportation cost directly allocable to a particular category of products shall be maintained separately so that allocation can be made.

(j) For common transportation cost, both for own fleet or hired ones, proper records for basis of apportionment shall be maintained.

(k) Records for transportation cost for exempted goods, excisable goods cleared for export shall be maintained separately.

(l) Separate records of cost for mode of transportation other than road like ship or air are to be maintained, which shall be included in total cost of transportation.

(m) Inward transportation costs shall form the part of the cost of procurement of materials which shall be identified for proper allocation or apportionment to the materials or products.

(n) Outward transportation cost shall form the part of the cost of sale and shall be allocated or apportioned to the materials and goods on a suitable basis.

(o) The following basis shall 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, namely

- **(i)** Weight;
- **(ii)** Volume of goods;
- **(iii)** Tonne- km;
- **(iv)** Unit or Equivalent unit;
- **(v)** Value of goods;
- **(vi)** Percentage of usage of space.

(p) Once a basis of apportionment is adopted, the same shall be followed consistently.

(q) For determining the transportation cost per unit, distance shall be factored in to arrive at weighted average cost.

(r) Abnormal and non recurring cost shall not be a part of transportation cost.

10. Royalty and Technical Know-how.-

(a) Adequate records shall be maintained showing royalty or technical know-how fee including other recurring or non-recurring payments of similar nature, if any, made for the goods or services under reference to collaborators or technology suppliers in terms of agreements entered into with them.

(b) Royalty and technical know-how Fee paid or incurred in lump-sum or which are in the nature of 'one-time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from the related asset. Amortisation of the amount of royalty or technical know- how fee paid for which the benefit is ensued in the current or future periods shall be determined based on the production or service volumes estimated for the period over which the asset is expected to benefit the entity.

(c) Amount of the royalty and technical know-how fee shall not include finance costs and imputed costs.

(d) Any subsidy or grant or incentive or any such payment received or receivable with respect to amount of royalty and technical know-how fee shall be reduced to measure the amount of royalty and technical know- how fee.

(e) Penalties, damages paid to statutory authorities or other third parties shall not form part of the amount of royalty and technical know-how fee.

(f) Credits or recoveries relating to the amount royalty and technical know-how fee, material and quantifiable, shall be deducted to arrive at the net amount of royalty and technical know-how fee.

(g) Any change in the cost accounting principles applied for the measurement of the amount of royalty and technical know-how fee shall be made only if, it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.

(h) Royalty and technical know-how fee that is directly traceable to a cost object shall be assigned to that cost object. In case such fee is not directly traceable to a cost object then it shall be assigned on any of the following basis, namely: -

(i) Units produced;

(ii) Units sold; or

(iii) Sales value.

(i) The amount of royalty fee paid for mining rights shall form part of the cost of material.

(j) The amount of royalty and technical know-how fee shall be assigned on the nature or purpose of such fee. The amount of royalty and technical know-how fee related to product or process know how shall be treated as cost of production; if related to trademarks or brands shall be treated as cost of sales.

11. Research and Development Expenses

(a) Research and development costs shall include all the costs that are directly traceable to research or development activities or that can be assigned to research and development activities strictly on the basis of (a) cause and effect or (b) benefits received Such costs shall include the following elements, namely:-

(i) the cost of materials and services consumed in research and development activities;

(ii) cost of bought out materials and hired services as per invoice or agreed price including duties and taxes directly attributable thereto net of trade discounts, rebates, taxes and duties refundable or to be credited;

(iii) the salaries, wages and other related costs of personnel engaged in research and development activities;

(iv) the depreciation of equipment and facilities, and other tangible assets, and amortisation of intangible assets to the extent that they are used for research and development activities;

(v) overhead costs, other than general administrative costs, related to research and development activities;

(vi) costs incurred for carrying out research and development activities by other entities and charged to the entity;

(vii) expenditure incurred in securing copyrights or licences;

(viii) expenditure incurred for developing computer software;

(ix) costs incurred for the design of tools, jigs, moulds and dies; and

(x) other costs that can be directly attributed to research and development activities and can be identified with specific projects.

(b) Subsidy or grant or incentive or amount of similar nature received or receivable with respect to research and development activity, if any, shall be reduced from the cost of such research, and development activity.

(c) Any abnormal cost where it is material and quantifiable shall not form part of the research and development cost.

(d) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the research and development cost.

(e) Research and development costs shall not include imputed costs.

(f) Credits or recoveries relating to research and development cost, if material and quantifiable, including from the sale of output produced from the research and development activity shall be deducted from the research and development cost.

(g) Research and development costs attributable to a specific cost object shall be assigned to that cost object directly. Research and development costs that are not attributable to a specific product or process shall not form part of the product cost.

(h) Development cost which results in the creation of an intangible asset shall be amortised over its useful life. Assignment of development costs shall be based on the principle of "benefits received".

(i) Research and development costs incurred for the development and improvement of an existing process or product shall be included in the cost of production. In case the Research and development activity related to the improvement of an existing process or product continues for more than one accounting period, the cost of the same shall be accumulated and amortised over the estimated period of use of the improved process or estimated period over which the improved product shall be produced by the entity after the commencement of commercial production, as the case may be, if the improved process or product is distinctly different from the existing process or product and the product is marketed as a new product. The amount allocated to a particular period shall be included in the cost of production of that period. If the expenditure is only to improve the quality of the existing product or minor modifications in attributes, the principle shall not be applied.

(j) Development costs attributable to a saleable service namely, providing technical know-how to outside parties shall be accumulated separately and treated as cost of providing the service.

12. Quality control expenses

(a) Adequate records shall be maintained to indicate the expenses incurred in respect of quality control department or cost centre or service centre for goods or services under reference. Where these services are also utilized for other goods or services of the company, the basis of apportionment to goods or services under reference and to other goods or services shall be on equitable and reasonable basis and applied consistently.

(b) Quality control cost incurred in-house shall be the aggregate of the cost of resources consumed in the quality control activities of the entity. The cost of resources procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited by the Tax Authorities. Such cost shall include cost of conformance to quality, namely, (a) prevention cost; and (b) appraisal cost.

(c) Identification of quality control costs shall be based on traceability in an economically feasible manner.

(d) Quality control costs other than those referred to above shall be determined on the basis of amount incurred in connection therewith.

(e) Finance costs incurred in connection with the self-generated or procured resources shall not form part of quality control cost.

(f) Quality control costs shall not include imputed costs.

(g) Any Subsidy or grant or incentive or any such payment received or receivable with respect to any quality control cost shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

(h) Any abnormal portion of the quality control cost where it is material and quantifiable shall not form part of the cost of quality control.

(i) Penalties, damages paid to statutory authorities or other third parties shall not form part of the quality control cost.

(j) Any change in the cost accounting principles applied for the measurement of the quality control cost shall be made only if, it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.

(k) Quality control cost that is directly traceable to the cost object shall be assigned to that cost object. Assignment of quality control cost to the cost objects shall be based on benefits received by them on the principles, namely:-

- **(i)** Cause and effect - Cause is the process or operation or activity and effect is the incurrence of cost and
- **(ii)** Benefits received - overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

13. Pollution control expenses.-

(a) Adequate records shall be maintained to indicate the expenses incurred in respect of pollution control. The basis of apportionment to goods or services under reference and to other goods or services shall be on equitable and reasonable basis and applied consistently.

(b) Pollution control costs shall be the aggregate of direct and indirect cost relating to pollution control activity. Direct cost shall include the cost of materials, consumable stores, spares, manpower, equipment usage, utilities, resources for testing and certification and other identifiable resources consumed in activities such as waste processing, disposal, remediation and others. Indirect cost shall include the cost of resources common to various pollution control activities such as pollution control registration and such like expenses.

(c) Costs of pollution control which are internal to the entity shall be accounted for when incurred. They shall be measured at the historical cost of resources consumed.

(d) Future remediation or disposal costs which are expected to be incurred with reasonable certainty as part of onerous contract or constructive obligation, legally enforceable shall be estimated and accounted based on the quantum of pollution generated in each period and the associated cost of remediation or disposal in future.

(e) Contingent future remediation or disposal costs e.g. those likely to arise on account of future legislative changes on pollution control shall not be treated as cost until the incidence of such costs become reasonably certain and can be measured.

(f) External costs of pollution which are generally the costs imposed on external parties including social costs are difficult to estimate with reasonable accuracy and are excluded from general purpose cost statements.

(g) Social costs of pollution are measured by economic models of cost measurement. The cost by way of compensation by the polluting entity either under future legislation or under social pressure cannot be quantified by traditional models of cost measurement. They are best kept out of general purpose cost statements.

(h) Cost of in-house pollution control activity shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such activity.

(i) Cost of pollution control activity carried out by outside contractors inside the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other costs incurred by the entity for such jobs.

(j) Cost of pollution control jobs carried out by contractor at its premises shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited. This cost shall also include the cost of other resources provided to the contractors.

(k) Cost of pollution control jobs carried out by outside contractors shall include charges made by the contractor and cost of own materials, consumable stores, spares, manpower, equipment usage, utilities and other costs used in such jobs.

(l) Each type of pollution control namely, water, air, soil pollution shall be treated as a distinct activity, if material and identifiable.

(m) Finance costs incurred in connection with the pollution control activities shall not form part of pollution control costs.

(n) Pollution control costs shall not include imputed costs.

(o) Price variances related to pollution control, where standard costs are in use, shall be treated as part of pollution control cost. The portion of usage variances attributable to normal reasons shall be treated as part of pollution control cost. Usage variances attributable to abnormal reasons shall be excluded from pollution control cost.

(p) Subsidy or grant or incentive or amount of similar nature received or receivable with respect to Pollution control activity, if any, shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

(q) Any Pollution control cost resulting from abnormal circumstances, if material and quantifiable, shall not form part of the pollution control cost.

(r) Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the pollution control cost.

(s) Credits or recoveries relating to the pollution control activity, material and quantifiable, shall be deducted to arrive at the net pollution control cost.

(t) Research and development cost to develop new process, new products or use of new materials to avoid or mitigate pollution shall be treated as research and development costs and not included under pollution control costs. Development costs incurred for commercial development of such product, process or material shall be included in pollution control costs.

(u) Any change in the cost accounting principles applied for the measurement of the pollution control cost shall be made only if, it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an organization.

(v) Pollution Control costs shall be traced to a cost object to the extent economically feasible.

(w) Direct costs of pollution control such as treatment and disposal of waste shall be assigned directly to the product, where traceable economically.

(x) Where these costs are not directly traceable to the product but are traceable to a process which causes pollution, the costs shall be assigned to the products passing through the process based on the quantity of the pollutant generated by the product.

(y) Where the pollution control cost is not directly traceable to cost object, it shall be treated as overhead and assigned based on either of the following two principles; namely:-

(1) **Cause and Effect -** Cause is the process or operation or activity and effect is the incurrence of cost and

(2) **Benefits received -** overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

14. Service department expenses.-

(a) Proper records shall be maintained in respect of service departments, that is, cost centres which primarily provides auxiliary services across the enterprise, to indicate expenses incurred in respect of each such service cost centre like engineering, work shop, designing, laboratory, safety, transport, computer cell, welfare and other related centres.

(b) Each identifiable service cost centre shall be treated as a distinct cost object for measurement of the cost of services subject to the principle of materiality.

(c) Cost of service cost centre shall be the aggregate of direct and indirect cost attributable to services being rendered by such cost centre.

(d) Cost of in-house services shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such service.

(e) Cost of other resources shall include related overheads.

(f) Cost of services rendered by contractors within the facilities of the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources provided to the contractors for such services.

(g) Cost of services rendered by contractors at their premises shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited. This cost shall also include the cost of resources provided to the contractors.

(h) Cost of services for the purpose of inter unit transfers shall also include distribution costs incurred for such transfers.

(i) Cost of services for the purpose of inter-company transfers shall also include distribution cost incurred for such transfers and administrative overheads.

(j) Cost of services rendered to outside parties shall also include distribution cost incurred for such transfers, administrative overheads and marketing overheads.

(k) Finance costs incurred in connection with the service cost Centre shall not form part of the cost of Service Cost Centre.

(l) The cost of service cost centre shall not include imputed costs.

(m) Where the cost of service cost centre is accounted at standard cost, the price and usage variances related to the services cost Centre shall be treated as part of cost of services. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.

(n) Any Subsidy or grant or incentive or any such payment received or receivable with respect to any service cost centre shall be reduced for ascertainment of the cost to which such amounts are related.

(o) The cost of production and distribution of the service shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost. Cost of a stand-by service shall include the committed costs of maintaining such a facility for the service.

(p) Any abnormal cost where it is material and quantifiable shall not form part of the cost of the service cost centre.

(q) Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of the service cost centre.

(r) Credits or recoveries relating to the service cost centre including charges for services rendered to outside parties, material and quantifiable, shall be reduced from the total cost of that service cost centre.

(s) Any change in the cost accounting principles applied for the measurement of the cost of Service cost centre shall be made, only if it is required by law or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.

(t) While assigning cost of services, traceability to a cost object in an economically feasible manner shall be the guiding principle.

(u) Where the cost of services rendered by a service cost centre is not directly traceable to a cost object, it shall be assigned on the most appropriate basis.

(v) The most appropriate basis of distribution of cost of a service cost centre to the cost centres consuming services is to be derived from logical parameters related to the usage of the service rendered. The parameter shall be equitable, reasonable and consistent.

15. Packing expenses.-

(a) Proper records shall be maintained separately for domestic and export packing showing the quantity and cost of various packing materials and other expenses incurred on primary or secondary packing indicating the basis of valuation.

(b) The packing material receipts shall be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified at the time of acquisition.

(c) Finance costs directly incurred in connection with the acquisition of packing material shall not form part of packing material cost.

(d) Self-manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads including share of administrative overheads comprising factory management and administration and share of research and development cost incurred for development and improvement of existing process or product.

(e) Normal loss or spoilage of packing material prior to receipt in the factory shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.

(f) The forex component of imported packing material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the packing material cost.

(g) Any demurrage, detention charges or penalty levied by the transport agency or any authority shall not form part of the cost of packing materials.

(h) Any subsidy or grant or incentive or any such payment received or receivable with respect to packing material shall be reduced for ascertainment of the cost to which such amounts are related.

(i) Issue of packing materials shall be valued using appropriate assumptions on cost flow, namely, First-in-First-Out, Last-in-First-Out, weighted average rate. The method of valuation shall be followed on a consistent basis.

(j) Wherever, packing material costs include transportation costs, the determination of costs of transportation shall be in accordance with para No. 9 on determination of cost of transportation.

(k) Packing material costs shall not include imputed costs.

(l) Where packing materials are accounted at standard cost, the price variances related to such materials shall be treated as part of packing material cost and the portion of usage variances due to normal reasons shall be treated as part of packing material cost. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.

(m) The normal loss arising from the issue or consumption of packing materials shall be included in the packing materials cost.

(n) Any abnormal cost where it is material and quantifiable shall be excluded from the packing material cost.

(o) The credits or recoveries in the nature of normal scrap arising from packing materials if any, shall be deducted from the total cost of packing materials to arrive at the net cost of packing materials.

(p) Packing material costs shall be directly traced to a cost object to the extent it is economically feasible.

(q) Where the packing material costs are not directly traceable to the cost object, these may be assigned on the basis of quantity consumed or similar measures like technical estimates.

(r) The packing material cost of reusable packing shall be assigned to the cost object taking into account the number of times or the period over which it is expected to be reused.

(s) Cost of primary packing materials shall form part of the cost of production.

(t) Cost of secondary packing materials shall form part of distribution overheads.

16. Interest and financing charges.-

(a) Interest and financing charges are costs incurred by an enterprise in connection with the borrowing of fund or other costs which in effect represent payment for the use of non- equity fund.

(b) Interest and financing charges incurred shall be identified for-

- **(i)** acquisition or construction or production of qualifying assets including fixed assets; and
- **(ii)** other finance costs for production of goods or operations or services rendered which cannot be classified as qualifying assets.

(c) Interest and financing charges directly attributable to the acquisition or construction or production of a qualifying asset shall be included in the cost of the asset.

(d) Interest and financing charges shall not include imputed costs.

(e) Subsidy or grant or incentive or amount of similar nature received or receivable with respect to Interest and Financing Charges if any, shall be reduced to ascertain the net interest and financing charges.

(f) Penal Interest for delayed payment, fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the interest and financing charges. In case the company delays the payment of statutory dues beyond the stipulated date, interest paid for delayed payment shall not be treated as penal interest.

(g) Interest paid for or received on investment shall not form part of the other financing charges for production of goods or operations or services rendered;

(h) Assignment of interest and financing charges to the cost objects shall be based on either of the following two principles; namely:-

(1) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost and

(2) Benefits received - to be apportioned to the various cost objects in proportion to the benefits received by them.

17. Any other item of cost.-

Proper records shall be maintained for any other item of cost being indispensable and considered necessary for inclusion in cost records for calculating cost of production of goods or rendering of services, cost of sales, margin in total and per unit of the goods or services under reference.

18. Capacity determination.-

(a) Capacity shall be determined in terms of units of production or equivalent machine or man hours.

(b) Installed capacity is determined based on-

(i) manufacturers' Technical specifications;

(ii) capacities of individual or interrelated production centres;

(iii) operational constraints or capacity of critical machines; or

(iv) number of shifts

(c) In case manufacturers' technical specifications are not available, the estimates by technical experts on capacity under ideal conditions shall be considered for determination of installed capacity. In case any production facility is added or discarded the installed capacity shall be reassessed from the date of such addition or discard In case the same is reassessed as per direction of the Government, It shall be in accordance with the principles laid down in the said directives. In case of improvement in the production process, the installed capacity shall be reassessed from the date of such improvement.

(d) Normal capacity shall be determined vis-a-vis installed capacity after carrying out adjustments for

(i) holidays, normal shut down days and normal idle time;

(ii) normal time lost in batch change over;

(iii) time lost due to preventive maintenance and normal break downs of equipments;

(iv) loss in efficiency due to ageing of the equipment; or

(v) number of shifts;

(e) Capacity utilization is actual production measured as a percentage of installed capacity.

19. Work-in-progress and finished stock

The method followed for determining the cost of work-in-progress and finished stock of the goods and for services under delivery or in-process shall be appropriate and shall be indicated in the cost records so as to reveal the cost element that have been taken into account in such computation. All conversion costs incurred in bringing the inventories to their present location and condition shall be taken into account while computing the cost of work-in-progress and finished stock The method adopted for determining the cost of work-in progress and finished goods shall be followed consistently.

20. Captive consumption

If the goods or services under reference are used for captive consumption, proper records shall be maintained showing the quantity and cost of each such goods or services transferred to other departments or cost centres or units of the company for self-consumption and sold to outside parties separately.

21. By-products and Joint Products

(a) Proper records shall be maintained for each item of by-product, if any, produced showing the receipt, issues and balances, both in quantity and value. The basis adopted for valuation of by-product for giving credit to the respective process shall be equitable and consistent and shall be indicated in cost records. Records showing the expenses incurred on further processing, if any, and actual sales realisation of by-product shall be maintained. The proper records shall be maintained in respect of credits or recoveries from the disposal of by-products

(b) Proper records shall be maintained the cost up to the point of separation of products or services shall be apportioned to joint products or services on reasonable and equitable basis and shall be applied consistently. The basis on which such joint costs are apportioned to different products or services arising from the process shall be indicated in the cost records. Proper records shall be maintained in respect credits or recoveries from the disposal of joint products or services.

22. 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 goods or services under such system. The cost variances shall be shown against separate heads and analyzed 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 goods or services shall be indicated clearly in the cost records. The reasons for the variances shall be duly explained in the cost records and statements.

23. Reconciliation of cost and financial accounts

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 adjust the profit of the goods or services under reference with the overall profit of the company. The variations, if any, shall be clearly indicated and explained.

24. Related party transactions

(a) Related Party means related party as defined under clause (76) of section 2 of the Companies Act, 2013 (18 of 2013).

(b) "Normal" price means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged in the sole consideration of sale and such sale is not made to a related party. Normal price can be construed to be a price at which two unrelated and non-desperate parties would agree to a transaction and where such transaction is not clouded due to the proximity of the parties to the transaction and free from influence though the parties may have shared interest.

(c) The basis adopted to determine Normal price shall be classified as under:

(i) Comparable uncontrolled price method;

(ii) Resale price method;

(iii) Cost plus method;

(iv) Profit split method;

(v) Transactional net margin method; or

(vi) Any other method, to be specified.

(d) In respect of related party transactions or supplies made or services rendered by a company to a company termed "related party relationship" and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of -

(i) purchase and sale of raw materials, finished goods, rendering of services, process materials and rejected goods including scraps and other related materials;

(ii) utilisation of plant facilities and technical know-how;

(iii) supply of utilities and any other services;

(iv) administrative, technical, managerial or any other consultancy services;

(v) purchase and sale of capital goods including plant and machinery; and

(vi) any other payment related to the production of goods or rendering of services under reference.

(e) These records shall also indicate the basis followed for arriving at the rates charged or paid for such goods or services so as to enable determination of the reasonableness of such rates in so far as they are in any way related to goods or services under reference.

25. Expenses or incentives on exports

(a) Proper records showing the expenses incurred on the export sales, if any, of the goods or services under reference shall be separately maintained so that the cost of export sales can be determined correctly. Separate cost statements shall be prepared for goods or services exported giving details of export expenses incurred or incentive earned.

(b) Proper records shall be maintained giving the details of export commitments license-wise and the fulfillment of these commitments giving the reasons for non-compliance, if any. In case, duty free imports are made, the cost statements shall reflect this fact. If the duty free imports have been made after actual production, the statement shall reflect this fact also.

26. Production Records

Quantitative records of all finished goods (packed or unpacked) or services rendered showing production, issues for sales and balances of different type of the goods or services under reference, shall be maintained. The quantitative details of production of goods or services rendered shall be maintained separately for self-produced, third party on job work, loan license basis etc.

27. Sales records

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 or inter unit transfer. In case of services details of domestic delivery or sales at control price, domestic delivery or sales at market price, export delivery or sales under advance license, export delivery or sales under other obligations, export delivery or sales at market price, and delivery or sales to related party or inter unit transfer. Such details shall be maintained separately for each plant or unit wise or service centre wise for total as well as per unit sales realization.

28. Cost statements

(a) Cost statements (monthly, quarterly and annually) showing quantitative information in respect of each good or service under reference shall be prepared showing details of available capacity, actual production, production as per excise records, capacity utilization (in-house), stock purchased for trading, stock and other adjustments, quantity available for sale, wastage and actual sale during current financial year and previous year.

(b) Such statements shall also include details in respect of all major items of costs constituting cost of production of goods or services, cost of sales of goods or services and margin in total as well as per unit of the goods or services. The goods or services emerging from a process, which forms raw material or an input material or service for a subsequent process, shall be valued at the cost of production or cost of service up to the previous stage.

(c) Cost Statements (monthly, quarterly and annually) in respect of reconciliation of indirect taxes showing details of total clearances of goods or services, assessable value, duties or taxes paid, CENVAT or VAT or Service Tax credit utilized, duties or taxes recovered and interest or penalty paid.

(d) If the company is operating more than one plant, factory or service centre, separate cost statements as specified above shall be prepared in respect of each plant, factory or service centre. Any other statement or information considered necessary for suitable presentation of costs and profitability of goods or services produced by the company shall also be prepared.

29. Statistical Records

(a) The records regarding available machine hours or direct labour hours in different production departments and actually utilized shall be maintained for production of goods or rendering of services under reference and shortfall suitably analyzed. Suitable records for computation of idle time of machines or labour shall also be maintained and analyzed.

(b) Proper records shall be maintained to enable the company to identify the capital employed, net fixed assets and working capital separately for the production of goods or rendering of services under reference and other goods or services to the extent such elements are separately identifiable. Non identifiable items shall be allocated on a suitable and reasonable basis to different goods or services. Fresh investments on fixed assets for production of goods or rendering of services under reference that have not contributed to the production of goods or rendering of services during the relevant period or 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.

30. Records of Physical Verification

Records of physical verification may be maintained in respect of all items held in the stock such as raw materials, process materials, packing materials, consumables stores, machinery spares, chemicals, fuels, finished goods and fixed assets etc. Reasons for shortages or surplus arising out of such verifications and the method followed for adjusting the same in the cost of the goods or services shall be indicated in the records.

Form – CRA – 2

(Pursuant to sub- rule (2) of rule 6 and sub- rule (3A) of rule 6)

Form of intimation of appointment of cost auditor by the company to Central Government

Form language ○ English ○ Hindi

Note: Refer the instruction kit for filing the form. All fields marked in * are to be mandatorily filled. IN CASE OF REVISED CRA-2, ALL THE DETAILS MUST BE FILLED AFRESH.

1. (a) * Corporate identity number (CIN) or foreign company registration number (FCRN) 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 [ ]

   (c) * e-mail ID of the company [ ]

   (d) *Phone (with STD code) [ ] - [ ]

   (e) *Nature of intimation of appointment of cost auditor(s) [ ]

   (f) (i) *SRN of CRA-2/23C filed earlier for appointment of cost auditor(s) for the current Financial Year [ ]

   (ii) *Number of such auditor(s) whose place of office is vacated [ ]

   (iii) Particulars of the auditor(s) whose place of office is vacated

   (i) *Firm registration number (FRN) of the Cost Auditor/Cost Auditor's firm/LLP [ ]

   (ii) *Name of the Cost Auditor/Cost Auditor's firm/LLP [ ]

   (iii) *Date of casual vacancy [ ]

   (v) *Reason of casual vacancy [ ]

3. *Product(s)/Service(s) to which cost Audit relates

(a) Number of Industries/Sectors/Products/Services (CETA Heading Level, wherever applicable as per rules) covered under regulated sectors ☐

Details of such industries/sectors/products/services

Industries/sectors/products/services	CETA heading (wherever Applicable)	No. of tariff items/ Products/ services

(b) Number of Industries/Sectors/Products/Services (CETA Heading Level, wherever applicable as per rules) covered under non-regulated sectors ☐

Details of such industries/sectors/products/services

Industries/sectors/products/services	CETA heading (wherever Applicable)	No. of tariff items/ Products/ services

4. *Details of all the cost auditor(s) appointed

*Number of cost auditor(s) ☐

I. (a) Category of the auditor ○ Individual ○ Partnership firm ○ Limited liability partnership (LLP)

(b) (i) *Membership number of the Cost Auditor/ member representing the Cost Auditor's Firm/LLP ☐

(ii) *Name of the Cost Auditor/member representing the Cost Auditor's Firm/LLP ☐

(iii) *Firm Registration Number (FRN) of the Cost Auditor/Cost Auditor's Firm/LLP ☐

(iv) *Name of the cost Auditor's Firm/LLP ☐

(c) (i) Address *Line I ☐

Line II ☐

(ii) *City ☐

(iii) *State ☐

(iv) *Country ☐

(v) *Pin Code ☐

(vi) *e-mail ID of the firm or member ☐

(d) *Date of the board meeting in which cost auditor was appointed [ ] (DD/MM/YYYY)

(e) *Type of appointment

O Original O Appointment due to casual vacancy O Appointment for new products/services/ location

(f) *Scope of audit of the cost auditor/firm/LLP

[ ]

5. *Financial year to be covered under the cost audit

From [ ] (DD/MM/YYYY) To [ ] (DD/MM/YYYY)

6. (a) *Is there any change in cost auditor(s) appointed, from the previous financial year O Yes O No O Not applicable

(b) *Mention the Firm Registration number(s) and name of the previous cost auditor(s) which has not been reappointed.

[ ]

(c) *Reasons for change

[ ]

(d) *Whether the previous cost auditor(s) has/have been informed about the change O Yes O No

Attachments

(1) *Copy of Board resolution of the company [Attach]

(2) Optional attachment, if any. [Attach]

List of attachments

[ ]

Remove Attachment

Declaration

I am authorized by the Board of Directors of the Company vide resolution number* [ ] dated * [ ] to sign this form and declare that all the requirements of Companies Act, 2013 and the rules made thereunder in respect of the subject matter of this form and matters incidental thereto have been complied with. I also declare that all the information given herein above is true, correct and complete including the attachments to this form and nothing material has been suppressed.

*To be digitally signed by **DSC BOX**

*Designation [ ]

*Director identification number of the director; or PAN of the Manager or CEO or CFO or authorized representative; Or Membership number of the company Secretary [ ]

Note: Attention is drawn to provisions of sections 448 and 449 of the Companies Act, 2013 which provide for punishment for false statement / certificate and punishment for false evidence respectively.

Modify **Check form** **Prescrutiny** **Submit**

This e-form has been taken on file maintained by the Central Government through electronic mode and on the basis of statement of correctness given by the company.

Form CRA-3

[Pursuant to rule 6(4) of the Companies (Cost Records and Audit) Rules, 2014]

FORM OF THE COST AUDIT REPORT

I/We, …………………........... having been appointed as Cost Auditor(s) under section 148(3) of the Companies Act, 2013(18 of 2013) 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 audited the Cost Records maintained under section 148 of the said Act, in compliance with the cost auditing standards, in respect of the…………………[mention name(s) of Product(s)/service(s)] for the period/year………………..(mention the financial year) maintained by the company and report, in addition to my/our observations and suggestions in para 2.

(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) In my/our opinion, proper cost records, as per rule 5 of the Companies (Cost Records and Audit) Rules, 2014 have/have not been maintained by the company in respect of product(s)/service(s) under reference.

(iii) In my/our opinion, proper returns adequate for the purpose of the cost audit have/have not been received from the branches not visited by me/us.

(iv) In my/our opinion and to the best of my/our information, the said books and records give/do not give the information required by the Companies Act, 2013, in the manner so required.

(v) In my/our opinion, the company has/does not have adequate system of internal audit of cost records which to my/our opinion is commensurate to its nature and size of its business.

(vi) In my/our opinion, information, statements in the annexure to this cost audit report gives/does not give a true and fair view of the cost of production of product(s)/rendering of service(s), cost of sales, margin and other information relating to product(s)/service(s) under reference.

(vii) Detailed unit-wise and product/service-wise cost statements and schedules thereto in respect of the product /service under reference of the company duly audited and certified by me/us are/ are not kept in the company.

2. Observations and suggestions, if any, of the Cost Auditor, relevant to the cost audit.

Dated: this …………. day of …………. 20…....

at ………… (mention name of place of signing this report)

SIGNATURE AND SEAL OF THE COST AUDITOR(S)

MEMBERSHIP NUMBER(S)

Notes:

(1) Delete words not applicable.

(2) 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/she shall indicate the same against the relevant para (i) to (vii) in the prescribed form of the Cost Audit Report giving details of discrepancies he/she has come across.

(3) 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

PART - A

1. General Information

1	Corporate identity number or foreign company registration number	
2	Name of company	
3	Address of registered office or of principal place of business in India of company	
4	Address of corporate office of company	
5	Email address of company	
6	Date of beginning of reporting financial year	dd/mm/yyyy
7	Date of end of reporting financial year	dd/mm/yyyy
8	Date of beginning of previous financial year	dd/mm/yyyy
9	Date of end of previous financial year	dd/mm/yyyy
10	Level of rounding used in cost statements	Absolute/thousands/ lacs/crores
11	Reporting currency of entity	INR
12	Number of cost auditors for reporting period	
13	Date of board of directors meeting in which annexure to cost audit report was approved	
14	Whether cost auditors report has been qualified or has any reservations or contains adverse remarks	
15	Consolidated qualifications, reservations or adverse remarks of all cost auditors	
16	Consolidated observations or suggestions of all cost auditors	
17	Whether company has related party transactions for sale *or* purchase of goods or services	

2. General Details of Cost Auditor

1	Whether cost auditor is lead auditor	
2	Category of cost auditor	
3	Firm's registration number	
4	Name of cost auditor/cost auditor's firm	
5	PAN of cost auditor/cost auditor's firm	
6	Address of cost auditor or cost auditor's firm	
7	Email id of cost auditor or cost auditor's firm	
8	Membership number of member signing report	
9	Name of member signing report	
10	Name(s) of product(s) or service(s) with CETA heading	
11	SRN number of Form 23C / CRA-2	
12	Number of audit committee meeting attended by cost auditor during year	
13	Date of signing cost audit report and annexure by cost auditor	
14	Place of signing cost audit report and annexure by cost auditor	

3. Cost Accounting Policy.-

(1) Briefly describe the cost accounting policy adopted by the Company and its adequacy or otherwise to determine correctly the cost of production/operation, cost of sales, sales realization and margin of the product(s)/service(s) under reference separately for each product(s)/service(s). The policy shall cover, inter alia, the following areas:

(a) Identification of cost centres/cost objects and cost drivers.

(b) Accounting for material cost including packing materials, stores and spares, employee cost, utilities and other relevant cost components.

(c) Accounting, allocation and absorption of overheads.

(d) Accounting for depreciation/amortization.

(e) Accounting for by-products/joint-products or services, scarps, wastage etc.

(f) Basis for Inventory Valuation.

(g) Methodology for valuation of Inter-Unit/Inter Company and Related Party transactions.

(h) Treatment of abnormal and non-recurring costs including classification of other non-cost items.

(i) Other relevant cost accounting policy adopted by the Company.

(2) Briefly specify the changes, if any, made in the cost accounting policy for the product(s)/service(s) under audit during the current financial year as compared to the previous financial year.

(3) Observations of the Cost Auditor regarding adequacy or otherwise of the Budgetary Control System, if any, followed by the company.

4. PRODUCT/SERVICE DETAILS (for the company as a whole)

Name of Product(s) /Services)	UOM	CETA heading (wherever applicable)	Whether Covered under Cost Audit Yes / No	Net Operational Revenue (net of taxes, duties etc.)	
				Current Year ₹	Previous Year ₹
1.					
2.					
3.					
4.					
....					
Total net revenue from operations					
Other Incomes of company					
Total revenue as per financial accounts					
Extra ordinary income, if any					
Total revenue including extra ordinary income, if any					
Turnover as per Excise/Service Tax Records					
Note: Explain the difference, if any, between Turnover as per Annual Accounts and Turnover as per Excise/Service Tax Records					

PART-B

For Manufacturing Sector

1. QUANTITATIVE INFORMATION (for each product with CETA heading separately)			
Name of Product			
CETA heading			
Particulars	**Unit**	**Current Year**	**Previous Tear**
1. Available Capacity			
(a) Installed Capacity			
(b) Capacity enhanced during the year, if any			
(c) Capacity available through leasing arrangements, if any			
(d) Capacity available through loan license / third parties			
(e) Total available Capacity			
2. Actual Production			
(a) Self manufactured			
(b) Produced under leasing arrangements			
(c) Produced on loan license / by third parties on job work			
(d) Total Production			
3. Production as per Excise Records			
4. Capacity Utilization (in-house)			
5. Finished Goods Purchased			
(a) Domestic Purchase of Finished Goods			
(b) Imports of Finished Goods			
(c) Total Finished Goods Purchased			
6. Stock and Other Adjustments			
(a) Change in Stock of Finished Goods			
(b) Self/Captive Consumption (incl. samples etc.)			
(c) Other Quantitative Adjustments, if any (wastage etc.)			
(d) Total Adjustments			
7. Total Available Quantity for Sale [2(d) +5(c) + 6(d)]			
8. Actual Sales			
(a) Domestic Sales of Product			
(b) Domestic Sales of Traded Product			

(c) Export Sale of Product			
(d) Export Sale of Traded Product			
(e) Total Quantity Sold			

2. ABRIDGED COST STATEMENT (for each product with CETA heading separately)						
	Name of Product					
	CETA heading					
	Unit of Measure					
		Production	**Finished Goods Purchased**	**Finished Stock Adjustment**	**Captive Consump-tion**	**Other Adjustments**	**Quantity Sold**
	Current Year						
	Previous Year						

Sl no.	**Particulars**	**Current Year**		**Previous Year**	
		Amount (₹)	**Rate per Unit (₹)**	**Amount (₹)**	**Rate per Unit (₹)**
1	Materials Consumed (specify details as per para 2A)				
2	Process Materials/chemicals				
3	Utilities (specify details as per 2B)				
4	Direct Employees Cost				
5	Direct Expenses				
6	Consumable Stores and Spares				
7	Repairs and Maintenance				
8	Quality Control Expenses				
9	Research and Development Expenses				
10	Technical know-how Fee / Royalty				
11	Depreciation/Amortization				
12	Other Production Overheads				
13	Industry Specific Operating Expenses (specify details as per para 2C)				
14	**Total (1 to 13)**				
15	Increase/Decrease in Work-in-Progress				
16	Less: Credits for Recoveries, if any				
17	Primary Packing Cost				
18	Cost of Production/Operations (14 + 15 to 17)				
19	Cost of Finished Goods Purchased				
20	Total Cost of Production and Purchases (18 +19)				
21	Increase/Decrease in Stock of Finished Goods				
22	Less: Self/Captive Consumption (incl. Samples, etc.)				
23	Other Adjustments (if any)				

24 25 26 27	Cost of Production/Operation of Product Sold (20 + 21 to 23) Administrative Overheads Secondary Packing Cost Selling and Distribution Overheads				
28 29	Cost of Sales before Interest (24 to 27) Interest and Financing Charges				
30 31	Cost of sales (28 + 29) Net sales Realization (net of Taxes and Duties)				
32	Margin [Profit/(Loss) as per Cost Accounts] (31 – 30)				

Notes:	
1.	Separate cost statement shall be prepared for each CETA heading representing the product.
2.	In case the same product has different unit of measure, separate cost statement shall be provided for different unit of measures.
3.	The items of cost shown In the Proforma are Indicative and the same shall be reflected keeping in mind the materiality of the item of cost in the product. The Proforma may be suitably modified to meet the requirement of the industry/product.
4.	In case the company follows a pre-determined or standard costing system, the above cost statement shall reflect figures at actuals after adjustment of variances, if any.

2A. Details of Materials Consumed								
Name of Product								
CETA heading								
Description of Material	**Category**	**UOM**	**Current Year**			**Previous Year**		
			Quantity	**Rate per Unit (₹)**	**Amount**	**Quantity**	**Rate per Unit (₹)**	**Amount**
1.								
2.								
3.								
4.								
5.								
6.								
7.								
8.								
9.								
10.								
Category: Indigenous/ Imported/ Self Manufactured								

2B. Details of Utilities Consumed							
Name of Product							
CETA heading							
Description of Material	UOM	Current Year			Previous Year		
		Quantity	Rate per Unit (₹)	Amount	Quantity	Rate per Unit (₹)	Amount
1.							
2.							
3.							
4.							
5.							
6.							
7.							
8.							
9.							
10.							

2C. Details of Industry Specific Operating Expenses		
Name of Product		
CETA heading		
Description of Industry Specific Operating Expenses	Current Year	Previous Year
	Amount	Amount
1.		
2.		
3.		
4.		
5.		
6.		
7.		
8.		
9.		
10.		

PART-C

For Service Sector

1. QUANTITATIVE INFORMATION (for each service separately)			
Name of Service			
Service Code (if applicable)			
Particulars	**Unit of Measurement**	**Current Year**	**Previous Year**
1. Available Capacity			
(a) Installed Capacity			
(b) Capacity enhanced during the year, if any			
(c) Total available Capacity			
2. Actual Services Provided			
(a) Own Services			
(b) Services under contractual arrangements			
(c) Outsourced Services			
(d) Total Services			
3. Total Services provided as per Service Tax Records			
4. Capacity Utilization (in-house)			
5. Actual Sales			
(a) Services rendered - Domestic			
(b) Services rendered - Export			
(c) Total Services Rendered			

2. ABRIDGED COST STATEMENT (for each service separately)					
Name of Service					
Service Code (if applicable)					
Unit of Measure					
		Services Provided	**Captive Consump-tion**	**Other Adjustments**	**Services rendered**
	Current Year				
	Previous Year				

Sl no.	**Particulars**	**Current Year**		**Previous Year**	
		Amount (₹)	**Rate per Unit (₹)**	**Amount (₹)**	**Rate per Unit (₹)**
1	Materials Consumed (specify details as per Para 2A)				
2	Utilities (specify details as per Para 2B)				
3	Direct Employees Cost				
4	Direct Expenses				
5	Consumable Stores and Spares				
6	Repairs and Maintenance				
7	Quality Control Expenses				
8	Research and Development Expenses				
9	Technical know- how Fee / Royalty				
10	Depreciation/Amortization				
11	Other Overheads				
12	Industry Specific Operating Expenses (specify details as per Para 2 C)				
13	**Total (1 to 12)**				
14	Less: Credits for Recoveries, if any				
15	Cost of Services provided (13 - 14)				
16	Cost of Outsourced/Contractual Services				
17	Total Services available				
18	Less: Self/Captive Consumption				
19	Other Adjustments (if any)				
20	Cost of Services Sold (17 - 18 + 19)				
21	Administrative Overheads				
22	Selling and Distribution Overheads				
23	Cost of Sales before Interest (20+21+22)				
24	Interest and Financing Charges				
25	Cost of Sales (23 + 24)				
26	Net Sales Realization (Net of Taxes and Duties)				
27	Margin [Profit/(Loss) as per Cost Accounts] (26 - 25)				

NOTES:	
1.	Separate cost statement shall be prepared for each service
2.	The items of cost shown in the Proforma are Indicative and the same shall be reflected keeping in mind the materiality of the Item of cost in the service.
3.	The Proforma may be suitably modified to meet the requirement of the industry/service.
4.	In case the company follows a pre-determined or standard costing system, the above cost statement shall reflect figures at actuals after adjustment of variances, if any.

2A. Details of Materials Consumed								
Name of Service								
Service Code (if applicable)								
Description of Material	Category	UOM	Current Year			Previous Year		
			Quantity	Rate per Unit (₹)	Amount	Quantity	Rate per Unit (₹)	Amount
1.								
2.								
3.								
4.								
5.								
6.								
7.								
8.								
9.								
10.								
Category Indigenous/ Imported/ Self Manufactured								

2B. Details of Utilities Consumed							
Name of Service							
Service Code (if applicable)							
Description of Material	UOM	Current Year			Previous Year		
		Quantity	Rate per Unit (₹)	Amount	Quantity	Rate per Unit (₹)	Amount
1.							
2.							

3.							
4.							
5.							
6.							
7.							
8.							
9.							
10.							

2C. Details of Industry Specific Operating Expenses		
Name of Service		
Service Code (if applicable)		
Description of Industry Specific Operating Expenses	**Current Year**	**Previous Year**
	Amount	**Amount**
1.		
2.		
3.		
4.		
5.		
6.		
7.		
8.		
9.		
10.		

PART-D

1. PRODUCT AND SERVICE PROFITABILITY STATEMENT (for audited products/services)

Sl. no.	Particulars	Current Year			Previous Year		
		Sales ₹	Cost of Sales ₹	Margin ₹	Sales ₹	Cost of Sales ₹	Margin ₹
	Product 1						
	Product 2						
	Product 3						
	......etc.						
	Service 1						
	Service 2						
	Service 3						
	..... etc.						
	Total						

2. PROFIT RECONCILIATION (for the company as a whole)

Sl. no.	Particulars	Current Year ₹	Previous Year ₹
1	Profit or Loss as per Cost Accounting Records		
	(a) For the audited product(s)/service(s)		
	(b) For the un-audited product(s)/servlce(s)		
2	Add: Incomes not considered in cost accounts (specify details)		
	a)		
	b)		
	c)		
	d)		
	e)		
	f)		
	g)		
	h)		

	i)		
	j)		
3	**Less:** Expenses not considered in cost accounts (specify details)		
	a)		
	b)		
	c)		
	d)		
	e)		
	f)		
	g)		
	h)		
	i)		
	j)		
4	Difference In Valuation of stock between financial accounts and cost accounts		
5	Other adjustments, if any		
6	Profit or Loss as per Financial Accounts		
Note: Show abnormal wastages, expenses on strikes/lock-outs and any other items of expenses or incomes of abnormal nature etc. not considered in cost separately			

3. VALUE ADDITION AND DISTRIBUTION OF EARNINGS (for the company as a whole)

Sl. no.	Particulars	Current Year ₹	Previous Year ₹
	Value Addition:		
1	Gross Sales (excluding sales returns)		
2	Less: Excise duty, etc.		
3	Net Sales		
4	Add: Export Incentives		
5	Add/less: Adjustment In Finished Stocks		
6	Less: Cost of bought out inputs		
	(a) Cost of Materials Consumed		
	(b) Process Materials / Chemicals		
	(c) Consumption of Stores and Spares		

	(d) Utilities (e.g. power and fuel)		
	(e) Others, if any		
	Total Cost of bought out inputs		
7	Value Added		
8	Add: Income from any other sources		
9	Add: Extra Ordinary Income		
10	Earnings available for distribution		
	Distribution of Earnings to:		
1	Employees as salaries and wages, retirement benefits, etc.		
2	Shareholders as dividend		
3	Company as retained funds		
4	Government as taxes (specify)		
5	Extra Ordinary Expenses		
6	Others, if any (specify)		
7	Total distribution of earnings		

4. FINANCIAL POSITION AND RATIO ANALYSIS (for the company as a whole)

Sl. no.	Particulars	Units	Current Year	Previous Year
A.	**Financial Position**			
1	Share Capital			
2	Reserves and Surplus			
3	Long Term Borrowings			
4	(a) Gross Assets (b) Net Assets			
5	(a) Current Assets (b) Less: Current Liabilities (c) Net Current Assets			
6	Capital Employed			
7	Net Worth			
B.	**Financial Performance**			
1	Value Added			
2	Net Revenue from Operations of Company			
3	Profit before Tax (PBT)			

C.	**Profitability Ratios**			
1	PBT to Capital Employed (B3/A6)	%		
2	PBT to Net worth (B3/ A7)	%		
3	PBT to Value Added (B3/B4)	%		
4	PBT to net revenue from Operations (B3/B2)	%		
D.	**Other Financial Ratios**			
1	Debt- Equity Ratio			
2	Current Assets to Current Liabilities			
3	Value Added to Net Revenue from Operations	%		
E.	**Working Capital ratios**			
1	Raw Materials Stock to Consumption	Months		
2	Stores and Spares to Consumption	Months		
3	Finished Goods Stock to Cost of Sales	Months		

Note. 1 Capital Employed means average of net fixed assets (excluding effect of revaluation of fixed assets) plus Non-current investments and net current assets existing at the beginning and close of the financial year.

Note. 2 Net Worth is as defined under clause (57) of section 2 of the Companies Act, 2013.

5. RELATED PARTY TRANSACTIONS (for the company as a whole)

Sl. no.	Name and Address of the Related Party	Name of the Product / Service	Nature of Transaction (Sale, Purchase etc.)	Quantity	Transfer Price	Amount	Normal Price	Basis adopted to determine the Normal Price
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								

NOTE. 1 Details shall be furnished for each Related Party and Product /Service separately.

NOTE. 2 Details of Related Party transactions without Indicating the Normal Price and the basis thereof shall be considered as incomplete Information.

6. Reconciliation of Indirect Taxes (for the Company as a whole)

	Particulars	Assessable Value ₹	Excise Duty ₹	Service Tax ₹	Cess and Others ₹	VAT ₹
	Duties/Taxes Payable					
	Excise Duty					
1	Domestic					
2	Export					
3	Stock Transfers (Net)					
4	Duty Free Clearance, Others etc.					
5	Total Excise Duty (1 to 4)					
6	Service Tax					
7	VAT, CST etc.					
8	Other State Taxes, if any					
9	Total Duties/Taxes Payable (5 to 8)					
	Duties/Taxes Paid					
10	Cenvat/VAT Credit Utillised- Inputs					
11	Cenvat/VAT Credit Utllised – Capital Goods					
12	Cenvat/VAT Credit Utillised – Input Services					
13	Cenvat/VAT Credit Utilised – Others					
14	Total (10 to 13)					
15	Paid through PLA/Cash					
16	Total Duties/Taxes paid (14 + 15)					
17	Duties/Taxes recovered					
18	Difference between Duties/Taxes Paid and Recovered					
19	Interest/Penalty/Fines Paid					
Note: Provide separate amounts in notes in respect of item 4 above.						

SIGNATURE	SIGNATURE	SIGNATURE
NAME	NAME	NAME
COST AUDITOR	COMPANY SECRETARY/DIRECTOR	DIRECTOR
MEMBERSHIP NUMBER	MEMBERSHIP/DIN NUMBER	DIN NUMBER
SEAL	STAMP	STAMP
DATE	DATE	DATE

Note.

(1) Wherever, there is any significant variation in the current year's figure over the previous year's figure for any item shown under each para of the Annexure to the Cost Audit Report, reasons thereof shall be given by the Cost Auditor.

(2) Wherever, duration of the current year or the previous year is not 12 (twelve) months, same shall be clearly indicated in the Report.

Form – CRA – 4 (Pursuant to sub- rule (6) of rule 6)	**Form for filing Cost Audit Report with the Central Government**

Form language ◯ English ◯ Hindi

Note: Refer the instruction kit for filing the form. All fields marked in * are to be mandatorily filled.

1. (a) * Corporate identity number (CIN) or foreign company Registration number (FCRN) 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 [ ]

   (c) * e-mail ID of the company [ ]

   (d) *SRN of 23C/CRA – 2 filed for appointment of Cost Auditor(s) [ ] **Pre-fill**

3. (a) *Financial year for which cost auditor was initially appointed

   From [ ] (DD/MM/YYYY) To [ ] (DD/MM/YYYY)

   (b)*Whether any change in Financial year Yes O No O

   (c)*Changed Financial Year for which report is being filed From (DD/MM/YYYY) To (DD/MM/YYYY)

   (d) *Date of Board of Directors meeting in which Annexure to the cost audit report was approved (DD/MM/YYYY)

4. (a) *State number of Industries/Sectors/Product(s)/Service(s) (CETA headling level, wherever applicable as per Rules) for which the Cost Audit Report is being submitted

   (i) Regulated [ ]

   (ii) Non- regulated [ ]

   (b) Details of such Industries/Sectors/Products(s)/Service(s) of the company

   (i) Details of such industries/sectors/products/Services under regulated sectors

Industries/sectors/products/services	CETA heading (wherever Applicable)	No. of tariff items/ Products/ services

(ii) Details of such industries/sectors/product(s)/ Service(s) under non-regulated sector

Industries/sectors/products/services	CETA heading (wherever Applicable)	No. of tariff items/ Products/ services

5. (a) *State number of Industries/Sectors/Product(s)/Service(s) (CETA headling level, wherever applicable as per Rules) not covered in the Cost Audit Report

(i) Regulated

(ii) Non-regulated

(b) (i) Details of such Industries/Sectors/Product(s)/Service(s) of the company under regulated sector

Industries/sectors/products/services	CETA heading (wherever Applicable)	No. of tariff items/ Products/ services

(ii) Details of such Industries/Sectors/Product(s)/Service(s) of the company under non-regulated sector

Industries/sectors/products/services	CETA heading (wherever Applicable)	No. of tariff items/ Products/ services

6. Details of the cost auditor(s) appointed

*Number of cost auditor(s) appointed

(a) *category of the auditor O Individual O partnership firm O Limited liability partnership (LLP)

(b)(i) *Membership number of the Cost Auditor or member representing the Cost Auditor's Firm/LLP

(ii) *Name of the Cost Auditor/member representing the Cost Auditor's Firm/LLP

(iii) *Firm Registration Number (FRN) of the Cost Auditor/Cost Auditor's Firm/LLP

(iv) *Name of the Cost Auditor's Firm/LLP

(c) (i) Address *Line I

Line II

(ii) *City

(iii) *State

(iv) *Country

(v) *Pin Code

(vi) *e-mail ID of the firm or member

(d) *Date of the board meeting in which cost auditor was appointed (DD/MM/YYYY)

(e) *Type of appointment O Original O Appointment due to casual vacancy O Appointment for new products/services/locations

(f) *Scope of audit of the cost auditor/firm/LLP

(g) *Date of receipt of copy of cost audit report by the company (DD/MM/YYYY)

7. (a) *Whether the cost auditor's report has been qualified Yes O No O

If yes, Please state

(b) *Whether cost auditor's report has any reservations — Yes O No O

If yes, please state

(c) *Whether cost auditor's report has any adverse remarks — Yes O No O

If yes, please state

(d) *Whether cost auditor's report contain any observations or suggestions — Yes O No O

If yes, cost auditor's observations/suggestions

Attachments

(1) *XBRL document in respect of the cost audit report and Company's information and explanation on every Qualification and reservation contained therein — Attach

List of attachments

(2) Optional attachment, if any. — Attach

Remove Attachment

Declaration

To the best of my knowledge and belief, the information given in this form and its attachments is correct and complete. I have been authorised by the Board of Director's resolution number ______ date ______ (DD/MM/YYYY) to sign and submit the application.

It is confirmed that the attached XBRL document(s) are the XBRL converted copy(s) of the duly signed cost audit report as required under Section 148(2) and company's information and explanations as required under Section 148(6) of the Companies Act, 2013 and the rules made thereunder. It is further confirmed that such document(s) have been prepared using XBRL taxonomy as notified by the Ministry of Corporate Affairs for this purpose.

To be digitally signed by

Director or Manager or CEO or CFO or Secretary of the company (in case of Indian company) or authorized representative (in case of Foreign company)

DSC BOX

*Designation

*Director identification number of the Director; or PAN of the Manager or CEO or CFO or authorized representative; or membership number of the Company Secretary

Note: Attention is drawn to provisions of sections 448 and 449 of the Companies Act, 2013 which provide for punishment for false statement / certificate and punishment for false evidence respectively.

Modify | **Check form** | **Prescrutiny** | **Submit**

This e-form has been taken on file maintained by the Central Government through electronic mode and on the basis of statement of correctness given by the company.

FAQ-1

19/03/2015

Frequently Asked Questions on Maintenance of Cost Accounting Records and Cost Audit under Companies Act, 2013

1.1 Which Rules govern maintenance of cost accounting records and cost audit as per Section 148 of the Companies Act, 2013?

The Central Government issued Companies (Cost Records and Audit) Rules, 2014 on June 30, 2014. Subsequently, it issued Companies (Cost Records and Audit) Amendment Rules, 2014 on December 31, 2014. The Amendment Rules has introduced certain changes to the original Rules issued on June 30, 2014. The Companies (Cost Records and Audit) Rules, 2014 read with the Amendment Rules 2014 are now applicable and governs the maintenance of cost accounting records and cost audit as per Section 148 of the Companies Act, 2013.

1.2 What is the applicability of the Companies (Cost Records and Audit) Rules, 2014 and what is the date on which it becomes effective and applicable?

(a) The Rules have classified sectors/industries under Regulated and Non-Regulated sectors. The sectors/industries covered under Table A of the Rules are under the Regulated Sector and sectors/industries covered under Table B are under the Non-Regulated Sector.

(b) Every company, including foreign companies defined in clause (42) of section 2 of the Act, engaged in the production of the goods or providing services, specified in Tables A and B, having an overall turnover from all its products and services of rupees thirty five crore or more during the immediately preceding financial year, shall be required to maintain cost accounting records.

However, foreign companies having only liaison office in India and engaged in production, import and supply or trading of medical devices listed in Sl. 33 of Table B are exempted. Further, companies which are classified as a micro enterprise or a small enterprise including as per the turnover criteria under sub-section (9) of section 7 of the Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006) are also excluded from the purview of the Rules.

(c) The Rules are effective from April 1, 2014 in respect of certain class of companies and for the others it is effective from April 1, 2015 as detailed below:

Rules Applicable from April 1, 2014 – Regulated Sectors

Sl.	Industry /Sector/ Product/Service	CETA Heading
1.	Telecommunication services made available to users by means of any transmission or reception of signs, signals, writing, images and sounds or intelligence of any nature (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India under the Telecom Regulatory Authority of India Act, 1997 (24 of 1997);	Not applicable

2.	Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003 (36 of 2003), other than for captive generation (referred to in the Electricity Rules, 2005);	....
3.	Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board under the Petroleum and Natural Gas Regulatory Board Act, 2006 (19 of 2006);	2709 to 2715;
4.	Drugs and pharmaceuticals	2901 to 2942; 3001 to 3006.
5.	Fertilizers;	3102 to 3105.
6.	Sugar and industrial alcohol;	1701; 1703; 2207

Rules Applicable from April 1, 2014 – Non-Regulated Sectors

Sl.	Industry /Sector/ Product/Service	CETA Heading
1.	Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items; Explanation. – For the purposes of this sub-clause, any company which is engaged in any item or items supplied exclusively for use under this clause, shall be deemed to be covered under these rules.	8401 to 8402; 8801 to 8805; 8901 to 8908
2.	Turbo jets and turbo propellers;	8411
3.	Arms and ammunitions;	3601 to 3603; 9301 to 9306.
4.	Propellant powders; prepared explosives (other than propellant powders); safety fuses; detonating fuses; percussion or detonating caps; igniters; electric detonators;	3601 to 3603
5.	Radar apparatus, radio navigational aid apparatus and radio remote control apparatus;	8526
6.	Tanks and other armoured fighting vehicles, motorised, whether or not fitted with weapons and parts of such vehicles, that are funded (investment made in the company) to the extent of ninety percent or more by the Government or Government agencies;	8710
7.	Port services of stevedoring, pilotage, hauling, mooring, re-mooring, hooking, measuring, loading and unloading services rendered by a Port in relation to a vessel or goods regulated by the Tariff Authority for Major Ports under section 111 of the Major Port Trusts Act, 1963 (38 of 1963);	Not applicable.
8.	Aeronautical services of air traffic management, aircraft operations, ground safety services, ground handling, cargo facilities and supplying fuel rendered by airports and regulated by the Airports Economic Regulatory Authority under the Airports Economic Regulatory Authority of India Act, 2008 (27 of 2008);	Not applicable.
9.	Steel;	7201 to 7229; 7301 to 7326
10.	Roads and other infrastructure projects corresponding to para No.(1) (a) as specified in Schedule VI of the Companies Act, 2013;	Not applicable.

Sl.	Industry /Sector/ Product/Service	CETA Heading
11.	Rubber and allied products being regulated by the Rubber Board constituted under the Rubber Act, 1947 (XXIV of 1947)	4001 to 4017
12.	Railway or tramway locomotives, rolling stock, railway or tramway fixtures and fittings, mechanical (including electro mechanical) traffic signalling equipment's of all kind;	8601 to 8608.
13.	Cement;	2523; 6811 to 6812
14.	Ores and Mineral Products;	2502 to 2522; 2524 to 2526; 2528 to 2530; 2601 to 2617
15.	Mineral fuels (other than Petroleum), mineral oils etc.;	2701 to 2708
16.	Base metals;	7401 to 7403; 7405 to 7413; 7419; 7501 to 7508; 7601 to 7614; 7801 to 7802; 7804; 7806; 7901 to 7905; 7907; 8001; 8003; 8007; 8101 to 8113.
17.	Inorganic chemicals, organic or inorganic compounds of precious metals, rare-earth metals of radioactive elements or isotopes, and Organic Chemicals;	2801 to 2853; 2901 to 2942; 3801 to 3807; 3402 to 3403; 3809 to 3824.
18.	Jute and Jute Products;	5303, 5310
19.	Edible Oil;	1507 to 1518
20.	Construction Industry as per para No.(5) (a) as specified in Schedule VI of the Companies Act, 2013 (18 of 2013)	Not applicable.
21.	Health services, namely functioning as or running hospitals, diagnostic centres, clinical centres or test laboratories;	Not applicable.
22.	Education services, other than such similar services falling under philanthropy or as part of social spend which do not form part of any business.	Not applicable.
23.	Production, import and supply or trading of following medical devices, namely:	
	Cardiac Stents, Drug Eluting Stents, Catheters, Intra Ocular Lenses, Bone Cements, Heart Valves, Orthopaedic Implants, Internal Prosthetic Replacements, Scalp Vein Set, Deep Brain Stimulator, Ventricular peripheral Shud, Spinal Implants, Automatic Impalpable Cardiac Deflobillator, Pacemaker (temporary and permanent), patent ductus arteriosus, atrial septal defect and ventricular septal defect closure device, Cardiac Re-synchronize Therapy, Urethra Spinicture Devices, Sling male or female, Prostate occlusion device, Urethral Stents	9018 to 9022

Rules Applicable from April 1, 2015 – Non-Regulated Sectors

Sl.	Industry /Sector/ Product/Service	CETA Heading
1.	Coffee and tea;	0901 to 0902
2	Milk powder;	0402
3.	Insecticides;	3808

4.	Plastics and Polymers;	3901 to 3914; 3916 to 3921; 3925
5.	Tyres and Tubes;	4011 to 4013
6	Paper;	4801 to 4802
7.	Textiles;	5004 to 5007; 5106 to 5113; 5205 to 5212; 5303; 5310; 5401 to 5408; 5501 to 5516
8.	Glass;	7003 to 7008, 7011, 7016
9.	Other machinery;	8403 to 8487
10.	Electricals or electronic machinery;	8501 to 8507; 8511 to 8512; 8514 to 8515; 8517; 8525 to 8536; 8538 to 8547.

1.3 The Institute of Cost Accountants of India (ICAI-CMA) had, from time to time, issued FAQs subsequent to implementation of Companies (Cost Accounting Records) Rules, 2011 and Companies (Cost Audit report) Rules, 2011. Will the clarifications and FAQs remain valid subsequent to Companies (Cost Records and Audit) Rules, 2014 coming into effect?

The FAQs and clarifications issued earlier are no longer valid. The same may be considered as withdrawn and not applicable for the Companies (Cost Records and Audit) Rules, 2014 unless specifically mentioned in these FAQs.

1.4 What constitutes the cost records under Rule 2(e)?

As per Rule 2(e) the Companies (Cost Records and Audit) Rules, 2014, "cost records" means 'books of account relating to utilization of materials, labour and other items of cost as applicable to the production of goods or provision of services as provided in section 148 of the Act and these Rules'. There cannot be any exhaustive list of cost accounting records. Any transaction - statistical, quantitative or other details - that has a bearing on the cost of the product/activity is important and form part of the cost accounting records.

Cost records are to be kept on regular basis to make it possible to "calculate per unit cost of production/operations, cost of sales and margin for each of its products for every financial year on monthly/quarterly/half-yearly/annual basis". What is required is to maintain such records and details in a structured manner on a regular basis so that accumulation is possible on a periodical basis.

1.5 The Rules state that cost records are to be maintained in Form CRA-1. However, CRA-1 does not prescribe any format but only provides principles to be followed for different cost elements. What are the role and status of Cost Accounting Standards/GACAP and its applicability vis-à-vis CRA-1?

The principles of maintenance of cost accounting records have been notified in the Rules in CRA-1. The principles are in sync with the cost accounting standards. The Rules are principle based and no formats have been prescribed for maintenance of cost accounting records like pre-2011 industry specific rules. No separate format based records maintenance has been prescribed even for the Regulated Industry and the prescription has left it open for industry to maintain cost accounting records according to its size and nature of business so long as it determines a true and fair view of the cost of production, cost of sales and margin of the products/services. The cost audit report is required to be in conformity with the "cost auditing standards" as referred to in Section 148 of the Companies Act, 2013.

It is also to be noted that the Council of the Institute of Cost Accountants of India has made it mandatory for cost accountants in practice to follow and conform to the Cost Accounting Standards issued by it and it is incumbent on the cost auditors to report any deviations from cost accounting standards.

1.6 What is the meaning of "Turnover" in relation to the Companies (Cost Records and Audit) Rules, 2014?

Sub-section 91 of Section 2 of the Companies Act, 2013 defines "turnover" as "the aggregate value of the realization of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year. For the purposes of these Rules, "Turnover" means gross turnover made by the company from the sale or supply of all products or services during the financial year. It includes any turnover from job work or loan license operations but exclude duties and taxes. Export benefit received should be treated as a part of sales.

1.7 Whether overall annual Turnover/individual turnover definition will include other operational income like Job work income, scrap sale, trading turnover, export benefits, sales of services etc.?

The Turnover shall include other operational income like Job work income, scrap sale, trading turnover, export benefits, sales of services etc.

1.8 Is maintenance of cost accounting records mandatory for a multi-product company where all the products are not covered under the Rules even if the Turnover of the individual product/s that are covered under the Rules is less than rupees thirty five crores?

The Rules provide threshold limits for the company as a whole irrespective of whether all its products are as per the prescribed industry/sector provided under Table A or Table B. The Rules do not provide any minimum product specific threshold limits for maintenance of cost accounting records and consequently the company would be required to maintain cost accounting records for the products covered under Table-A or Table-B or both even if the turnover of such products is below rupees thirty five crores.

1.9 What is the difference between Cost Accounting policy and Cost Accounting system?

Cost Accounting Policy of a company state the policy adopted by the company for treatment of individual cost components in cost determination.

The Cost Accounting system of a company, on the other hand, provides a flow of the cost accounting data/information across the activity flow culminating in arriving at the cost of final product/service.

1.10 A company meets the threshold limits for both maintenance of cost records and cost audit in Year-0 (previous year) and consequently comes under the purview of the Rules in Year-1 (current year). If the turnover of company gets reduced to lower than the prescribed threshold limit in Year-1 (current year), whether Cost Records and Cost Audit will be applicable for Year-2 (next year).

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 states that a company engaged in the production of the goods or providing of services as prescribed having an overall turnover from all its products and services of rupees thirty five crore or more during the immediately preceding financial year, shall include cost records for such products or services in their books of account. Since the threshold limit for applicability of maintenance of cost accounting records is met in Year-0, the cost records are required to be maintained from Year-1. Once the maintenance of cost records becomes applicable, it would be maintained on a continuous basis in the subsequent years also. In the same line, cost audit will be applicable from Year-1 and for every year thereafter.

1.11 How to identify products covered under 4-digit CETA Code as mentioned in the Rules?

Central Excise Tariff Act Heading has been defined in Rule 2(aa) of Companies (Cost Records and Audit) Rules 2014. It states *"Central Excise Tariff Act Heading" means the heading as referred to in the Additional Notes in the First Schedule to the Central Excise Tariff Act, 1985 [5 of 1986].*

First Schedule to the Central Excise Tariff Act, 1985 states – *"heading" in respect of goods, means a description in list of tariff provisions accompanied by a four-digit number and includes all sub-headings of tariff items the first four-digits of which correspond to that number*.

1.12 The Rules prescribed in 2011 had introduced the concept of reporting under "Product Group". The present Rules are silent about Product Group. What is the requirement of preparation of cost statements of products/services so far as maintenance of cost accounting records is concerned and reporting thereof in the cost audit report?

The concept of "Product Group" has been dispensed with in the present Rules. The cost records referred to in sub-rule (1) of Rule 5 is required to be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for **each of its products and activities**. Hence, it is imperative that the cost accounting records are required to be maintained and cost statements prepared for each and every product/ service/activity that the company is engaged in.

So far as reporting is concerned, Abridged Cost Statement for every product identified with the CETA Code is required to be provided. For activities/services for which CETA Code is not applicable, the Abridged Cost Statement shall be for each service/activity.

1.13 Whether separate Form CRA-2 is required to be filed by a company having two or more different types of products covered under cost audit?

CRA-2 Form (intimation for appointment of cost auditor to Central Government) has replaced the earlier Form 23C (application seeking approval for appointment of cost auditor). A single Form CRA-2 is required to be filed providing details of the sectors/industries covered under cost audit and details of cost auditor. For Companies appointing multiple cost auditors, only one single Form CRA-2 is required to be filed. Provision has been made in the Form to accommodate details of multiple cost auditors.

1.14 The Tables listing the industry/sector/product/service in the Rules have described the same by way of description as well as CETA Heading, wherever applicable. For certain sectors, the coverage under the CETA Heading are apparently not in line with the description of the sector. How to determine the coverage in such cases?

The description and the CETA Heading have to be read harmoniously and construed to be supplementing each other. The CETA Heading has been provided in the amended Rules in addition to what was provided in the original Rules issued in June 2014. The CETA Codes are inclusive and all products covered under the codes are covered irrespective of the description.

For example, in case of Petroleum Industry, the description states "Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board under the Petroleum and Natural Gas Regulatory Board Act, 2006 (19 of 2006)" and the CETA Headings are 2709 to 2715. Hence, all products covered under CETA Headings 2709 to 2715 are included as well as activities like storage, transportation, distribution of Crude Oil or Gas etc. and any other activity that is defined under the Petroleum and Natural Gas Regulatory Board Act, 2006 and regulated by the PNGRB are covered.

Similarly, Rubber and allied products would include all rubber products as specified under CETA Codes 4001 to 4017 and will not be restricted only to such rubber products regulated by the Rubber Board.

Companies engaged in manufacturing Machinery and mechanical appliances falling under CETA Codes 8401 to 8402; 8801 to 8805; 8901 to 8908 are similarly covered irrespective of its ultimate customer/consumer, subject to the company meeting the threshold limits prescribed and it is not necessary that the products have to be exclusively used in defence, space and atomic energy sectors.

1.15 What is meant by Telecommunication Services and what is its coverage?

The Companies (Cost Records and Audit) Rules, 2014 has covered *"Telecommunication services made available to users by means of any transmission or reception of signs, signals, writing, images and sounds or intelligence of any nature (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India under the Telecom Regulatory Authority of India Act, 1997 (24 of 1997)". The Telecom Regulatory Authority of India Act, 1997 defines "telecommunication service" as "service of any description (including electronic mail, voice mail, data services, audio text service, video text services, radio paging and cellular mobile telephone services) which is made available to users by means of any transmission or reception of signs, signals, writing, images and sounds or intelligence of any nature, by wire, radio, visual or other electro-magnetic means but shall not include broadcasting services".*

Subsequently, the Central Government has included broadcasting services within the ambit of telecommunication services by notifying *"broadcasting services and cable services to be telecommunication service". [Notification No. 39 issued by Ministry of Communication and Information Technology dated 9 January 2004, S.O. No. 44(E) issued by TRAI, vide F. No. 13-1/2004]*.

In view of the above, Telecommunication Services made available to users and regulated by the Telecom Regulatory Authority of India under the Telecom Regulatory Authority of India Act, 1997 would include all such services being regulated by TRAI including broadcasting services.

1.16 What is the coverage of "Roads and other infrastructure projects" under Item 10 of Table B of the Rules?

"Roads and other infrastructure projects" has been defined to be corresponding to para No.(1)(a) as specified in Schedule VI of the Companies Act, 2013. Sub-clause (a) to Para (1) of Schedule VI of the Companies Act, 2013 covers "Roads, national highways, state highways, major district roads, other district roads and village roads, including toll roads, bridges, highways, road transport providers and other road-related services". Hence, every activity including construction and maintenance of the above projects are covered under the Rules.

1.17 What is the coverage of Construction Industry under Item 21 of Table B of the Rules?

Construction Industry has been defined to be corresponding to para No. (5)(a) as specified in Schedule VI of the Companies Act, 2013. Para (5) of Schedule VI of the Companies Act, 2013 pertains to "Industrial, commercial and social development and maintenance" and covers "real estate development, including an industrial park or special economic zone" as per sub-clause (a). Hence, every construction activity in relation to the above are covered under the Rules.

1.18 What is the coverage of Aeronautical Services?

Clause 3(B)(8) of the Companies (Cost Records and Audit) Rules, 2014 covers under the ambit of the Rules *"Aeronautical services of air traffic management, aircraft operations, ground safety services, ground handling, cargo facilities and supplying fuel rendered by airports and regulated by the Airports Economic Regulatory Authority under the Airports Economic Regulatory Authority of India Act, 2008 (27 of 2008)"*.

The Airports Economic Regulatory Authority of India Act, 2008 has defined "aeronautical services" as follows:

(i) For navigation, surveillance, and supportive communication thereto for air traffic management;

(ii) For the landing, housing or parking of an aircraft or any other ground facility offered in connection with aircraft operations at an airport;

(iii) For ground safety services at an airport;

(iv) For ground handling services relating to aircraft, passengers and cargo at an airport;

(v) For the cargo facility at an airport;

(vi) For supplying fuel to the aircraft at an airport;

The Rule has covered all the above services under the ambit of maintenance of cost accounting records and cost audit subject to threshold limits.

However, all airports and aircraft operations belonging to or subject to the control of the Armed Forces or paramilitary Forces of the Union are excluded from the scope of these Rules.

1.19 Whether maintenance of cost accounting records and cost audit thereof, subject to threshold limits prescribed, is applicable to products which are for 100% captive consumption?

The Companies (Cost Records and Audit) Rules, 2014 has specified different products and services for which maintenance of cost accounting records and cost audit thereof, subject to threshold limits prescribed, is mandatory.

In case a product is manufactured and 100% captively consumed for production of some other product which is also covered under these Rules and is subject to cost audit, then the cost of such captively consumed product would form part of the final product which is also under cost audit and as such a separate cost audit report for the captively consumed product will not be necessary.

However, if the product is partly for captive consumption and partly sold, or if the product is 100% captively consumed for production of some other product which is not covered under these Rules, then cost audit would be applicable for such captively consumed product(s).

1.20 What would be the treatment of cost consumption of electricity from a captive generating plant and applicability of cost audit to such captive generating plants?

Rule 3(A)(2) dealing with generation, transmission, distribution and supply of electricity has excluded captive generation as defined in the Electricity Rules, 2005. It may be noted that in case of a company whose product(s)/service(s) are covered under the Rules and it consumes electricity from the captive generating plant, determination of cost of generation, transmission, distribution and supply of electricity as per CRA-1 would be mandatory since the cost of consumption of electricity has to be at cost. Hence, maintenance of cost records for generation, transmission, distribution and supply of electricity would be applicable. However, cost audit will not be applicable to such captive plants, provided the entire generation is consumed captively and no portion is sold outside.

1.21 A Company is engaged in both Regulated and Non-Regulated sectors and all its products are not covered under the Rules. How to determine applicability of cost audit for the products covered under the Regulated and Non-Regulated sectors since different threshold limits have been prescribed under Rule 4?

Rule 4 states that cost audit would be applicable for products under:

(a) Table A if the overall turnover of the company is at least ₹ 50 crore and

(b) Table B if the overall turnover of the company is ₹ 100 crore.

Hence, the coverage of cost audit for a company where all its products are covered under Table A or Table B or a combination of the two would be guided by these threshold limits.

In case of a multi-product company where all its products are not covered under Table A or Table B or a combination of both, then the following would apply:

(a) If the overall turnover of the company is more than ₹ 50 crore but less than ₹100 crore, then only products covered under Table-A will be covered under cost audit provided the sum total of all the products of the company covered under Table A and Table B is more than ₹25 crore.

(b) If the overall turnover of the company is more than ₹100 crore, then:

   (i) products under both Table A and Table B will be covered under cost audit provided the sum total of all the products of the company covered under Table A and Table B is more than ₹ 35 crore

   (ii) only products of Table A will be covered if the sum total of all the products of the company covered under Table A and Table B is more than ₹ 25 crore but less than ₹ 35 crore.

Explanation: Rule 4 has defined threshold limits for Table A and Table B separately but the aggregate turnover of the individual product or products or service or services has been defined to be all products for which cost records are required to be maintained under rule 3.

1.22 A company does job work for others. The raw materials are supplied to the company by the principal and the job worker gets conversion charges only. The Job Worker company pays the excise duty which is reimbursed by the principal. Will the job worker be covered under the Companies (Cost Records and Audit) Rules, 2014?

The Rules are applicable to a company. If the products of the Job Worker is listed under Table A or Table B of the Rules and the Job Worker company meets the threshold limits as prescribed, then the job worker company will be required to maintain cost accounting records. If the threshold criteria of the cost audit as prescribed are met, the company would be covered under cost audit also. Payment of excise duty by the Job Worker and in turn getting reimbursement for it is immaterial for application of the Rules.

1.23 Whether companies registered under Section 8 of the Companies Act, 2013 (corresponding to Section 25 of the Companies Act, 1956) and One Person Company (OPC) introduced in Companies Act, 2013 covered under the Rules?

The Companies (Cost Records and Audit) Rules, 2014 are applicable to every company registered under the Companies Act, 2013 which are engaged in production of goods or providing of services listed in Table-A or Table-B of Rule 3. Different threshold limits have been prescribed in the Rules for applicability of maintenance of cost accounting records and coverage under cost audit. Exemption has been granted only to companies which are classified as a micro enterprise or a small enterprise including as per the turnover criteria under sub-section (9) of section 7 of the Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006) and foreign companies having only liaison offices engaged in Production, import and supply or trading of medical devices specified under Item 33 of Table-B of Rule 3. Any other legal entity registered as a company that meets the conditions stated in Rule 3 and Rule 4 are covered.

1.24 The manufacturing process of a company generates Metal Scrap during production of its main products which may or may not be covered under cost audit. Such scrap is sold in the market after the same is cleared under CETA Codes that are covered in the Rules. Will the company be covered under cost audit for generation of scrap?

Generation of scrap is not a production or processing or manufacturing but is incidental to manufacture of its main products. The Rules are applicable to production of goods or providing of services. CETA Codes have been inducted in the Rules for proper identification of Products that are manufactured. The act of payment of Excise Duty is immaterial in the context of application of the Rules. The generation of scrap and its consequent sale in the market cannot be construed to be covered under the Rules.

1.25 Whether Value Addition and Distribution of Earnings [Part D, Para 3] is to be computed based on Cost record data or audited financial data?

Value Addition statement is to be computed based on audited financial accounts.

1.26 Whether Financial Position and Ratio Analysis [Part D, Para 4] is to be computed based on Cost record data or audited financial data?

Financial Position and Ratio Analysis is to be computed based on audited financial accounts. This reporting Para has been aligned with the nomenclature of Schedule III of the Companies Act, 2013.

1.27 What is the procedure for appointment of cost auditor under the Companies Act, 2013?

The cost auditor is to be appointed by the Board of Directors on the recommendation of the Audit Committee, where the company is required to have an Audit Committee. The cost auditor proposed to be appointed is required to give a letter of consent to the Board of Directors. The company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in **form CRA-2**, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within thirty days of such appointment of cost auditor.

1.28 Who can be appointed as a cost auditor?

Only a Cost Accountant, as defined under section 2(28) of the Companies Act, 2013, can be appointed as a cost auditor.

Clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 defines "Cost Accountant". It means a Cost Accountant who holds a valid certificate of practice under sub-section (1) of section 6 of the Cost and Works Accountants Act, 1959 and is in whole-time practice. Cost Accountant includes a Firm of Cost Accountants and a LLP of cost accountants.

1.29 What are the eligibility criteria for appointment as a cost auditor?

Eligibility Criteria under Section 141 of the Companies Act, 2013 read with Rule 10 of the Companies (Audit and Auditors) Rules, 2014 and Section 148 of the Companies Act, 2013. The following persons are not eligible for appointment as a cost auditor:

(a) A body corporate. However, a Limited Liability partnership registered under the Limited Liability Partnership Act, 2008 can be appointed. *[Section 141(3)(a)]*.

(b) An officer or employee of the company. *[Section 141(3)(b)]*.

(c) A person who is a partner, or who is in the employment, of an officer or employee of the company. *[Section 141(3)(c)]*.

(d) A person who, or his relative or partner is holding any security of or interest in the company or any of its subsidiary or of its holding or associate company or a subsidiary of such holding company. *[Section 141(3)(d)(i)]*.

(e) Relatives of any partner of the firm holding any security of or interest in the company of face value exceeding ₹ 1 lakh. *[Section 141(3)(d)(i) and Rule 10(1) of Companies (Audit and Auditors) Rules, 2014]*.

(f) A person who is indebted to the company or its subsidiary, or its holding or associate company or a subsidiary or such holding company, for an amount exceeding ₹ 5 lakhs. *[Section 141(3)(d)(ii) and Rule 10(2) of Companies (Audit and Auditors) Rules, 2014]*.

(g) A person who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for an amount exceeding ₹1 lakh. *[Section 141(3)(d)(iii) and Rule 10(3) of Companies (Audit and Auditors) Rules, 2014]*.

(h) A person or a firm who, whether directly or indirectly, has business relationship with the company or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company. *[Section 141(3)(e) and Rule 10(4) of Companies (Audit and Auditors) Rules, 2014]*.

"Business Relationship" is defined in *Rule 10(4) of Companies (Audit and Auditors) Rules, 2014* and the same shall be construed as any transaction entered into for a commercial purpose, except commercial transactions which are in the nature of professional services permitted to be rendered by a cost auditor or a cost audit firm under the Act and commercial transactions which are in the ordinary course of business of the company at arm's length price - like sale of products or services to the cost auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.

(i) A person whose relative is a director or is in the employment of the company as a director or key managerial personnel of the company. *[Section 141(3)(f)]*.

(j) A person who is in the full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor if such person or persons is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies. *[Section 141(3)(g)]*.

(k) A person who has been convicted by a court for an offence involving fraud and a period of ten years has not elapsed from the date of such conviction. *[Section 141(3)(h)]*.

(l) Any person whose subsidiary or associate company or any other form of entity, is engaged as on date of appointment in consulting and providing specialised services to the company and its subsidiary companies: *[Section 141(3)(i) and Section 144]*.

   (a) accounting and book keeping services
   (b) internal audit
   (c) design and implementation of any financial information system
   (d) actuarial services
   (e) investment advisory services
   (f) investment banking services
   (g) rendering of outsourced financial services
   (h) management services

1.30 The Companies Act, 2013 has introduced provision regarding rotation of auditors. Is the provision of rotation of auditors applicable to cost auditors also?

The provisions for maintenance of cost accounting records and cost audit are governed by Section 148 of the Companies Act, 2013. The provisions of Section 148 clearly states that no person appointed under Section 139 as an auditor of the company shall be appointed for conducting audit of cost records of the company. Section 148 also provides that qualifications, disqualifications, rights, duties and obligations applicable to auditors (financial) shall apply to a cost auditor appointed under this section. The eligibility, qualifications and disqualifications are provided in Section 141 of the Act and powers and duties are provided in Section 143. Section 143(14) specifically states that the provisions of Section 143 shall mutatis mutandis apply to a cost auditor appointed under Section 148. There are no other provisions governing the appointment of a cost auditor.

Section 139(3) of the Act, applicable to appointment of auditors (financial), and Rule 6 of Companies (Audit and Auditors) Rules, 2014 deals with the provision of rotation of auditors and these provisions are applicable only to appointment of auditors (financial). The Act does not provide for rotation in case of appointment of cost auditors and the same is not applicable to a cost auditor. It may, however, be noted that though there is no statutory provision for rotation of cost auditors, individual companies may do so as a part of their policy, as is the practice with Public Sector Undertakings.

1.31 What is the procedure to be followed for fixing the remuneration of a cost auditor?

Rule 14 of the Companies (Audit and Auditors) Rules, 2014 has laid down the procedure of appointment and fixing the remuneration of a cost auditor. It states as follows:

Remuneration of the Cost Auditor: *For the purpose of sub-section (3) of section 148,—*

(a) in the case of companies which are required to constitute an audit committee—

   (i) the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;

   (ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;

(b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

1.32 What are the duties of the Companies in relation to provisions of Section 148 of the Companies Act, 2013 and the Rules framed thereunder?

Every company required to get cost audit conducted under Section 148(2) of the Companies Act, 2013 shall:-

(a) Appoint a cost auditor within one hundred and eighty days of the commencement of every financial year;

(b) Inform the cost auditor concerned of his or its appointment;

(c) File a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in **form CRA-2**, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014;

(d) Within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in **form CRA-4** along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

1.33 Is a cost auditor required to audit and certify monthly, quarterly, half-yearly and yearly cost statements?

As per Rule 5, every company under these rules including all units and branches thereof are required, in respect of each of its financial year, to maintain cost records in form CRA-1. The cost records are required to be maintained on regular basis in such manner so as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis. The cost auditor is appointed to conduct audit of the cost records and make report thereon for the financial year for which he is appointed. It is not incumbent upon the cost auditor to certify monthly, quarterly, half-yearly cost statements.

1.34 CRA-3 requires Details of Material Consumed, Details of Utilities Consumed and Details of Industry Specific Operating Expenses respectively [Part B and Part C, Para 2(a), 2(b) and 2(c)]. In case of companies where number of materials or utilities or industry specific operating expenses is more than 10 each, which items should be disclosed in the respective paras?

It is to be noted that the cost audit report is required to be filed in XBRL mode and there is no provision for extending the number of items under any of the heads to accommodate more than 10 items. Hence, in cases where number of such items is more than 10 under any of the heads of material or utility or industry specific operating expenses, the 9 main items in terms of value should be provided separately and the balance items should be clubbed together under "Others" and shown as the tenth item.

1.35 Whether figures are to be provided for Rupees per Unit or Amount in Rupees in the Product and Service Profitability Statement [CRA-3, Part D, Para 1]?

Amount in Rupees are required to be provided under this Para. The number of products or services will be equal to the number of products and services covered under cost audit and for which Abridged Cost Statement has been provided.

1.36 Is there any obligation on the part of cost auditor to report offence of fraud being or has been committed in the Company by its officers or employees?

Sub-rule (7) of Rule 6 of the Companies (Cost Records and Audit) Rules 2014 states that *"the provisions of sub-section (12) of section 143 of the Act and the relevant rules made thereunder shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules"*.

As per sub-section (12) of section 143 of the Companies Act 2013, extract of which is given above, it is obligatory on the part of cost auditor to report offence of fraud which is being or has been committed in the company by its officers or employees, to the Central Government as per the prescribed procedure under the Rules.

As per the proviso to above sub-section, it has been stated that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

FAQ-2

08/07/2015

Frequently Asked Questions on Maintenance of Cost Accounting Records and Cost Audit under Companies Act, 2013

2.1 What types of Educational Services are covered under the Companies (Cost Records and Audit) Rules 2014?

The Companies (Cost Records and Audit) Rules 2014 covers **"Education services, other than such similar services falling under philanthropy or as part of social spend which do not form part of any business".**

Any company imparting training or education by means of any mode is covered under Education Services. However, auxiliary services provided by companies, as a separate independent entity, to educational institutions viz., (i) transportation of students, faculty and staff; (ii) catering service including any mid-day meals scheme; (iii) security or cleaning or house-keeping services in such educational institution; (iv) services relating to admission to such institution or conduct of examination are not included under Education Services.

In case the educational institution covered under the Rules is providing the above auxiliary services as a part of their total operations, then the institution will be required to maintain records for such auxiliary services also.

2.2 What types of Health Services are covered under the Companies (Cost Records and Audit) Rules 2014?

The Companies (Cost Records and Audit) Rules 2014 covers ***"Health services, namely functioning as or running hospitals, diagnostic centres, clinical centres or test laboratories"*.**

Any company engaged in providing Health services through functioning as or running hospitals, diagnostic centres, clinical centres, test laboratories, physiotherapy centres and post-operative/ treatment centres are covered within the ambit of the Companies (Cost Records and Audit) Rules 2014. Further, companies running hospitals exclusively for its own employees are excluded from the ambit of these Rules, provided however, if such hospitals are providing health services to outsiders also in addition to its own employees on chargeable basis, then such hospitals are covered within the ambit of these Rules.

It is clarified that companies engaged in running of Beauty parlours / beauty treatment are not covered under these Rules.

2.3 A company is engaged in construction of residential housing, offices, industrial units, Roads, Bridges, Marine facilities etc. having sites in India and abroad. The company also has Joint venture projects in India and abroad. Whether Companies (Cost Records and Audit) Rules 2014 would be applicable to the company?

All companies engaged in construction business either as contractors or as subcontractors, who meet with the threshold limits laid down in the Companies (Cost Records and Audit) Rules, 2014 and undertake jobs with the use of own materials [whether self-manufactured/produced or procured from outside] shall be required to maintain cost records and get cost audit conducted as per the provisions of the Companies (Cost Records and Audit) Rules, 2014.

The provisions of the Companies (Cost Records and Audit) Rules, 2014 would also apply for construction activities undertaken under BOT/BOOT mode, or the projects undertaken as EPC contractor or the projects undertaken abroad by a company incorporated in India.

The Companies (Cost Records and Audit) Rules, 2014, do not make any distinction between the Contractor and Sub-Contractor and accordingly all such companies will be included within the ambit of the Rules.

2.4 A company is engaged in manufacturing products on its own as well as purchase the same products from other companies. The outsourced products are treated as trading activity in the financial accounts. Same products are also manufactured by supply of materials to converters. What would

be treatment of such products for the purposes of maintenance of cost accounting records and cost audit?

Products manufactured by the company as well as conversion activity through third parties will be covered under the Companies (Cost Records and Audit) Rules 2014 and the company would be required to maintain cost accounting records and get cost audit conducted subject to threshold limits. The finished products bought from outside parties (treated as Trading Activity in Financial Accounts) would be reflected as "Cost of Finished Goods Purchased" in Abridged Cost Statement.

2.5 The Companies (Cost Records & Audit) Rules, 2014 provides exemption from cost audit to a company which is covered under rule 3, and whose revenue from exports, in foreign exchange, exceeds seventy five per cent of its total revenue. How to determine the percentage to total revenue in the following cases:

(i) In a company who is manufacturing Pharmaceutical products, the revenue from export of pharmaceutical products earned in foreign exchange divided by total revenue including other income etc. is 58%.

(ii) The revenue in foreign exchange earned from export of pharmaceutical products plus revenue in foreign exchange earned from rendering of research & development service divided by total revenue including other income etc.is 82%.

Cost audit is applicable for specified products/services. Rule 4(3) states *"The requirement for cost audit under these rules shall not apply to a company which is covered in rule 3, and (i) whose revenue from experts, in foreign exchange, exceeds seventy five per cent of its total revenue"*. The inclusion or coverage of a company under Rule 3 is in respect of products/services listed under Table-A and Table-B and consequently the computation of 75% is to be calculated for the specific products/ services covered under Rule 3 and not in respect of all the products/services of the company.

The total revenue and turnover of R&D Activities, not being covered under Rule 3 cannot be taken into consideration for computation of 75%.

In this connection it is also clarified that "total revenue" of a company is to be considered as the total revenue as defined in Schedule III of the Companies Act, 2013. Total Revenue as defined in Schedule III is Total Operating Revenue plus Other Incomes.

2.6 A company has units in SEZ and in non-SEZ areas. The Companies (Cost Records and Audit) Rules 2014 has exempted companies operating in special economic zones from cost audit. What would be applicability of the Companies (Cost Records and Audit) Rules 2014 on such a company in respect of maintenance of cost accounting records and cost audit?

Rule 3 of the Companies (Cost Records and Audit) Rules 2014 is specific and it has mandated maintenance of cost accounting records on all products/activities listed under Table-A and Table-B subject to threshold limits. No exemption is available to any company from maintenance of cost accounting records once it meets the threshold limits. Hence, the above company would be required to maintain cost accounting records for all its units including the one located in the special economic zone.

In view of the provisions of Rule 4(3)(ii) of the Companies (Cost Records and Audit) Rules 2014 the unit located in the special economic zone would be outside the purview of cost audit and the company would not be required to include particulars of such unit in its cost audit report. The other units of the company located outside the special economic zone would be covered under cost audit subject to the prescribed threshold limits.

2.7 A cost auditor is required to certify under Para 1(vii) of the Cost Audit Report – *"Detailed unit-wise and product/service-wise cost statements and schedules thereto in respect of the product/service under reference of the company duly audited and certified by me/us are/are not kept in the company"*. Whether product Cost Sheet prepared SKU wise/ type-wise/ size-wise/ specification-wise by the company is required to be certified by the cost auditor and kept in the company?

Rule 5(2) of the Companies (Cost Records and Audit) Rules 2014 requires that "the cost records referred to in sub-rule (1) shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities".

The Rules have identified products as per CETA heading as defined in Rule 2(aa) which states *"Central Excise Tariff Act Heading means the heading as referred to in the Additional Notes in the First Schedule to the Central Excise Tariff Act, 1985[5 of 1986]"*.

First Schedule to the Central Excise Tariff Act, 1985 states – "heading" in respect of goods, means a description in list of tariff provisions accompanied by a four-digit number and includes all sub-headings of tariff items the first four-digits of which correspond to that number.

The above definitions make it clear that maintenance of cost accounting records should conform to the CETA Heading and detailed unit-wise and product/service-wise cost statements and schedules thereto are required to be certified by the cost auditor.

2.8 In the abridged cost statement, what are Industry specific operating expenses? When should this be used?

Industry Specific operating expenses are those which are peculiar to a particular industry such as Telecommunication Industry which shows expenses such as Network Operating cost, License fee, Radio Spectrum charges, Microwave charges etc. which are peculiar to this Industry and should be disclosed separately in the cost statement. The Industry Specific operating expenses will vary from industry to industry depending upon the nature of operations. The industry specific operating expenses shall have to be identified and reported upon in the abridged cost statement.

2.9 What is installed capacity and how is this different from total available capacity? How the installed capacity is to be calculated in a multi-product company using the same machine/ facilities? Should installed capacity be the capacity at the beginning of the year or at the end of the year under audit?

The Institute of Cost Accountants of India has defined *"Installed Capacity is the maximum productive capacity, according to the manufacturer's specifications or determined through an expert study"* [CAS-2 of Cost Accounting Standards]. The Installed Capacity to be disclosed in the Quantitative Details of CRA-3 is to be considered as at the beginning of the year. Capacity enhanced during the year should be considered as the increase in Installed Capacity during the year on pro-rata basis. Available capacity is the total installed capacity after adjustment of capacity enhanced during the year and if any capacity is available by means of leasing arrangement or taking on third-party capacity for increasing the total capacity.

If the same available capacity is utilised for production of multiple products, the following different basis may be adopted to determine the available capacity in respect of each of the products:

(i) If the company has a system of allocating the total available capacity for production of multiple products, then such allocated available capacity is to be considered for the products being manufactured by utilising the same production facility.

(ii) If the production allocation is not pre-determined and changes from period to period, then the capacity utilisation is to be determined on the basis of total production of all the products taken together and the total available capacity should be considered for all the products.

2.10 Whether each and every transactions with Related Parties is to be disclosed under Para D-5 of Annexure to the Cost Audit Report?

Details of related Party Transaction are required to be provided in respect of each Related Party and each Product/Service for the year as a whole and not transaction-wise.

2.11 Revised Form CRA-2 has been made available by the Ministry of Corporate Affairs conforming to the Companies (Cost Records and Audit) Rules, 2014 on 31st December, 2014. What are the required attachments to Form CRA-2?

The Form has provided an attachment button for attachment of certified copy of the Board Resolution appointing the cost auditor. The consent letter of the cost auditor should be attached as optional attachment.

2.12 Is CRA-3 applicable for companies whose financial year commenced prior to April 1, 2014? Which Rules are applicable to companies whose financial year commenced on January 1, 2014?

The Section 148 of the Companies Act, 2013 and Companies (Cost Records and Audit) Rules, 2014 are applicable from April 1, 2014. Companies that were covered under the erstwhile Companies

(Cost Accounting Records) Rules, 2011 and met the threshold limits prescribed therein are required to get the cost audit of their companies audited for the financial year 01/01/2014 to 31/12/2014 under the 2011 Rules and submit their respective reports under Companies (Cost Audit Report) Rules, 2011.

Companies (Cost Records and Audit) Rules, 2014 is applicable to companies maintaining calendar financial year from 01/01/2015 onwards subject to the products/services being covered under Table-A or Table-B of Rule 3 and meeting the prescribed threshold limits.

2.13 The Companies (Cost Records and Audit) Rules, 2014 requires submission of a single cost audit report at company level. What is the procedure of certifying and submission of cost audit report of a company where more than one cost auditor is appointed?

In case of a company having more than one cost auditor, it would be necessary for the company to appoint/designate one cost auditor as the lead cost auditor for consolidation of the report.

The individual cost auditors appointed for specific units/products would be required to audit and provide Para numbers A-4, B-1, B-2, B-2A, B-2B, B-2C, C-1, C-2, C-2A, C-2B, C-2C (as applicable), D-1 in respect of the products/services coming under the purview of their respective audits. The individual auditors would also be required to submit to the Board of Directors the individual cost audit report as per Form of the Cost Audit Report given in CRA-3.

The lead auditor would be responsible for preparing the Para numbers A-3, D-2, D-3, D-4, D-5, D-6 and consolidate Para numbers A-4, B-1, B-2, B-2A, B-2B, B-2C, C-1, C-2, C-2A, C-2B, C-2C (as applicable), D-1 received from the individual cost auditors.

The consolidated report should contain the reports of all the individual cost auditors including the report of the Lead Cost Auditor. In case individual cost auditors have any observations or suggestions or qualifications, they would be required to mention the same under Para 2 of the cost audit report and the lead auditor would have to mention the specific observations and/or qualifications of all the individual cost auditors in the place provided for the same in the under Para A-1.

The consolidated report so prepared would be converted to XBRL and submitted to the Central Government by the Company in Form CRA-4.

2.14 The Companies (Cost Records and Audit) Rules, 2014 covers "Generation, transmission, distribution and supply of electricity" with no corresponding CETA Heading. Whether the Quantitative Information and Abridged Cost Statement in respect of Electricity are required to be reported under the Service Sector in the absence of a CETA Heading?

The reporting of electricity generation activity will be considered under "Manufacturing" and should be shown under CETA Heading 2716. Transmission and Distribution activities should be reported under the "Service Sector".

2.15 A Company is engaged in both Regulated and Non-Regulated sectors and all its products are not covered under the Rules. How to determine applicability of cost audit for the products covered under the Regulated and Non-Regulated sectors since different threshold limits have been prescribed under Rule 4?

The above issue was clarified in FAQ-1 vide FAQ 1.21. The issue is further clarified by means of the following example for ease of understanding.

	Turnover (₹ Crores) of					Applicability of	
	Table A Products	**Table B Products**	**Table A + B Products**	**Other Products**	**Total Operating Revenue**	**Cost Records**	**Cost Audit**
Case 1	5	10	15	19	34	No	No
Case 2	5	10	15	25	40	Yes	No
Case 3	10	15	25	26	51	Yes	Only Table A Product

Case 4	0	25	25	26	51	Yes	No
Case 5	20	14	34	75	109	Yes	Only Table A Product
Case 6	20	20	40	61	101	Yes	Both Tables A & B Products

2.16 What is the status of companies after the notification of Companies (Cost Records and Audit) Rules, 2014, who have not filed cost audit report and/or compliance report pertaining to any year prior to financial year commencing on or after April 1, 2014?

Companies that were covered under the Companies (Cost Accounting Records) Rules, 2011 or any of the 6 industry specific Cost Accounting Records Rules and were required to file Compliance Report and/or Cost Audit Report for and upto any financial year commencing prior to April 1, 2014 are required to comply with the erstwhile Rules and file the Compliance Report and/or Cost Audit Report in XBRL Mode for the defaulted years. For this purpose, the Costing Taxonomy 2012 will continue to be available and such reports would be required to be filed in Form A-XBRL and Form I-XBRL, as the case may be.

2.17 Many Companies have filed Form 23C as well as Form CRA-2 for 2014-15 in respect of different products and/or multiple cost auditors, if applicable. Which SRN Number has to be reported in the cost audit report while filing the same in XBRL Mode?

(a) Companies who have filed multiple Form 23C in respect of multiple cost auditors will be required to provide the SRN Numbers against each Form 23C filed.

(b) In case the company after filing individual Form 23C has also filed Form CRA-2, in such case the company will be required to provide the SRN Number of the latest CRA-2 only since the details of multiple cost auditors, if applicable for the company, would be covered under one Form CRA-2.

2.18 A company is engaged in manufacturing of multiple products. Some of the products are covered under the Companies (Cost Records and Audit) Rules, 2014 and some are not. Part-A, Para 4 of the Annexure to the Cost Audit Report (Product/Service Details for the company as a whole) requires Net Operational Revenue to be reported for each CETA Heading for both the current year and the previous year. Can the Net Operational Revenue of all the Products that are not covered under the Rules be reported in this Para as a single line item?

Part-A, Para 4 of the Annexure to the Cost Audit Report of Companies (Cost Records and Audit) Rules, 2014 require reporting of Net Operational Revenue of every CETA Heading separately comprised in the Total Operational Revenue as per Financial Accounts. Hence, the company would be required to report Net Revenue of every CETA Heading irrespective of whether the same is covered under maintenance of cost accounting records and cost audit or not. In case some of the Products are under the same CETA Heading but having different units of measurement (UOM), then Net Revenue is to be reported for separate UOMs. It may be noted that the number of quantitative details and abridged cost statements will have to be provided for each unique combination of CETA Heading and UOM of the Products which are covered under cost audit.

If the company is engaged in manufacturing of products as well as providing of services and/or trading, such services which are covered under the Companies (Cost Records and Audit) Rules, 2014 will be required to be reported separately according to the definition provided in the Rules classified under different types of services within the same class of service. It may be noted that the number of quantitative details and abridged cost statements will have to be provided for each classification of service covered under cost audit.

Other services that are not covered under the Rules and Revenue from Trading Activity may be reported under suitable heads denoting the service/activity.

The New Taxonomy has introduced a separate line item in this Para to report "Other Operating Incomes" which will form part of the Total Operating Revenue.

SECTION - B

2.2 GUIDANCE NOTE ON COST ACCOUNTING STANDARD ON COST OF PRODUCTION FOR CAPTIVE CONSUMPTION (CAS-4)

The Council of the Institute of Cost and Works Accountants of India has issued the Cost Accounting Standard 4 (CAS-4) for Determination of Cost of Production for Captive Consumption. This standard lays down the principles and methods for determining the cost of production of excisable goods used for captive consumption, presentation and disclosure in the cost sheet.

This Guidance Note deals with the principles and methods as provided in CAS-4 and practical aspects in connection with the determination of cost of production of excisable goods used for captive consumption.

In the preparation of cost sheet including those requiring attestation, cost of production of excisable goods used for captive consumption shall be determined as per CAS-4. The Cost Accounting Standards have been set in ***bold italic*** type and reference number has been retained as in CAS-4 for ready reference.

CAS 4 refers to Central Excise Act and Rules framed there under for determination of assessable value of goods used for captive consumption. Therefore, this Guidance note refers to relevant sections of Central Excise Act,1944, Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000, other relevant rules thereto, case laws on the subject and provides methodology for determination of assessable value of captively consumed goods on cost construction method as a measure of simplification.

Circular No. 692/08/2003-CX dated 13th February, 2003 issued by Department of Revenue (CBE&C) inter alia provides "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." Paragraph 3 of the above circular further provides:

"cost of production of captively consumed goods will henceforth be done strictly in accordance with CAS-4....."

The above circular is reproduced as Annexure I.

In view of above, CAS-4 is applicable from 13th February, 2003. The Department has, however, clarified that though CAS-4 was approved by the Government of India on 13.2.2003, cases pending finalization for the period earlier to this may be considered in line with costing principles laid down in CAS-4, issued by the Institute of Cost and Works Accountants of India. Assessments finalized prior to 13th February, 2003 not to be opened.

CAS-4 applies to following type of organizations registered with Excise Department if goods manufactured are for captive consumption:

1. Proprietorship concern
2. Partnership Firms
3. Cooperative Societies
4. Private/Public Limited Companies.

SSI units registered with Excise Department are exempt from payment of excise duty as per registration conditions.

Introduction

The scheme of valuation of excisable goods is contained in Sec. 3A, Sec. 4 and Sec. 4A of the Central Excise Act, 1944. The goods manufactured have to be valued in a prescribed manner as per above provisions to determine the excise duty payable by the assessee. Section 3 provides that excise duties shall be levied and collected on all excisable goods which are produced or manufactured in India at the rates set forth in Schedule to the Central Excise Tariff Act, 1985. Section 4 provides the mechanism to determine the value of goods subject to duty for the purpose of assessment. Section 4 was replaced by new Section 4 w.e.f 1-07-2000 and concept of 'transaction value' has been introduced under Section 4(3)(d). Section 4A provides for valuation of excisable goods with reference to retail sale price and applicable to commodities as notified by the Government from time to time and on which retail price is required to be indicated under the provision of the Standard of Weights & Measures Act, 1976 and the Rules made there under.

Section 4(1) (a) of Central Excise Act, 1944 deals with the Valuation of excisable goods when following requirements are satisfied:

1. Goods are sold at the time and place of removal from factory/warehouse;
2. The assessee and the buyer of the goods are not related; and
3. The price is the sole consideration of sale.

Each transaction is treated as a separate transaction for valuation purposes.

If any one of the above requirements is not satisfied, assessable value shall be determined under the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 notified on 30.6.2000, as provided under Section 4(1)(b) of the Act. For ready reference extract of Section 4 of the Central Excise Act, 1944 and the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 are annexed as **Annexure II and III.** Rules 8 and 9 deal with the valuation of goods captively consumed.

Meaning of Captive Consumption:

"Captive Consumption" means that the goods are not sold by the assessee but are used for consumption by him or on his behalf in the production or manufacture of other articles in the same premises or elsewhere.

When goods manufactured are supplied to a related party who does not sell the goods but consumes the same in manufacture of another product(s), such goods are also deemed to be "captively consumed" for the purpose of valuation under Excise Laws.

In some cases during the manufacture, certain intermediate goods emerge and are used in manufacture/production of other goods. The use of such intermediate product within the factory is also termed as "Captive Consumption".

Sometimes the goods are not removed from the factory but are used in the further manufacture/ production of goods and in such cases also, duty is payable as soon as the goods are manufactured/ produced within the factory unless exempted. Goods captively consumed in the same factory of the manufacturer are exempted from duty as per Notification No. 67/95-CE dt.16.03.1995, if duty is payable on the final product. For example, the manufacturer of motor vehicles manufactures various parts of the motor vehicles like brakes, panels etc. These parts are also excisable goods and have separate entry in the schedule to Central Excise Tariff Act, 1985. If these parts are removed from the factory, duty is payable but if these parts are used in the same factory of the manufacturer in the assembly / further manufacture of motor vehicles then the use of parts and components is called as captive consumption, and is not subject to excise duty in view of above notification.

Type of Goods:

Following type of goods are covered under CAS-4:

1. Goods manufactured not sold but captively consumed
2. Goods manufactured partly sold and partly captively consumed
3. Goods manufactured sold to related party for captive consumption

Goods manufactured, not sold but captively consumed:

Rule 8 of the Central Excise Valuation Rules provides that where the excisable goods are not sold but are used for consumption by assessee or on his behalf in the production or manufacture of other articles, the value shall be 110% (as of now)of the cost of production or manufacture of such goods. (115% was substituted by 110% vide notification no. 60 / 2003 – CE (NT) dated 05-08-2003) In other words, when goods are captively consumed, the assessable value will be 110% of cost of production. The earlier concept of deemed profit / notional profit has been done away and margin of 10% by way of profit etc is prescribed in the rule itself for ease of assessment of goods used for captive consumption. The cost of production is to be determined as per CAS-4 vide Government of India, Ministry of Finance & Company Affairs (Department of Revenue's Circular dated 13th February, 2003 (refer Annexure I)).

Judgement of Supreme Court dated 1.8.2006 :

In a landmark judgment dated 1.8.2006 in case No. Appeal (civil)2947-2948 of 2001 Commissioner of Central Excise, Pune vs M/s Cadbury India Ltd.(Refer Annexure IV), Hon'ble Supreme Court of India, observed :

"the Institute of Cost and Works Accountants of India (ICWAI) has laid down the principles of determining cost of production for captive consumption and formulated the standards for costing: CAS-4. According to CAS-4 the definition of "cost of production" is as under:

"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."

"The cost accounting principles laid down by ICWAI have been recognized by the Central Board of Excise and Customs vide Circular No.692/8/2003 CX dated 13.2.2003. The circular requires the department to determine the cost of production of captively consumed goods strictly in accordance with CAS-4. "

The Tribunal in the case of BMF BELTINGS LTD. vs. CCE : 2005 (184) E.L.T. 158 (Tri. Bang.) for the period 1995 to 2000 has directed the department to apply CAS-4 for the determination of the cost of production of the captively consumed goods. In ITC vs. CCE (190) ELT 119 the Tribunal held that the department has to calculate the cost of production in terms of CAS-4. Other decisions of the Tribunal, wherein it has directed that CAS-4 be applied for determination of the cost of production, are Teja Engineering v/s CCE 2006 (193) ELT 100 (Tri-Chennai), Ashima Denims v/s CCE 2005 (191) ELT 318 (Tri-Mumbai), and Arti Industries vs. CCE 2005 (186) ELT 208 (Tri-Chennai). This is therefore a consistent view taken by the Tribunal. The department has not filed any appeal in these cases and accepted the legal position. Apart from this, in the light of several decisions of this Court, the Department is also bound by the said circular No.692/9/2003 CX dated 13th February,2003 issued by the CBE&C."

In view of the above judgement also,the cost of production for captively consumed goods is to be determined as per CAS-4.

Valuation of Goods Partly Captively Consumed And Partly Sold:

Where the goods to be valued are captively consumed in one's own factory, valuation will be done on the basis of 110% of the cost of production of goods. If the goods are partially sold by the assessee and partially captively consumed, the goods sold would be assessed on the basis of transaction value under section 4 and the goods captively consumed would be valued under rule 8 i.e.110% of the cost production of goods, states the Board's circular no.643/32/2002-CE dt. 1-7-2002.

There can be situations where an assessee may manufacture an intermediate product (which is excisable) which requires be processing or using for further production in another unit of the same manufacturer located at a different place. In such a situation also, the principle of rule 8 is applicable. The cost of production of good manufactured plus 10% thereof is to be adopted for determining the assessable value.

Valuation of Goods sold to related party:

Rule 9 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 deals with sale to related person. Related person has been defined in Section 4(3)(b) of the Excise Act (Refer **Annexure II**). If a manufacturer sells goods to any of the related person, it will be treated as goods sold to related person. Rule 9 specifies that the goods can be sold to related persons for two purposes, one for onward sale when the related person is dealer/ distributor of the assessee and secondly the related person buys goods from the assessee for consumption in the production or manufacture of articles. In case, the related person does not sell the goods but uses or consumes such goods in the production or manufacture of the articles, the value shall be determined in the manner specified in rule 8, i.e. assessable value to be 110% of cost of production as per proviso to Rule 9.

Rule 10(a) of Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000,also provides that where excisable goods are sold to the related party/ inter connected undertaking who does not sell the goods but uses or consumes such goods in the production or manufacture of articles, the value of goods shall be determined in the manner specified in Rule 8 . The details of persons who shall be deemed to be related are prescribed under Section 4(3) (Refer Annexure II).

Valuation of capital goods manufactured and captively consumed:

Capital goods manufactured in a factory and used within the factory of manufacturer for manufacture/ production of excisable goods, are exempt from payment of excise duty as per Notification No.67/1995-CE dated 16th March,1995. This exemption is also available in case capital goods are manufactured by third party in the factory of manufacturer.

Free sample

CBE&C vide its circular No.643/34/2002 CX dated 1.7.2002 had clarified that for excisable goods removed as free sample, provision of Rule 4 will not apply but excise duty will be paid on 110% of cost of production as per Rule 8. However on reconsideration, the CBE&C has modified the above circular. As per revised circular No. 813/10/2005 CX dated 25.4.2005, value of free samples should be determined under Rule 4 of the Valuation Rules. The revised circular thus provides that valuation should be on the basis of value of identical goods cleared at or around the same time. However, in case of new or improved product, price of similar goods may not be available. Therefore for such goods, valuation should be on the basis of cost of production plus 10%, under Rule 11 read with Rule 8, in the absence of any other mode available for valuation.

Goods removed for test/trial outside the factory:

In above case Rule 4 is invoked as soon as assessee removes the manufactured goods for trial outside the factory. Since similar goods have been sold, the assessable value will be determined based on sale of such goods after making adjustment on account of difference in dates of delivery and the specification of goods.

Definitions

The following terms are used in this guidance note with the meaning specified.

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.

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).

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)

Principles for Determination of cost of production for captive consumption

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.

Various types of materials used for production of goods have been indicated. It depends on the type of product and process of manufacture involved. For example for production of engineering product both indigenous and imported raw materials may be used besides bought out items. In process industry, it may be indigenous/imported raw materials and other item of materials.

Materials are also classified as direct material and indirect material. Direct materials identified to finished product is a part of material cost while indirect material is part of overheads.

The cost elements to be considered for determining the cost of material consumed have been indicated above. The cost of material should be measured at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement. (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities) that can be quantified with reasonable accuracy at the time of acquisition. The method of valuation of material consumed shall be as per financial accounts, i.e., First in First out (FIFO) or weighted Average Rate.

LC charges/ Bank charges will not form part of material cost.

Normal loss or spoilage of material prior to reaching the factory will be absorbed in the cost of materials, after reducing the amounts chargeable to suppliers and recovery as scrap. Losses due to shrinkage or evaporation and gain due to elongation or absorption of moisture before the material is received will be absorbed in material cost to the extent they are normal.

Records relating to of material cost such as purchase, receipt, storage, issued for manufacture, sales or delivery of goods, including inputs and capital goods as the case may be, are required to be maintained under the Central Excise Law besides excise records for daily production report, daily stock account, CENVAT credit account for inputs, and the like . In brief it is to be ensured that there is effective material management system, properly documented, correctly accounted for to arrive at quantity and cost of material consumed for different types of products produced/manufactured. The item-wise material consumption for major item is reconciled with financial account.

The cost of material consumed is determined with respect to (i) the source / type of material consumed, and (ii) the method of valuation followed for issue of goods to production.

Any subsidy/grant/incentive and any such payment received /receivable with respect to any material shall be reduced from the cost of material consumed.

In case raw material is imported through advance license/DEPB or under any other scheme and used for manufacture of goods for captive consumption, adjustment for import duty shall be made to bring the raw material cost to the level of duty paid import. However, Duty Drawback refund benefit shall not be reduced from the input cost. Other export benefits like DEPB and DFRC will not be adjusted for calculation of cost of production.

Any demurrage or detention charges or penalty levied by transport or other authorities shall not form part of the cost of materials.

Bought out components:

Landed cost of indigenous / imported / bought out items shall be calculated on the above basis.

Illustrations of calculation of landed cost of indigenous and imported material are at Annexure VA and VB.

Self manufactured Items:

These will include any goods manufactured with raw material, indigenous or imported bought out material etc. by the manufacturer in the same factory for further use in manufacture of final product. For this purpose, the cost of production of such self manufactured items shall be considered as material cost for the subsequent product, after considering inward freight, octroi, etc., as applicable. Intermediate products/ goods transferred by another unit of the same manufacturer etc. shall be based on cost of production as per CAS-4.

Process material, colour and chemicals, packing materials: The cost of these shall be calculated on the same lines as above. In some cases, these items may get manufactured on job work basis from outside parties. In such cases, cost should consist of the cost of material supplied plus job work charges/ processing charges paid to the job worker/processor. The incidental charges like freight, insurance, handling charges etc, if any, shall also form cost of material.

In case of certain process materials like catalysts having longer process useful life, the cost of catalyst should be spread over its useful life.

Quantity of Material consumed:

The quantity of material consumed is to be worked out from material issue records from stores for each product. Such consumption in quantity may be derived by two methods.

Method (i): Based on actual issues for batch, unit or job - This method is preferred as it establishes direct relationship of actual material usage for the product.

Method (ii): Based on any method other than actual e.g. Standard

Under this method material is issued at Standard Bill of material. The standard cost for each direct material is defined at the beginning of the year. The variances from standard on account of price/ usage and the like are adjusted to consumption at the end of the period. Some organizations follow "Back flush Costing "system for issue of material. As soon as a finished good is ready for stock, material is back flushed (issued) as per the bill of material for that product. Any variation between the actual issues (both quantity and value) and the standard as accumulated over the period is charged off to consumption at the end of the period. Abnormal consumption, if any, shall not form part of material consumption on products.

This method is to be used in case of goods, where the direct link of actual consumption for product is not available. The manufacturer using this method should certify the quantitative requirement considered for calculation of material consumption as per Bill of Material. It may be ensured that usage variance is within reasonable limit and it should be adjusted in calculation of cost of production.

Reconciliation of cost of material consumed - It is advisable that cost of the material consumed for working out cost of production is reconciled with financial books. For major direct materials, reconciliation is to be ensured both in quantity and value.

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.

Direct wages and salaries are also termed as Employee cost. Employee cost are classified as direct employees cost and indirect employees cost. Direct employee cost is assigned to or linked with a cost centre or cost object. Indirect Employee Cost is treated as Overhead as dealt later.

Employee cost shall include the employee benefits as detailed above. If fringe benefits have not be identified with relevant cost centre, these should be allocated in the ratio of direct salaries and wages of the cost centres. Where an employee has worked in more than one departments/cost centres, it may be assigned on the basis of time spent.

The manufacturer shall prepare a detailed statement indicating Direct Employee Cost to different products and basis of allocation. Total Employee Cost shall be reconciled with financial accounts.

VRS payment, if any, shall not form part of cost of production.

5.3 Direct Expenses

Direct expenses are the expenses other than direct material cost and direct employee's 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.

Utilities include Power, water, steam, compressed air, Effluent Treatment etc. Some of the utilities are generated within the plant and others are purchased from outside source. Actual cost of utilities should be accumulated through utility cost centres and charged to user cost centres/departments on actual or technical estimates. In case meters have been installed, allocation of power/steam shall be as per actual reading. If any utility is supplied by a sister concern, the same shall be at landed cost. In case a utility cannot be identified with a product or service cost centre, the same may be treated as part of works overhead.

If a utility is partly produced and partly purchased, it shall be charged on weighted average rate.

A separate cost sheet for each of the utilities is to be prepared by the manufacturer. illustrations of power and steam utilitiy cost sheet are given at **Annexure VI and VII.**

Royalty:

Royalty is payable either in relation to production or sales. If royalty payment is in respect of production of the goods captively consumed, then the same should be added as the cost element. Royalty for Marketing and Distribution, if paid, will be excluded from cost of production. Sometimes, royalty payments are one time payment at the time factory is established and are identified with the plant cost. It is capitalized and depreciated/ amortized with the plant cost.

Technical Assistance/Know-how fees:

Technical Assistance/know-how fees should be apportioned to products for which it is payable based on the payment/ provision for the relevant period as per agreement with the supplier and its impact shall be determined with reference to planned production.

Amortized cost of moulds, dies, patterns, designs, drawings etc.:

The cost of moulds, dies, patterns, patents etc should be apportioned to products for which such moulds, patterns, patents are used which are directly identifiable with the products, based on the useful life of the item.

Based on the representation received from foundry manufacturer, the department has clarified treatment of pattern cost vide MF (DR) Circular No. 170/4/96-CX 1(F.No.6/14/94-CX 1) dated 23.1.1996 (Annexure VIII) as under:

"the proportionate cost of pattern has to be included in the assessable value of the castings even in cases where such patterns are being supplied by the buyers of the castings or are prepared / manufactured by the job worker at the cost of the buyer. In cases where there is a difficulty in apportioning the cost of pattern, apportionment can be made depending on the expected life and capability of the pattern and the quantity of castings that can be manufactured from it and thus working the cost to be apportioned per unit. For this purpose a certificate from a Cost Accountant may be accepted."

Job / Processing charges:

Job Work Charges / Processing Charges which are directly identified or linked with the products will form part of direct expenses.

Hire charges for tools and equipment:

Hire charges in respect of tools and equipments which can be directly identified with a particular product will form part of direct expenses. Hire charges for tools and equipment for general use is in the nature of indirect expenses and is to be included in works overheads.

Charges for a particular product designing etc:

Product design charges to the extent charged or amortized in the books of account in respect of tools and equipments which can be directly identified with a particular product will form part of direct expenses.

5.4 Works Overheads:

Works overheads are the indirect costs incurred in the production process.

The term Works Overhead, Factory Overheads, Production Overheads and Manufacturing overheads denote the same meaning and are used interchangeably. Works overheads shall include administration cost relating to production, factory, works or manufacturing.

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, and Pollution Control etc.

These expenses are incurred in the production process or in rendering service. These are used for a type of cost that cannot be directly assigned to a cost centre or product, but can only be apportioned to cost units/ cost object. Cost Accounting Standard 3, which deals with the methods of accumulation, allocation, apportionment of overheads to different cost centres and absorption thereof to products or services, should be followed.

A reconciliation statement showing the amount incurred under different heads of overheads and amount absorbed by different products used for captive consumption and for sale should be prepared by the assessee. The reconciliation will help in ensuring accuracy of cost statements.

List of items of expenses for works overheads, as indicated above, are illustrative and their treatment is indicated below. Other expenses such as Security, dispensary, canteen, staff welfare and the like will also form part of works overhead.

Consumable stores are items used in the maintenance of plant for example lubricant, cotton waste, paint and the like. Spares are purchased items used for replacement of worn out part of machinery and the like. Other indirect materials are items of small value such as bolt, nut nails, and the like which cannot be directly identified economically with a product and are treated as indirect material. These form part of the works overhead.

The depreciation on the fixed assets shall be as per the method of depreciation followed for the purpose of financial accounts as specified under Companies Act, 2013. Depreciation on idle fixed assets shall be excluded from cost of production. Further, depreciation should not be calculated based on the replacement value or notional value on revaluation of the assets. As per CAS-4 Depreciation of plant and machinery, factory building and the like is part of works overhead.

Insurance premium for various assets and risk connected with production activity should be included in works overheads. However, insurance on loss of profit policy and finished goods in transit policy should not be part of works overhead. Lease rental on fixed asset shall be also considered under this head.

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.

Quality control cost shall include various costs related to Quality Control, Quality Assurance Department functions and activities such as inspection of incoming material, inspection during progressive stages of manufacture of product on completion of finished product, Testing, Analysis Charges, Fees / Charges paid to IS / QS/Quality certification expenses etc. Expenses shall be identified under major heads such as salaries and wages, ISO certification etc.

CAS-4 provides that the quality control cost is to be shown separately in the cost sheet.

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.

Research and Development costs are the cost of undertaking research to improve quality of the present product or improve process of manufacture, develop a new product, etc.

The R & D cost for the existing product/ process shall be included in the cost of production. In case the company has followed a policy to treat a part of the R & D cost of existing product/process as deferred cost, share applicable for the year/period will be included in cost of production.

R & D cost incurred for developing a new product should be excluded from calculation of cost of production.

R&D cost is to be shown separately in the cost sheet as per Appendix I to CAS-4.

5.7 Administrative Overheads:

Administrative overheads need to be analyzed 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.

The role of administration is to facilitate the manufacturing, general policy making and marketing activities. The administrative overheads shall be included in the cost of production only to the extent they are attributable to the factory. Administrative overheads in relation to activities other than manufacturing activities e.g. marketing, selling, depot/branches etc. shall be excluded from the cost of production.

Administrative Overheads for production may include share from:

- Salaries of staff for administrative and other departments relating to production such as Accounts, Purchase, HRD, Production Planning, Security etc.
- General office expenses - like rent, lighting, rates & taxes, telephone, stationery, postage etc.
- Depreciation of office building, office equipment, furniture, vehicles, etc
- Repairs & Maintenance of office building, office equipment, furniture, vehicles, etc.
- Legal expenses in relation to factory.

Treatment of Head Office/Corporate Office Expenses:

A company may have a number of factories with a head office. In a multi-locational/ multi-product company, there are common activities carried out at Head Office like purchase, inventory management, finance, personnel, R & D, Quality Assurance, security etc. These activities sometimes, are centralized at one place i.e. Head Office for business convenience and scale of economy and booked as head office expenses along with other activities like secretarial, project, treasury, investment, trading, etc. They do not form part of the Administration overheads. For example: Industrial relation Department; Material management; Operation/production planning Department; Human Resources, System Design & Development Set Up and the like are production related activities. Nomenclature or place where the activity takes place is not relevant. In such a situation, activities at Head Office/Corporate level are to be clearly demarcated and segregated so as to distinguish activities that contribute clearly and directly to production activities from general management and administration activities. It is necessary to properly analyze the expenses of such activities of head office and allocate these to plants/products on rational basis.

Freight and forwarding charges on dispatch of goods for captive consumption:

In case goods for captive consumption are dispatched from one factory premises to another factory premises, the cost of transportation incurred by sender of the goods is to be treated as cost of transportation under Rule 5 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000, hence excluded from calculation of cost of production for CAS.

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.

Packing Cost includes:

I. Cost of Packing Material used

II. Job charges paid for manufacture of packing material, if any.

III. Packing charges including salaries & wages of the persons involved in packing activity.

IV. Other expenses relating to packing activity.

Landed cost of the packing material should be calculated as per the guidelines given in para related to material cost. If product for captive consumption is transferred without packing (unpacked), packing cost need not be included in the cost of production. In case, captive product is transferred on returnable/ durable packing container, pro-rata cost shall be estimated and charged based on the life of the container. In case packed goods are sent to job worker, the cost of packing will form part of cost of production, unless these are returned to buyer for re-use.

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 analyzed 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 staff salaries, rent etc.

The variable production overheads shall be absorbed in production cost based on actual capacity utilization.

The fixed production overheads and other similar items 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.

Absorption of overheads:

Based on behaviour, overheads are classified as variable overhead and fixed overhead. Variable Overheads comprise of expenses which vary in proportion to the change in the volume of production e.g. cost of utilities, royalty, job charges, etc.

Fixed overheads comprise of expenses which do not vary with the change in volume of production such as of rent, insurance, technical assistance/know-how fees, amortized cost of moulds, patterns, patents, hire charges for tools and equipments, charges for a particular design, and the like.

The principles laid down in CAS-3, relating to the methods of accumulation, 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 sheet should be followed for the purpose of allocation and absorption of overheads.

The variable production overheads shall be absorbed in cost of product, based on actual capacity utilization. The fixed production overheads shall be absorbed on normal capacity basis or actual capacity utilization whichever is higher. 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 for a defined period is the practical capacity minus the loss of productive capacity due to external factors. Whereas Practical or Achievable capacity as “the maximum productive capacity of a plant reduced by the predictable and unavoidable factors of interruption pertaining to internal causes such as inevitable interruptions due to time lost for preventive maintenance, repairs, set ups, normal delays, weekly off days and holidays etc.

An illustration on absorption of overheads based on normal capacity utilisation is at Annexure IX.

A reconciliation statement showing the amount incurred under different heads of overheads and amount absorbed by different products should be prepared for this purpose. The reconciliation will help in ensuring accuracy of cost of production in cost statements.

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 dispatched.

For determining the cost of production for captive consumption, adjustment for opening and closing stock of work-in-progress shall be made. The valuation of opening stock and closing stock of WIP is valued at cost on the basis of stages of completion. Similarly for calculation of cost of finished goods dispatched, adjustment for opening and closing stock of finished goods, if any, is to be made. 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.

Adjustment of opening and closing stock of WIP/finished goods will arise only when the cost of production is to be determined for historical cost and due consideration shall be given for above adjustment in determining the cost of production. However, if cost of production is to be determined for a future period, it will be based on projected cost and projected capacity utilisation. In such cases, adjustment of opening and closing WIP/finished goods and valuation thereof does not arise.

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 be the basis. It may be allocated based on a measure of the number of units, weight or volume. 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.

The joint cost shall be allocated to the cost of production of Joint Products as per the generally accepted cost accounting principles.

By-product:

By product is a product recovered incidentally from the material used in the manufacture of main products. It has lower importance compared to the main product(s).It is difficult to determine the cost of by-product. By products are sold:

(1) Either In original form without further processing; or

(2) or processed in order to be saleable. In such case, the main product is credited with the sale realization (gross/net) as the case may be. In other words expenses incurred to bring by-product to marketable conditions shall be adjusted from the sale of by product and net realizable value of by-product shall be credited to cost of production of main product.

In case sale realization is not available, credit to main product at substitute value of by product may be given.

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 shall be 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

Stage	Input material cost	Processing cost	Total
	(₹/MT)	(₹/MT)	(₹/MT)
1	2000	500	2500
2	2500	1000	3500
3	3500	1000	4500

If during the production process at stage 3, the scrap is produced and the same is recycled at stage 2 after making an expenditure of ₹ 200 per MT to make it suitable for re-processing at stage 2, then scrap will be valued @ ₹ (2500 - 200) i.e. ₹ 2300. If no expenditure is involved to make scrap re-usable, the scrap value will be @ ₹ 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.

The above illustration refers to recycled waste or inferior/ sub-standard production. Normal process loss is ignored for the sake of simplicity. If the cost calculation is done for the past period and the actual sales realization of scrap is available, the same shall be deducted after adjustment for opening and closing stock of scrap (to arrive at the realizable value of scrap generated) from the cost of production for the relevant period. In case the scrap is not disposed off/sold during the period and lying in the stock, the realizable value of scrap can be calculated from the quotations/market rate.

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 dispatch of the captively consumed goods produced under reference.

The miscellaneous income needs to be analyzed in detail for its nature (capital / revenue) and if not related to production activities, the same may be ignored. The income arising out of sale of used empty containers of the input materials shall be adjusted in the cost of production.

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.

Landed cost of inputs received free of cost should be calculated as per the guidelines given in para related to material cost. The cost of inputs received free of cost shall be included in the cost of production for captive consumption.

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.

Amortization should be done on the basis of estimated production that can be achieved during the life of the Mould, Tool, Die or Pattern. After the estimated life, if the moulds, dies are still in use and if the full cost has already been amortized, then amortization cost need not be considered for the purpose of cost of production. However, for this purpose, proper record needs to be maintained. The estimated life / estimated production may be certified by technical person. Where the dies, moulds etc are supplied by the customer, the necessary details may be obtained from the customer.

In case of dies, moulds etc purchased / manufactured in-house, its cost should be ascertained and amortised over its useful life.

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.

Interest and financial charges can be on bank borrowings, amortization of discounts or premium related to borrowings, amortization of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

Interest and financial charges are finance cost and do not form part of cost of production for captive consumption. Logic for excluding interest from captive consumption is that for purpose of assessable value a margin of 10% of cost of production is added to take care of return on capital employed. (Normally return on capital employed takes care of return on owners' equity and interest on borrowed fund). To make the calculation simple above approach of 110% of cost of production of captively consumed good is taken as assessable value.

5.17 Abnormal and Non-recurring Cost

Abnormal and non-recurring cost arises 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.

Loss due to fire, natural calamities and the like (as indicated above) are treated as abnormal and non-recurring cost, and excluded from cost of production. Further, expenses which are not related to manufacturing activity and which do not form part of the cost as per the generally accepted cost accounting principles may be excluded for this purpose e.g. - donations, loss on sale of fixed assets, etc.

Cost Sheet

The cost sheet should be prepared in the format as per Appendix-1 to the Standard 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 128 of the Companies Act, 2013, 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 128 of the Companies Act, 2013, 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.

Separate cost sheet shall be prepared for each type / variety / description of product used for captive consumption. The cost sheet may be suitably modified to cover the special features, if any, of the industry. Where goods of different variety / type / size of a group of products are manufactured and the manufacturing process is the same, the cost of production may be worked out for main product/variety and the cost of other type / variety of the product may be worked out by applying above cost per unit and adjustment made for addition / deletion of items required for a particular product. Separate cost statement is to be prepared for each size and variety of goods on the above basis.

In case of multi-location units, the cost of production should be worked out separately for each unit as per CAS-4.

The Cost Accountant certifying the cost sheet of cost of production for captive consumption shall verify and reconcile the product cost arrived at for the certification with that worked out to comply with provisions of Section 128 of the Companies Act, 2013.

In case where the product is covered under the Companies (Cost Records and Audit) Rules 2014 issued in pursuant to Section 128 of the Companies Act, 2013, the system for cost calculation would be in place and the relevant information will be readily available for such calculations. If the product is not covered under above provision, maintenance of cost accounting records as per the generally accepted costing principles read with Cost Accounting Standards shall be useful for the purpose.

Manufacturers following standard costing system should adjust the variances to the various products as per generally accepted cost accounting principles for calculation of product wise cost of production.

Two illustrations of Cost Sheet are annexed as Annexure X (a) and X (b).

Attestation/Certification:

The responsibility of preparation of cost sheet is that of the management. After cost sheet has been authenticated by company's authorized representative, cost accountant in practice has to certify the same as per certificate appended below the cost sheet. Cost accountant shall carry out test checks with reference to books of account, cost records and other records required for the purpose. Records required under Excise relating to receipt, purchases, manufacture storage, sales or delivery of goods inputs, etc may be scrutinized. He should ensure that cost data reflect true and fair view of the cost of production. Suggested list of test check to be carried out are given below.

Test checks will depend upon the type of organization i.e. covered under maintenance of cost accounts records as required under Section 128 and cost audit thereof under section 148 of the Companies Act 2013. Cost accounting records and cost report may be examined and other organisations. In case of organisations covered under above provisions, the Cost Accountant certifying the cost sheet of cost of production for captive consumption shall verify and reconcile the product cost arrived at for certification with that worked out to comply with provisions of Section 128 of the Companies Act, 2013 and cost audit report thereof.

Other organizations are:

1. Not covered under statutory maintenance of cost accounting records but have goods cost accounting system and proper records are maintained. In such cases cost records should be reviewed and information shall be called for the purpose.

2. Organisation do not maintain cost records at all: Organization shall submit the relevant records and data on the basis of which cost sheet has been prepared with reference to financial and excise records relating to production. With computerized accounting system, organization can supply the necessary data required for the purpose.

Test Checks:

Test checks required may be decided keeping in view the type of organisations detailed above. Examine the material accounting systems from purchase to issue of material. Compare the norms of consumption of input of materials as mentioned in ER 4, 5 and ER 6. If the product is already being produced, consumption shall be compared with previous period. Test check some issue vouchers relating to raw material and process material. If breakup of material cost is not indicated in the cost statement, ask for separate details item-wise. The basis of valuation shall be as per financial accounts. If the method of valuation is changed, it should be ensured that it does not result in undervaluation of cost of material.

Compare consumption of major raw material as shown in annual accounts. Check whether by product waste is being properly accounted for and credit is given to the main raw material.

Review procedure of employee cost booking, direct expenses and other overheads relating to classification and allocation and absorption. (Breakup of Overhead into fixed and variable overheads).

Check that the expenses as exhibited in the cost sheet have been properly worked out as provided under CAS-4.

Authentication on cost sheet, workings and/or declaration shall, preferably obtained from the professional accountant of the company.

However, when the normal capacity utilization is not quantifiable and /or actual capacity utilization is likely to be low, as compared to previous period; It is advisable that the manufacturer shall go for Provisional Assessment under rule 7 of Central Excise Rules, 2002. After the end of the year annual certification should be done based on the finalized books of account and if the cost of production is found different than the provisional costs, differential duty shall be paid by the manufacturer.

In case of multi-location units, the cost of production should be worked out separately for each unit as per CAS-4.

Periodicity of cost sheet/certification:

The basic purpose of CAS-4 is to determine the cost of production for goods capitvely consumed and calculate deemed transaction value thereof. Therefore, valuation is required at the time of removal of the goods. If costing is for the future period, it will be done at projected costs, projected capacity utilisation. In such cases, valuation of opening and closing stock of WIP and finished stock is to be ignored. In case, when the normal capacity utilization is not quantifiable and / or actual capacity utilization is likely to be low, as compared to previous period; it is advisable that the manufacturer shall go for Provisional Assessment under rule 7 of Central Excise Rules, 2002. After the end of the year annual certification should be done based on the finalized books of account and if the cost of production is found different than the provisional costs, differential duty shall be paid by the manufacturer.

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.

(i) 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.

The cost accounting principles and methods adopted for determining the cost of production to be followed consistently from one period to subsequent period. If there is any change in the cost accounting principles and methods during the period resulting in material effect on the cost of production, the same shall be disclosed indicating its impact in the cost statement.

Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule or below the certificate relating to above items or any other matter.

Annexure I

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.354/81/2000TRU 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.

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 , CBE&C on 23.1.2003.

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.

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.

This Circular may be brought to the notice of the field formations.

Suitable Trade Notices may be issued for the benefit of the Trade.

Hindi version will follow.

Receipt of these instructions may be acknowledged.

Annexure II

EXTRACT OF SECTION 4 OF CENTRAL EXCISE ACT, 1944

4. Valuation of excisable goods for purposes of charging of duty of excise.

1) Where under this Act, the duty of excise is chargeable on any excisable goods with reference to their value then, on each removal of the goods, such value shall -

   a. In a case where the goods are sold by the assessee, for delivery at the time and place of the removal, the assessee and the buyer of the goods are not related and the price is the sole consideration for the sale, be the transaction value;

   b. In any other case, including the case where the goods are not sold be the value determined in such manner as may be prescribed.

2) The provisions of this section shall not apply in respect of any excisable goods for which a tariff value has been fixed under sub-section (2) of section 3.

3) For the purposes of this section, -

   a. "assessee' means the person who is liable to pay the duty of excise under this Act and includes his agent:

   b. persons shall be deemed to be "related" if –

      I. they are inter-connected undertakings;

      II. they are relatives;

      III. amongst them the buyer is a relative and a distributor of the assessee, or a sub-distributor of such distributor; or

      IV. they are so associated that they have interest, directly or indirectly, in the business of each other.

Explanation: In this clause-

(i) "inter-connected undertakings" shall have the meaning assigned to it in clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969; and

(ii) "relative" shall have the meaning assigned to it in clause (77) of section 2 of the Companies act, 2013;

   (a) "Place of removal" means-

      I. a factory or any other place or premises of production or manufacture of the excisable goods;

      II. A warehouse or any other pace or premises wherein the excisable goods have been permitted to be deposited without payment of duty; from where such goods are removed;

   (b) "transaction value" means the price actually paid or payable for the goods, when sold, and includes in addition to the amount charged as price, any amount that the buyer is liable to pay to, Or on behalf of, the assessee, by reason of , or in connection with the sale, whether payable at the time of the sale or at any other time, including, but not limited to, any amount charged for, or to make provision for, advertising or publicity, marketing and selling organization expenses, storage, outward handling, servicing, warranty, commission or any other matter; but does not include the amount of duty of excise, sales tax and other taxes, if any, actually paid or actually payable on such goods.

Annexure III

CENTRAL EXCISE VALUAION (DETERMINATION OF PRICE OF EXCISABLE GOODS) RULES, 2000

Notification No. 45/2000-C.E. (N.T.) dated 30-6-2000 [Effective from 1-7-2000].

Amended by

Notification No. 11/2003-C.E. (N. T.), dated 1-3-2003

Notification No. 60/2003-C.E. (N.T.), dated 05-08-2003

Notification No. 09/2007-C.E. (N. T.), dated 1-3-2007

[Issue by the Ministry of Finance (Department of revenue) vide F. No. 354/81/2000-TRU; Published in the Gazette of India Extraordinary Part II, Section 3, sub-section (i) dated 30.6.2000]. NOTIFICATION [NO. 45/2000- Central Excise (N.T.)]

G.S.R.575 (E):- In exercise of the powers conferred by section 37 of the Central Excise Act, 1944 (1of 1944), and in supersession of the Central Excise (Valuation) Rules, 1975 except as respect things done or omitted to be done before such supersession, the Central Government hereby makes the following rules, namely:-

1. (1) These rules may be called the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000.

   (2) They shall come into force on and from the 1st day of July, 2000.

CHAPTER I

PRELIMINARY

2. In these rules, unless the context otherwise requires:-

   a) "Act" means the Central Excise Act, 1944 (1of 1944)

   b) "normal transaction value" means the transaction value at which the greatest aggregate quantity of goods are sold ;

   c) "value" means the value referred to in section 4 of the Act;

   d) words and expressions used in these rules and not defined but defined in the Act shall have the meanings respectively assigned to them in the Act.

CHAPTER II

DETERMINATION OF VALUE

3. The value of any excisable goods shall, for the purposes of clause (b) of sub-section (1) of section 4 of the Act, be determined in accordance with these rules.

4. The value of the excisable goods shall be based on the value of such goods sold by the assessee for delivery at any other time nearest to the time of the time of the removal of goods under assessment, subject, if necessary, to such adjustment on account of the difference in the dates of delivery of such goods and of the excisable goods under assessment, as may appear reasonable.

5. Where any excisable goods are sold in the circumstances specified in clause (a) of sub-section (1) of section 4 of the Act except the circumstance in which the excisable goods are sold for delivery at a place other than the place of removal, then the value of such excisable goods shall be deemed to be the transaction value , excluding the actual cost of transportation from the place of removal upto the place of delivery of such excisable goods.

Explanation 1: "Cost of transportation includes"

I. the actual cost of transportation, and

II. In case where freight is averaged, the cost of transportation calculated in accordance with generally accepted principles of costing.

Explanation 2: For removal of doubts, it is clarified that the cost of transportation from the factory to the place of removal, where the factory is not the place of removal, shall not be excluded for the purposes of determining the value of excisable goods.

6. Where the excisable goods are sold in the circumstances specified in clause (a) of sub section (1) of section 4 of the Act except the circumstance in where the price is not the sole consideration for sale, the value of such goods shall be deemed to be the aggregate of such transaction value and the amount of money value of any additional consideration flowing directly or indirectly from the buyer to the assessee.

Explanation 1: For removal of doubts, it is hereby clarified that the value, apportioned as appropriate, of the following goods and services, whether supplied directly or indirectly by the buyer free of charge or at reduced cost for use in connection with the production and sale of such goods, to the extent that such value has not been included in the price actually paid or payable, shall be treated to be the amount of money value of additional consideration flowing directly or indirectly from the buyer to the assessee in relation to sale of the goods being valued and aggregated accordingly, namely:-

I. Value of materials, components, parts and similar items relatable to such goods;

II. Value of tools, dies, moulds, drawings, blue prints, technical maps and charts and similar items used in the production of such goods;

III. Value of materials consumed, including packaging materials, in the production of such goods;

IV. Value of engineering, development, art work, design work and plans and sketches undertaken elsewhere than in the factory of production and necessary for the production of such goods.

Explanation 2 – Where an assessee receives any advance payment from the buyer against delivery of any excisable goods , no notional interest on such advance shall be added to the value unless the Central Excise Officer have evidenced to the effect that the advance received has influenced the fixation of price of the goods by way of charging a lesser price from or by offering a special discount to the buyer who has made the advance deposit.

Illustration 1: X an assessee, sells his goods to Y against full advance payment at ₹ 100 per piece. However, X also sells such goods to Z without any advance payment at the same price of ₹ 100 per piece. No notional interest on the advance received by X is includible in the transaction value.

Illustration 2: A an assessee manufactures and supplies certain goods as per design and specification furnished by B at a price of ₹ 10 lakhs. A takes 50% of the price as advance against these goods and there is no sale of such goods to any other buyer. There is no evidence available with the Central Excise Officer that the notional interest on such advance has resulted in lowering of the prices. Thus, no notional interest on the advance received shall be added to the transaction value.

7. Where the excisable goods are not sold by the assessee at the time and place of removal but are transferred to a depot, premises of a consignment agent or any other place or premises (hereinafter referred to as "such other place") from where the excisable goods are to be sold after their clearance from the place of removal and where the assessee and the buyer of the said goods are not related and the price is the sole consideration for the sale, the value shall be the normal transaction value of such goods sold from such other place at or about the same time and, where such goods are not sold at or about the same time, at the time nearest to the time of removal of goods under assessment.

8. Where the excisable goods are not sold by the assessee but are used for consumption by him or on his behalf in the production or manufacture of other articles. The value shall be one hundred and ten per cent of the cost of production or manufacture of such goods.

9. When the assessee so arranges that the excisable goods are not sold by an assessee except to or through a person who is related in the manner specified in either of sub clauses (ii) or (iii) or (iv) of clause (b) of sub-section (3) of section 4 of the Act, the value of the goods shall be the normal transaction value at which these are sold by the related person at the time of removal, to buyer (not being related person); or where such goods are not sold to such buyers, to buyers (being related person), who sells such goods in retail:

   Provided that in a case where the related person does not sell the goods but uses or consumes such goods in the production or manufacture of articles, the value of goods shall be determined in the manner specified in rule 8.

10. When the assessee so arranges that the excisable goods are not sold by him except to or through an inter-connected undertaking, the value of goods shall be determined in the following manner, namely:-

   (a) If the undertakings are so connected that they are also related in terms of sub-clause (ii) or (iii) or (iv) of clause (b) of sub-section (3) of Section 4 of the Act or the buyer is a holding company or subsidiary company of the assessee, then the value shall be determined in the manner prescribed in rule 9.

      Explanation:- In this clause "holding company" and "subsidiary company" shall have the same meanings as in the Companies Act, 2013.

   (b) In any other case, the value shall be determined as if they are not related persons for the purpose of sub-section (1) of section 4.

10A. Where the excisable goods are produced or manufactured by a job-worker, on behalf of a person (hereinafter referred to as principal manufacturer), then, -

   (i) in a case where the goods are sold by the principal manufacturer for delivery at the time of removal of goods from the factory of job-worker, where the principal manufacturer and the buyer of the goods are not related and the price is the sole consideration for the sale, the value of the excisable goods shall be the transaction value of the said goods sold by the principal manufacturer;

   (ii) In a case where the goods are not sold by the principal manufacturer at the time of removal of goods from the factory of job-worker, but are transferred to some other place from where the said goods are to be sold after their clearance from the factory of job-worker and where the principal manufacturer and buyer of the goods are not related and the price is the sole consideration for the sale, the value of the excisable goods shall be the normal transaction value of such goods sold from such other place at or about the same time and, where such goods are not sold at or about the same time, at the time nearest to the time of removal of said goods from the factory of job-worker;

   (iii) in a case not covered under clause (i) or (ii), the provisions of foregoing rules, wherever applicable, shall mutatis mutandis apply for determination of the value of the excisable goods:

      Provided that the cost of transportation, if any, from the premises, wherefrom the goods are sold, to the place of delivery shall not be included in the value of excisable goods.

      Explanation – For the purposes of this rule, job-worker means a person engaged in the manufacture or production of goods on behalf of a principal manufacturer, from any inputs or goods supplied by the said principal manufacturer or by any other person authorized by him.

11. If the value of any excisable goods cannot be determined under the foregoing rules, the value shall be determined using reasonable means consistent with the principles and general provisions of these rules and sub-section (1) of section 4 of the Act.

Annexure-IV

CASE NO.: Appeal (civil) 2947-2948 of 2001
PETITIONER: Commissioner of Central Excise, Pune
RESPONDENT: M/s. Cadbury India Ltd.
DATE OF JUDGEMENT: 01/08/2006
BENCH: Ashok Bhan & Markandey Katju

JUDGEMENT: (with Civil Appeal Nos.1856-1857/2002, 5232-5233/2003,1425/2005 and 2878-2879/2005) MARKANDEY KATJU, J. Civil Appeals Nos. 2947-2948/2001 have been filed against the impugned final order dated 28.9.2000 passed by the Customs Excise and Gold (Control) Appellate Tribunal, West Regional Bench at Mumbai in Appeal No. E/1021, 1022/2000-MUN.

Heard learned counsel for the parties.

The question involved in these appeals is about the valuation of milk crumbs, refined milk chocolate and four other products manufactured by the respondent - M/s. Cadbury India Limited, in its factory at Induri, Pune and captively consumed in that factory and other factories of the respondent in the manufacture of chocolate. No part of these products are sold by the respondent.

The respondent had sought valuation of these goods under Rule 6(b)(ii) of the Central Excise (Valuation) Rules, which provides for basing the valuation on such goods on the "cost of production on manufacture including profits, if any, the assessee would have earned in the sale of such goods."

The assessee had showed the price of these goods supported by a statement verified by a chartered accountant. The statement indicated the cost of edible and packing material used in the manufacture including its overheads. A separate statement in support of the profit added was formulated and these assessments were provisionally approved.

At the time of the finalization of the assessment, the department took the view that the value of the goods should include the labour cost, direct expenses, total factory expense, administration expenses, travelling expense, insurance premium, advertising expense and interest. The Assistant Commissioner added these elements to the declared value. He added the total expenses of the company as shown in the balance sheet and deducted the cost material. A percentage of this cost of the remaining figure was treated as the factor by which the assessable value should be increased.

In appeal the Commissioner (Appeals) upheld the order of the Assistant Commissioner. He held that since Rule 6(b)(ii) itself specified including the profit on the goods captively consumed hence this indicated the intention in the rule that the valuation should be brought to the level of the sale value of the goods and hence this includes all expenses referred to above. The Commissioner (Appeals) also relied on the circular dated 30.10.1996 issued by the Board relating to captively consumed goods. He has also relied upon paragraph 49 of the Supreme Court's judgment in Union of India vs. Bombay Tyres International AIR 1984 SC 420. In further appeal the Tribunal set aside the orders of the Commissioner and the Assistant Commissioner. The Tribunal held that sub-rule (ii) of Rule 6(b) can be invoked only in a situation where the goods are not sold and there are no comparable goods. The Tribunal held that the expenses other than the cost of manufacture, cost of raw materials and the profit would not be includible in the assessable value.

The issue in the present case is about the value of the goods captively consumed by the respondent. The assessee has contended that there is no dispute that these intermediate goods are not marketable and are not bought and sold in the market. Hence the valuation of these intermediate goods has to be done according to Rule 6(b)(ii) of the Central Excise (Valuation) Rules, 1975.

Rule 6(b)(ii) reads as follows : "Rule 6 If the value of the excisable goods under assessment cannot be determined under Rule 4 or Rule 5, and a) (b) (i) (ii) if the value cannot be determined under sub-clause (i), on the cost of production or manufacture including profits, if any, which the assessee would have normally earned on the sale of such goods;"

According to settled principles of accountancy only the elements that have actually gone into the manufacture/production of these intermediates i.e. sum total of the direct labor cost, direct material cost, direct cost of manufacture and the factory overheads of the factory producing such intermediate products are included in the cost of production. The Appellant produced alongwith the reply to the Show Cause Notice the following authoritative texts: Wheldon's Cost Accounting and Costing Methods, Cost Accounting methods by B K Bhar, Principles of Cost Accounting by N.K. Prasad, Glossary of Management Accounting Terms by ICWAI.

In CCE v. Dai Ichi Karkaria Ltd., (1999) 7 SCC 448, at page 459 it has been held that the normal principles of accountancy shall be applied to determine the cost. In this decision this Court observed:

"Learned Counsel for the respondents drew our attention to the judgment of this Court in Challapalli Sugar Ltd. v. CIT. The Court was concerned with "written-down value". The "written-down value" had to be taken into consideration while considering the question of deduction on account of depreciation and development rebate under the Income Tax Act.

"Written-down value" depended upon the "actual cost" of the assets to the assessee.

The expression "actual cost" had not been defined in the Income Tax Act, 1922 and the question was whether the interest paid before the commencement of production on the amount borrowed for the acquisition and installation of the plant and machinery could be considered to be a part of the "actual cost" of the assets to the assessee. As the expression "actual cost" had not been defined, this Court was of the view that it should be construed "in the sense which no commercial man would misunderstand. For this purpose, it could be necessary to ascertain the connotation of the above expression in accordance with the normal rules of accountancy prevailing in commerce and industry". Having considered authoritative books in this regard, this Court said that the accepted accountancy rule for determining the cost of fixed assets was to include all expenditure necessary to bring such assets into existence and to put them in a working condition. That rule of accountancy had to be adopted for determining the "actual cost" of the assets in the absence of any statutory definition or other indication to the contrary."

Subsequent to the filing of these appeals, the Institute of Cost and Works Accountants of India (ICWAI) has laid down the principles of determining cost of production for captive consumption and formulated the standards for costing: CAS-4. According to CAS-4 the definition of "cost of production" is as under:

"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." The cost accounting principles laid down by ICWAI have been recognized by the Central Board of Excise and Customs vide Circular No.692/8/2003 CX dated 13.2.2003. The circular requires the department to determine the cost of production of captively consumed goods strictly in accordance with CAS-4.

The Tribunal in the case of BMF BELTINGS LTD. vs. CCE : 2005 (184) E.L.T. 158 (Tri. Bang.) for the period 1995 to 2000 has directed the department to apply CAS-4 for the determination of the cost of production of the captively consumed goods. In ITC vs. CCE (190) ELT 119 the Tribunal held that the department has to calculate the cost of production in terms of CAS-4. Other decisions of the Tribunal, wherein it has directed that CAS-4 be applied for determination of the cost of production, are Teja Engineering v/s CCE 2006 (193) ELT 100 (Tri-Chennai), Ashima Denims v/s CCE 2005 (191) ELT 318

(Tri-Mumbai), and Arti Industries vs. CCE 2005 (186) ELT 208 (Tri-Chennai). This is therefore a consistent view taken by the Tribunal.

The department has not filed any appeal in these cases and accepted the legal position. Apart from this, in the light of several decisions of this Court, the Department is also bound by the said circular No.692/8/2003 CX dated 13.2.2003 issued by the CBE&C. As such it cannot now take a contrary stand. It may be noted that in the present case the intermediate products (milk crumbs, refined milk chocolate and four other intermediate products) are captively consumed in the Respondent's own factory. These Intermediate products are not sold nor are marketable.

Hence there can be no question of including the expenses of the factory which produces the final product namely the chocolate e.g. advertising, insurance and another expenses in their valuation as was sought to be added by the Commissioner (Appeals) and the Assistant Commissioner. For the reasons given above, we find no merit in these appeals and they are dismissed. No costs. Civil Appeal Nos. 1856-1957/2002, 5232-5233/2003, 1425/2005 & 2878-2879/2005) In view of the decision in Civil Appeal Nos. 2947-2948/2001, these appeals are accordingly dismissed. No costs.

Annexure- VA & VB

Illustration of Landed cost of Indigenous/Imported Material

Annexure VA

Indigenous Material:

The landed cost of indigenous material shall be calculated in the following manner:

1.	Basic Material cost (after deducting discounts, if any)	
2	Add:	Excise Duty
		VAT/Sales Tax
		Turnover tax
		Surcharge such Education cess and the like
		Octroi/Entry Tax
		Other levies, if any
		Total
3	Less	Cenvat credit
		Sales Tax/VAT set off
		Other set offs direct attributable to the material
4		Total(1+2-3)
Above Duties /levies are indicative and actual may vary with reference to type of material.		

Illustration of the Landed Cost of indigenous material:

Sl.	Particular of goods	Qty	Rate	Amount
1	ABC goods	11700	11.00	1,28,700
2	Basic Excise duty @ 16%			20,592
3	Cess on BED @ 2%			412
4	SHE Cess @ 1%			206
5	Total (1+2+3+4)			1,49,910
6	VAT 4%			5,996
7	Freight			15,600
8	Total (5+6+7)			1,71,506
9	Less : Cenvat (2+3+4)			21,210
10	Less : VAT (6)			5,996
11	Net Cost (8-9-10)			1,44,300

Annexure-VB

Landed cost of Imported Material

Imported Material

The landed cost of imported material shall be calculated in the following manner:

1.	CIF Value of material	
2.	Add	Custom Duty
		Surcharge
		Additional Duty/Countervailing Duty
		Special Additional Duty
		Protective Duty
		Anti Dumping Duty
		Octroi/Entry Tax
		Other levies
		Other Expenses directly attributable to procurement(freight inwards,Local freight,transit insurance,local insurance)
		Other charges such as Cusatomms clearance etc
3	Less:	Cenvat Credit (including CVD)
		Other rebates,benefits recovered/recoverable
4		Total (1+2-3)
Above Duties /levies are indicative and actual may vary with reference to type of material imported.		

Illustration of landed cost of imported material:

Sl.	Particulars	Rate	Amount ₹
1	Basic Value		100.00
2	Basic Custom Duty	5%	5.00
3	Sub Total (1 + 2)		105.00
4	CVD	8%	8.40
5	ED Cess on CVD	2%	0.17
6	SHE Cess on CVD	1%	0.08
7	Sub Total (3 to 6)		113.65
8	Custom Edu Cess	2%	2.27
9	Custom SHE Cess	1%	1.14
10	SAD (on 7+8+9)	4%	4.68
11	Total Landed Cost		121.74
12	Cenvat Available (4+5+6+10)		13.33

Annexure VI

Name of the unit	XYZ	
Name and address of the factory	ABC, New Delhi	
STATEMENT SHOWING THE COST OF Power produced and Consumed during the year		
S.No	**PARTICULARS**	**QTY (Kwh)**
1	Installed Capacity	215136000
2	Quantiy Produced	13,60,73,501
3	Capacity Utilisation	63
4	Quantiy Re-circulated	
5	Quantity purchased, if any	
6	Internal consumption in power plant	1,21,46,703
7	Net unit available	12,39,26,798

SR.	PARTICULARS	UNIT	QUANTITY	RATE	AMOUNT	RATE/KwH
				₹/UNIT	₹	20XX-XX
A.						
1	Material cost					
	a. Furnace Oil	MT	66064	4878.03	32,22,62,370	2.60
	b. High Speed Diesel	KL	76	37,393	28,41,893	0.02
	c. Natural Gas	SCM	7,26,460	12	87,95,457	0.07
	d. Coal	MT	66,064	3,596.58	23,76,04,281	1.92
	e. Lube Oil				39,94,651	0.03
2	Process Material / Chemicals				-	-
3	Direct Wages & Salaries				1,55,56,852	0.13
4	Utilities				-	-
5	Other direct expenses				-	-
6	Consumable Stores & Spares				38,41,898	0.03
7	Repairs and Maintenance				82,74,080	0.07
8	Depreciation				4,27,45,759	0.34
9	Insurance				61,99,660	0.05
10	Fly Ash Disposal Cost				11,28,241	0.01
11	Other Works Overhead				28,75,377	0.02
12	Sub-total (1 to 10)				65,61,20,519	5.29
13	Less : Credit , if any				-	-
14	Total Cost				65,61,20,519	5.29
B.	Apportioned to product					
			Units		Amount	
	Product A		12,15,22,526		64,33,01,484	
	Product B		4,35,029		23,02,905	
	Product c		19,34,644		1,02,41,388	
	Product D		34,600		1,83,161	
	Service Dept		17,300		91,581	
	Total		12,39,44,099		65,61,20,519	

Annexure VII

Name of the unit		ABC				
Address		P Road,				
Steam Cost Sheet for the year ending 31.3.20XX						
Quantitative Information						
Steam Generated		135000 MT				
Cost						
Particulars		**Unit**	**Quantity**	**Rate**	**Amount**	**₹/M.T.**
A.	**Variable Expenses**					
1	Furnance oil	KL	4500	22500	101250000	750.00
2	Power	KWH	1636500	5.2	8509800	63.04
3	Treated Water	KL	4350	36	156600	1.16
4	Other fuel	Ncum	16552500	7.4	122488500	907.32
	Total –A				232404900	1721.52
B.	**Fixed Cost**					
1	Personnel	₹			1202500	8.91
2	Stores	₹			2564500	19.00
3	Repairs & Maintenance	₹			454650	3.37
4	Others	₹			39000	0.29
5	Depreciation	₹			226050	1.67
	Total - B				4486700	33.23
	Total cost (A+B)				236891600	1754.75
	Steam utilized		**QTY MT**		**Amount ₹**	
	Department A		35000		61416341	
	Department B		87000		152663476	
	Department C		13000		22811784	
	Total		**135000**		**236891600**	

Annexure VIII

Circular: 170/4/96-CX dated 23-Jan-1996

Valuation of castings — Patterns supplied by the buyers required to be included

Circular No. 170/4/96-CX, dated 23-1-1996

[From F.No. 6/14/94-CX.1]

Government of India

Ministry of Finance (Department of Revenue)

New Delhi

Subject: Foundry Industries - Calculation of assessable value of castings - Addition of value of patterns supplied by the buyers in the assessable value.

It has been brought to the notice of the Board by Maharashtra Chambers of Commerce & Industry that there is difficulty in determination of value of patterns used in foundry industry to be added in the cost of castings for arriving at the assessable value of the castings as the quantity of casting to be made out of a pattern cannot be anticipated and sometimes some modifications or repairs are also made in the pattern after some period of use.

A survey was floated to ascertain the actual position in the field formations. From the reports received, it is observed that generally Commissioners are of the view that cost of the pattern should be added in the assessable value of the castings. However, in some Commissionerates, the proportionate value of the pattern is not being added in the assessable value of the casting if such patterns are supplied by the buyers of the castings. Generally Commissionerates find that there is no difficulty in apportioning the cost of pattern in the assessable value of the casting. However, a few Commissioners have expressed difficulty in apportionment of the cost in cases where old patterns are supplied by the buyers of the castings to the job worker and when patterns are returned back to the buyers.

The matters has been examined and it is hereby clarified that the proportionate cost of pattern has to be included in the assessable value of the casting even in cases, where such patterns are being supplied by the buyers of the casting or are got prepared / manufactured by the job worker at the cost of the buyer. In cases where there is difficulty in apportioning the cost of pattern, apportionment can be made depending on the expected life and capability of the pattern and the quantity of castings that can be manufactured from it and thus working the cost to be apportioned per unit. For this purpose, a certificate from a Cost Accountant may be accepted.

Annexure IX

Absorption of Overheads Cost

Illustration of overhead absorption	
Installed capacity	150 Nos. Bulk Carrier
Normal Capacity fixed after accounting for normal unavoidable interruptions	130 Nos. Bulk Carrier
Production during :	
Year 1	110 Nos. Bulk Carrier
Year 2	125 Nos. Bulk Carrier
Year 3	53 Nos. Bulk Carrier

Production during year 3 was lower due to strike by contract labour for 5 months which resulted in loss of production. Therefore it was decided by the management to remove portion of fixed overheads incurred during the strike period and the same was shown as a reconciliation item (Abnormal Overhead) in the Profit Reconciliation Statement for Profit as per Cost Accounts and Profit as per financial Account. Detailed working is as under:	
Variable Overheads for 53 Bulk carriers	₹ 5,30,000
Variable Overhead per Bulk Carrier	₹ 10,000
(A) Fixed Overheads for the year based on Normal Capacity of 130 Bulk Carriers	₹ 13,26,000
(B) Abnormal Fixed Overhead due to unutilized capacity	₹ 7,85,400
(C) Share of Fixed Overhead for Actual Production	₹ 5,40,600
(D) Fixed Overhead per Bulk Carrier	₹ 10,200
Overheads Absorbed	
(a) Variable Overhead	₹ 5,30,000
(b) Fixed Overhead	₹ 5,40,600
(c) Total	₹ 10,70,600
Fixed Overhead unabsorbed (treated as an item of reconciliation between Costing P&L A/c & Financial A/c	₹ 7,85,400

ANNEXURE X A

Name of the Manufacturer Address of the Manufacturer Registration No of Manufacture		ABC Ltd GT Road,Ghaziabad ABB75	
Description of product captive Excise Tariff Heading:		Component XK7	
Statement of Cost of production of Component A manufactured of during the period of 1st April			
		QTY	
Q1	Quantity Produced (Unit of Measure)	250	
Q2	Quantity Despatched (Unit of Measure)		
	Particulars	Total cost (₹)	Cost /unit (₹)
1	Material consumed	35,000	140.00
2	Direct Wages and Salaries	9,500	38.00
3	Direct Expenses	350	1.40
4	Works Overheads	1,500	6.00
5	Quality Control Cost	750	3.00
6	Research & Development Cost	90	0.36
7	Administrative Overheads (relating to production activity	35	0.14

8	Total (1 to 7)	47,225	188.90
9	Add : Opening stock of Work – in – progress	-	0.00
10	Less : Closing stock of work –in –progress	-	0.00
11	Total (8+9+10)	47,225	188.90
12	Less : Credit for Recoveries /Scrap/By-products/misc income	-	0.00
13	Packing cost	-	0.00
14	Cost of production	47,225	188.90
15	Add :Inputs received free of cost	-	0.00
16	Add : Amortised cost of Moulds, Tools, Dies & Patterns etc received free of cost	-	0.00
17	Cost of Production for goods produced for captive consumption (14+15+16)	47,225	188.90
18	Add : Opening stock of finished goods	-	0.00
19	Less : Closing stock of finished goods	-	0.00
20	Cost of production for goods dispatched (17+18-19)	47,225	188.90

Note: Breakup of material cost is to be verified in terms of quantity and type of material used in the component. Above cost sheet is for future projections, it is to be checked that estimates are based on realistic data such as project report or any previous period data available. Other expenses related to the product are to be considered after proper scrutiny of the relevant records .

ANNEXURE X B

Name of the manufacturer **Address of the Manufacturer**	**XYZ** **ABC Nagar Kanpur**
Description of product captively consumed **Excise Tariff Heading**	**Processed cloth**

Statement of Cost of production of xyz manufactured of during the period of 1 Apt -31 Mar. 20XX (Year 3)

		Qty	
Q1	**Quantity Produced (Unit of Measure)**	**34000**	
Q2	**Quantity Despatched (Unit of Measure)**	**34150**	
	Particulars **Cost details**	**Total cost (₹)**	**Cost /unit (₹)**
1	**Material consumed :**		
	Grey cloth	827560	24.34
	Colours & Chemicals	100182	2.95
2	Direct Wages and Salaries :	6460	0.19
3	Utility :		
	Power	27200	0.80
	Steam Cost	44604	1.31
	Heat Cost	14620	0.43
4	Works Overheads	60825	1.79
	Depreciation	19040	0.56

5	Quality Control Cost	-	-
6	Research & Development Cost	-	-
7	Administrative Overheads	5,780	0.17
8	Total (1 to 7)	11,06,271	32.54
9	Add : Opening stock of Work – in – progress	22,703	
10	Less : Closing stock of work –in –progress	33,711	
11	Total (8+9+10)	10,95,263	32.07
12	Less : Credit for Recoveries /Scrap/By-products/misc income	37,719	1.10
13	Packing cost	-	-
14	Cost of production	10,57,544	30.97
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	6,558	0.19
19	Less : Closing stock of finished goods	6,176	0.18
20	Cost of production for goods dispatched (17+18-19)	10,57,926	30.98

Annexure XI

COST ACCOUNTING STANDARD

ON

COST OF PRODUCTION FOR CAPTIVE CONSUMPTION (CAS-4)

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%(now revised to 110%) of cost of production of such goods, and as may be prescribed by the Government from time to time.

2. Objective

1.1 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.

1.2 The cost statement prepared based on standard will be used for determination of assessable value of excisable goods used for captive consumption.

1.3 The standard and its disclosure requirement will provide better transparency in the valuation of excisable goods used for captive consumption.

3. Scope

1.1 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.

1.2 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

(i) Royalty based on production

(ii) Technical Assistance / know –how fees

(iii) Amortized cost of moulds, patterns, patents etc

(iv) Job charges

(v) Hire charges for tools and equipment

(vi) 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 need 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 does 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 (₹/ MT)	Processing cost (₹/MT)	Total (₹/MT)
1	2000	500	2500
2	3500	1000	3500
3	3500	1000	4500

If during the production process at stage 3, the scrap is produced and the same is recycled at stage 2 after making an expenditure of ₹ 200 per MT to make it suitable for re-processing at stage 2, then scrap will be valued @ ₹ (2500 – 200) i.e ₹ 2300. If no expenditure is involved to make scrap re-usable, the scrap value will be @ ₹ 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 128 of the Companies Act, 2013, 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 128 of the Companies Act, 2013, 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	
Q 1	Quantity Produced (Unit of Measure)		
Q2	Quantity Despatched (Unit of Measure)		
	Particulars	**Total Cost (₹)**	**Cost/unit (₹)**
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 bove cost data reflect true and fair view of the cost of production.

Disclaimer

There are some provisions though spelt under the Companies Act, 2013, but not yet notified/enforced "till date of publication of this Study Material". Hence, for such provisions, the relevant and corresponding Sections/Provisions of the Companies Act, 1956 is applicable. All concerned are requested to follow both – the MCA, GOI website as well as Clarification/Circular issued/to be issued by the Institute from time to time – on applicability of sections of Companies Act for CMA Examinations.

2.3 GUIDANCE NOTE ON COST ACCOUNTING STANDARD ON MATERIAL COST (CAS-6)

The Council of the Institute of Cost and Works Accountants of India (ICWAI) has issued the Cost Accounting Standard 6 (CAS-6) on Material Cost which lays down a set of principles and methods of classification, measurement and assignment of material cost, for determination of the cost of product or service and the presentation and disclosure in the cost statements.

CAS-6 does not deal with Packing Materials as a separate Cost Accounting Standard on Packing Material Cost (CAS-9) has been issued on the subject.

The Guidance Note deals with principles and methods as provided in the CAS-6 and practical aspects in connection with the determination of material cost of a product or service.

In the preparation of cost statements including those requiring attestation, material cost shall be determined as per CAS-6. The Cost Accounting Standards have been set in ***bold italic*** type and reference number of the standard has been retained as in CAS-6 for ready reference.

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 state that for the purposes of sub-section (1) of section 148 of the Act, the class of companies, including foreign companies defined in clause (42) of section 2 of the Act engaged in the production of the goods or providing services, specified in the Table below, having an overall turnover from all its products and services of rupees **thirty five crore or more** during the immediately preceding financial year, shall include cost records for such products or services in their books of account.

Rule 4(a) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (A) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **fifty crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **twenty five crore or more**.

Rule 4(b) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (B) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **one hundred crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **thirty five crore or more**.

Introduction

Materials constitute one of the important elements of production. Types of materials covered under CAS-6 are raw materials, process materials, additives, manufactured / bought out components, sub-assemblies, accessories, semi finished goods, consumable stores, spares and other indirect materials.

Raw Materials:

Raw material is a basic /main material used in the manufacture of product. For example sugar cane is the raw material for production of sugar. Cotton is the raw material for production of cotton yarn.

An illustrative list of industries and raw materials used is annexed at Annexure 1.

Process Materials:

Process materials/additives are materials used in the process of manufacture in addition to raw material. It varies from industry to industry. Process material for sugar industry is lime, sulphur; in cement industry pozallana and gypsum are additive materials; and in paper industry clay/china clay is additive material.

Bought Out Components:

Bought out component means a manufactured (industrial) product, which forms part of the finished product (for example fastener, fan belt and the like) and is fitted to the product without any further processing. In other words bought components are purchased items used in the assembly of main product. These items are developed by the supplier as per specifications of manufacturer. Bought out component when used in the main product are called “Original Equipment Supplies (O.E.S)”. These items are also available in the market for replacement of worn out parts and is called as spare /bought out parts.

Sub-assemblies:

“Sub-assembly” (also sometimes called as “aggregates”) means an assembly of various components with a distinct identity, and forms part of the finished product, for example engine, steering in an automobile.

“Accessory” may be either a component or sub-assembly, which is not essential for the basic functioning of the product, but supplied as an optional item (for example an air conditioner or music system in an automobile). However, in the case of mining, earthmoving drilling equipment and other similar items of machinery, accessories are supplied with the basic equipment, depending upon the operating conditions in the field as standard equipment.

Consumable Stores:

Consumable stores are items used in the maintenance of plant for example lubricant, cotton waste, paint and the like. Spares are purchased items used for replacement of worn out part of machinery and the like.

Other indirect materials are items of small value such as bolt, nut nails, and the like which cannot be directly identified economically with a product and are treated as indirect material.

Material acquired in exchange of other material:

When material is acquired in exchange for other material or service supplied, the cost of material acquired is taken as cost of material supplied or services provided plus other applicable cost such as freight.

In paper industry where bagasse from sugar mill is obtained by the paper mill by supplying coal to the sugar mills, in the cost statement, the cost of coal supplied is included in the cost of bagasse procured.

All the above items are identifiable with a product and are classified as direct material cost.

Materials are classified under a common designation on the basis of similarities of nature, attribute or relations, source of supply and the like. Materials are classified according to nature such as raw material, consumable stores, spares and the like. In terms of relationship, materials are classified as direct material and indirect material. On the basis of source of supply, materials are classified as indigenous materials / imported materials. Indigenous materials are manufactured within the country and imported materials are purchased from other countries.

For purpose of identification and convenience, each item of material is given a distinct name. Similar items are classified under sub-groups and number of such group is classified under the main or major groups. For example, items of brass may be classified under sub-head 'non-ferrous metals' and under the main head ‘metals’.

The objective of the CAS-6 is to bring uniformity and consistency in the principles and methods of determination of cost of material of a product / service. The principles and methods adopted shall be applied consistently from one period to another and for reasonable uniformity between different products / units. For example if FIFO method is used for valuation of issue of materials, the same shall be followed consistently from one period to another.

Definitions

The following terms are used in this guidance note with the meaning specified.

Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.***

Administrative overheads: ***Expenses in the nature of indirect costs, incurred for general management of an organization.***

Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

Defectives: ***End Product and/or intermediate product units that do not meet quality standards. This may include reworks or rejects.***

Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***

Rejects: ***Defectives which cannot meet the quality standards even after putting in additional resources.***

Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed only for the purpose of the decision making.***

Direct Materials: ***Materials, the costs of which can be attributed to a cost object in an economically feasible way.***

Indirect Materials: ***Materials, the costs of which cannot be directly attributed to a particular cost object.***

Material Cost: ***The cost of material of any nature used for the purpose of production of a product or a service.***

Production overheads: ***Indirect costs involved in the production process or in rendering service.***

Scrap: ***Discarded material having some value in few cases 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.***

Standard Cost: ***A predetermined norm applied as a scale of reference for assessing actual cost, whether these are more or less.***

Waste: ***Material loss during production or storage due to various factors such as evaporation, chemical reaction, contamination, unrecoverable residue, shrinkage etc., and discarded material which may or may not have value.***

Spoilage: ***Production that does not meet with dimensional or quality standards in such a way that it cannot be rectified economically and is sold for a disposal value. Net Spoilage is the difference between costs accumulated up to the point of rejection and the salvage value.***

Principles of Measurement

5.1. Principle of valuation of receipt of materials:

5.1.1 ***The material receipt should be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities) that can be quantified with reasonable accuracy at the time of acquisition.***

The valuation of receipt of materials is to be based on the terms and conditions stated in the purchase order depending upon source of supply i.e. indigenous or imported.

Indigenous Material:

The purchase order inter alia states

(1) Specification of material being purchased

(2) Purchase price

(3) Quantity of supply

(4) Time of supply

(5) Place of supply

(6) Payment terms

(7) Other commercial conditions regarding inspection, rejection, trade discount and similar item.

If purchase price is ex-works of purchaser, inward freight is inbuilt in the price structure. If purchase price is ex-works of supplier, inward freight is to be paid by the purchaser and it is to be included in the valuation of receipt. Other terms used in this regard are F.O.R destination / F.O.R of supplier's place (F.O.R – means free on rail). If it is F.O.R destination, loading at the place of supplier and railway freight is in built in the material purchase price. Unloading and transportation from railway station to works is to be incurred by the purchaser and is to be charged to the material purchase value. In case of F.O.R supplier's place, railway freight is to the account of purchaser.

In addition to basic purchase price, duties and taxes, freight inwards, insurance and other expenditure directly attributable to procurement are to be taken into account while valuing the receipt if these can be quantified with reasonable accuracy at the time of receipt. If any of these items of expenditure cannot be quantified with reasonable accuracy, these shall be treated as material handling cost. Trade discount, rebates, taxes and duties refundable (or to be credited by the taxing authorities) are to be set off. Examples of taxes to be deducted from cost are:

- Cenvat Credit
- Countervailing/custom duty credit
- Vat credit
- Any other tax

Illustration on valuation of receipt of indigenous supply is at Annexure II.

The cost of the material is determined as per invoice. If supply of material is ex-works of purchaser, there will be no freight and cartage charges in the invoice. In case inward freight is incurred, it shall form part of the cost of procurement of materials and is to be apportioned to the items purchased on rational basis such as weight / number and the like.

Imported Material:

Following points are to be considered while valuing imported material:

(a) Actual customs duty paid on the basis of classification by the Customs Authorities will be assigned, net of any credits.

(b) Material imported free of duty or at concessional rate of duty under export incentive scheme will be accounted for at the actual rate of duty applicable so long as there is reasonable expectation that the entity will satisfy the conditions for the duty exemption or concession. In case the material is used for a purpose other than the intended purpose, provision for import duty should be made. This entry may be offset when the material is available for export purposes at the imported parity rate of material.

(c) Harbour dues, stevedoring charges, congestion charges, and the like on the basis of actual, if imported singly should be accounted. If imported as part of a basket of other material, then proportionate charges will be allocated on import value.

(d) Intermediate storage – actual charged by the storage provider should form part of the cost of material.

(e) Clearing Agent's Charges will be added to cost of materials. Where other services are also provided by the commission agent besides procurement of orders, for example arranging for LC, the charges for such services will also be assigned to the materials covered on a suitable basis.

(f) Adjustment of CENVAT /VAT as per applicable regulation.

(g) Duty drawback and other similar duties subsequently recovered shall also be deducted from the cost of material.

(h) Bank Charges are in the nature of administrative overheads and will not form part of material cost.

Illustrations on FOB and CIF basis of import of material are at Annexure III a & III b.

Preparatory Cost:

All traceable costs to the extent possible for bringing the material up to the place of manufacture are to be reckoned. This may include preparatory costs in some industries. In case of procurement of cane considerable efforts and resources are involved, which can be directly identified and classified as sugar cane development costs. This would include cost incurred for dressing of sugar cane before crushing and the like. Similarly, in mining industry raw ore undergoes changes through many stages and cost up to each stage is considered separately and added to the next stage cost.

In paper industry bamboo, hardwood, wood waste (Veneer waste, Rulla and the like from Plywood Industry) are used as raw material. Before these materials can be used, various preparatory operations such as cutting, debarking, chipping and screening to make proper size of wood chips are performed to make the material fit for use. This preparatory cost forms part of the raw material cost.

Wood requires seasoning and the cost of cutting, seasoning should be treated as material cost. Seasoning of raw material for wine is another example of preparatory cost.

Handling costs up to works / factory gate:

If handling cost is specific and handled singly, it is to be assigned to the material handled. If employees are used for handling the material, it is to be apportioned on the basis of time taken by them.

Incoming Inspection:

If the material calls for inspection by a third party, specific cost will be assigned to the material inspected. If the Inspection is carried out internally and its cost is significant, it is to be apportioned on the basis of time spent on inspection or other suitable measure of effort. In case the material is supplied by the supplier at his cost and risk with regard to quantity etc, there will be no cost for inspection to the buyer.

Other cost incurred for material acquisition is insuring of material. If insurance premium is specific and insured singly, it is to be assigned to the specific material insured. In case it is part of a comprehensive policy then the assignment of the insurance premium will be on the basis of the proportionate value insured. If insurance becomes part of the carrier's responsibility no separate cost will be assigned in this regard.

Treatment of containers for materials purchased:

Treatment of container cost in the cost of material purchased is as under:

Container is non returnable and for which no cost is charged in the invoice:

The container cost is included in the material cost. An estimated residual value of the container may be reduced for ascertainment of material cost, if sold for some value, from time to time. If the value is not so significant, it may be credited to manufacturing overheads.

Container is returnable, but charged in invoice and refunded, when returned:

As refunds are made, the cost of material will be net of the charge for returnable container. Necessary physical controls will be operative. Containers not returned in time may be charged to the entity. The amount so charged by the supplier should be aggregated with manufacturing overheads.

The cost borne by the entity will only be added to the cost of material. If charged value is ₹ 100/- per container and return credit is for ₹ 40/-, balance ₹ 60/- is the cost to be included in material cost.

Container is charged separately in the invoice and not returnable:

This will be included in material cost.

Container sold as scrap:

The value may be reduced from material cost if material and significant, otherwise sale value of scrap be adjusted against manufacturing overheads.

5.1.2 ***Finance costs incurred in connection with the acquisition of materials shall not form part of material cost.***

Finance costs are interest and the like, on borrowed funds. Finance costs are excluded from cost of material. The letter of credit charges are for credit risk or a transaction risk (demand bill) and are part of bank charges which form part of administrative overheads.

Sometimes goods are kept in bonded warehouse and clearance of goods is delayed. This may happen due to any financial stringency delaying the payment to the bank. Such payments of storage are to be excluded from cost of material calculation and are dealt with in the financial accounts.

5.1.3 ***Self manufactured materials shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads. In case of captive consumption, the valuation shall be in accordance with Cost Accounting Standard 4.***

Self manufactured materials include components assemblies and subassemblies, accessories and the like manufactured internally for making the final product. For example, gear box assembly, steering system assemblies and the like are made separately and used in the final product assembly. Many products like TV, Switchgear, Computers and the like have innumerable small components either bought or self manufactured. Self manufactured material used in the assembly of main product are also classified as intermediate products.

Cost of self manufactured material is to be determined taking into account the cost of direct material, direct employee cost, direct expenses, share of factory overhead and share of administrative overheads relating to production. 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.

The term Factory Overheads, Works Overhead, Production Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

Factory Overheads are the indirect costs incurred in the production process or in rendering service. These are used for a type of cost that cannot be directly assigned to a cost centre or product, but can only be apportioned to cost units.

Administrative Overheads are the cost of all activities relating to general management and administration of an organization. These are to be analyzed and distributed between administrative overheads relating to production activities and administrative overheads relating to selling and distribution activities on rational basis. Administrative Overheads relating to production activities will form part of self-manufactured materials.

Self manufactured components, if captively consumed and are subject to levy of excise duty, its valuation is to be determined as per CAS-4.

5.1.4 ***Spares which are specific to an item of equipment shall not be taken to inventory, but shall be capitalized with the cost of the specific equipment. Cost of capital spares and/or insurance spares, whether procured with the equipment or subsequently, shall be amortised over a period, not exceeding the useful life of the equipment.***

The spares which are specific to any equipment procured at the time of purchase are capitalized. The spares are to be depreciated as per the Accounting Policies of the entity. Sometimes, capital spares are not separately invoiced but merged with the cost of equipment supplied. These are depreciated with the cost of machinery over its useful life. It may be charged to cost based on machine hours utilized.

Spares which are termed as insurance spares are stored to meet a contingency such as failure of a critical part in order to have insurance against stoppage of production. Such spares may be used for replacing a defective part. These are special purpose spares specific to a specific machinery or group. These are also to be amortized over the useful life of the machinery.

5.1.5 *Normal loss or spoilage of material prior to reaching the factory or at places where the services are provided shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.*

Sometimes materials are lost in transit or spoiled. Treatment of such a loss will depend upon the terms and conditions of purchase order. If the purchase order does not specify any level of loss and supplier is responsible to supply good quantity, in such cases, the loss is to be borne by the supplier or the insurer as the case may be.

The normal loss is to be absorbed by the good units. Abnormal loss of material is charged to Profit and Loss Account and does not form part of the cost of material. In case of spoiled material if there is any significant realizable value , loss is to be accounted net of such value.

5.1.6 *Losses due to shrinkage or evaporation and gain due to elongation or absorption of moisture etc., before the material is received shall be absorbed in material cost to the extent they are normal, with corresponding adjustment in the quantity.*

In case of certain materials before its receipt, losses due to shrinkage /evaporation and gain due to elongation or absorption of moisture arises. An anticipated level for such losses or gains for each type of material is to be predetermined. Unit price of material is reduced or inflated to cover the cost of the normal percentage of loss or gain. An illustration is given below:

1000 units of material X purchased @ ₹ 4/- per unit = ₹ 4000

Anticipated loss on shrinkage: 4% i.e. 40 units

Receipt will be 960 units and price inflated = ₹ 4000/(1000-40 Units) = ₹ 4.17 per unit

If there is gain in the quantity, issue rate will be reduced.

Certain materials contain moisture at the time of purchase which may evaporate during summer, thereby losing some weight or moisture may be absorbed during monsoon thereby gaining some weight. One of the methods of dealing with such material is to record the material as dry weight after deducting the moisture percentage which is considered normal. For any variation in moisture, suitable adjustment shall be made to record weight in term of dry weight. Loss in quantity due to excess moisture over the normal percentage will not form part of the material cost.

Illustration showing the treatment of driage loss in sugar industry is at Annexure IV.

5.1.7 *The FOREX component of imported material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the material cost.*

FOREX conversion has to be on the date of transaction. The cost and financial accounts will have the same basis for alignment. The date on which the property in goods passes is adopted as the date of transaction. The difference between the actual payment and the amount taken as material cost of goods received is taken to a separate account to show the exchange rate variations (not becoming part of material cost calculations.)

Illustration on treatment of FOREX component is at Annexure V.

5.1.8 Any *demurrage or detention charges, or penalty levied by transport or other authorities shall not form part of the cost of materials.*

Demurrage and penalties are levied by the Transporters /Custom Authorities for delay in clearance of wagon/vessel and the like.

Illustrations are:

- Demurrages levied by transporter for not removing goods,
- Penalties for keeping hazardous goods in unauthorized places in transit without proper safeguards.

- Penalties levied by Customs Authorities for delayed clearance.

Demurrage and penalties are abnormal cost and are not part of the material cost. It is charged to Profit & Loss Account.

5.1.9 ***Subsidy/Grant/Incentive and any such payment received/receivable with respect to any material shall be reduced from cost for ascertainment of the cost of the cost object to which such amounts are related.***

Subsidy and grant received should be recognized on a systematic basis. These should be matched with the related cost for which these are intended to compensate. Subsidy received for any material is to be reduced from the material cost.

There can be some subsidy for using materials produced by a specific priority industry or energy saving device and the like. Such subsidy is to be adjusted from the material cost.

Incentives received should be reduced from the material cost of the products in respect of which the incentives are received. There can be some difficulty to match incentive with the cost of production due to possible timing differences between the period of production, and the period of receipt of the incentives. Incentives are sometimes recorded on the basis of receipt. In such a situation matching becomes difficult. It will be desirable that accounting entries relating to incentives are passed on accrual basis to reflect the true and fair position of the cost of the product in the cost statements.

5.2. Principle of valuation of issue of material

5.2.1 ***Issues shall be valued using appropriate assumptions on cost flow.***

The CAS-6 provides for adopting any of the following three methods for valuation of issues of material:

(a) First in First out (FIFO)

(b) Last in First out (LIFO)

(c) Weighted Average Rate

Method of valuation of issue of material once adopted shall be followed consistently. If method of valuation is changed, its impact on costs of material shall be disclosed.

The FIFO formula assumes a cost flow that the items of materials that were purchased or produced first are issued first, while LIFO assumes the exactly opposite cost flow charging the current price to cost. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each fresh shipment is received.

Accounting Standard AS-2 provides for cost formulae, viz. Specific identification, FIFO (First-in-First-out) and Weighted Average cost method. Most of the organizations are adopting one of above cost formulae for the purpose. If any other cost formula is adopted, the difference between financial accounts and cost accounts shall be disclosed in the reconciliation of profit as per cost records and the financial accounts.

LIFO method can be gainfully applied while estimating /projection of cost as it reflects current price cost.

Illustration on FIFO/LIFO/Weighted average method of issue of material is at Annexure VI.

Any accepted method of pricing of issue may be used. However, whatever method of pricing is adopted, the same should be specified and followed consistently.

In case of some bulky/volumetric materials such as coal, limestone, gypsum, salt, slag and the like, it is not always possible to weigh the same and therefore the quantities of receipts and issues of materials are mostly determined by volumetric measurements. Such volumetric measurements are also validated by the actual weight of the stocks at random from time to time. However, it is necessary to check the stock of materials regularly and if any variation in the book stock and physical stock is found, the method of adjustment of such shortage shall be identified with the relevant product(s). Normally, adjustment in the variation of the book stocks and physical stocks are accounted in consumption of such material because of the approximation involved in the receipt and issue of the same.

Another material which requires special mention is petroleum product when issued for further processing. For example Fuel oil is supplied in KL (volume) and its price is also in terms of ₹ /KL. This price is related to at a volume measured at 29.5^0 C (All India ambient temperature) and a temperature variance allowance is given if the item is considered at a higher temperature at the time of issue, particularly bulk loading.

5.2.2 Where materials are accounted at standard cost, the price variances related to materials shall be treated as part of material cost.

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 for deviation is placed. 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. In some process industries like refractory, pharma, formulations and the like, standard mix of raw materials is used to determine the cost of material and variance between standards and actual is adjusted periodically.

Standard Price Method can also be applied for valuation of issue of material. In this method price of issues is predetermined for a stated period taking into account all the factors affecting price such as anticipated market trends, transportation charges and normal quantity of purchase. Standard prices are determined for each material and material requisitions are valued at standard price irrespective of the actual purchase price. Any difference between the standard and actual prices of purchase results in material price variance. The material price variance is to be treated as part of material cost.

When standard costing system is in vogue, there can be other variances relating to usage during the course of production which may be due to normal or abnormal reasons. Variances due to normal reasons should be treated as cost, while the variances due to abnormal / reasons are treated outside the cost of production.

Illustration of material cost variance (price, use, mix and yield) is at Annexure VII.

The variance account enables management to observe the extent to which actual materials costs are differing from planned objectives or predetermined estimates.

5.2.3 ***Any abnormal cost shall be excluded from the material cost.***

Abnormal cost is not considered in the cost of production and excluded from cost of material. The rationale of exclusion is that inclusion of such items in the cost will make the cost not comparable with a normal situation. Such an aberration is avoided to understand the cost in a better perspective for any purpose. For instance, the cost of material cannot be loaded with losses due to an earthquake which is an abnormal event. Similarly, loss of production due to major fire accident or a major shutdown due to sudden and long machine breakdown for days together for want of a special part may be treated as Abnormal Cost.

Material lost due to major fire accident, burglary, obsolescence, if significant, material and quantifiable shall not form part of cost of the production as not to distort the cost due to abnormal reasons. It is dealt with in the costing Profit and Loss Account.

5.2.4 ***Wherever, material costs include transportation costs, determination of costs of transportation shall be governed by CAS 5 – Cost Accounting Standard on Determination of Average (Equalized) Cost of Transportation.***

Inward freight shall form the part of the cost of material. In case inward freight charges are indicated in the invoice, which is for more than one material, inward freight shall be allocated to different materials indicated in the invoice on reasonable and appropriate basis such as weight, volume, numbers and the like.

If the material is carried by a special carrier, it will be assigned to the specific material transported.

5.2.5 ***Material cost may include imputed costs not considered in financial accounts.***

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, not actually paid is an example of imputed cost for a project evaluation.

As such there is an imputed cost in all the resources of a business if they are applied to another profitable activity. For example in caustic soda plant hydrogen is produced as by product. If the unit has a captive power plant, it is used as fuel. Its cost is to be imputed based on the fuel substituted such as coal/ furnace oil, based on equivalent calorific value.

5.3 ***Self manufactured components and sub-assemblies shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads. In case of captive consumption, the valuation shall be in accordance with Cost Accounting Standard 4.***

Self manufactured components are valued at cost including production overheads. This is dealt with under standard 5.1.3 of the Standard.

5.4 ***The material cost of normal scrap/ defectives which are rejects shall be included in the material cost of goods manufactured. The material cost of actual scrap / defectives, not exceeding the normal shall be adjusted in the material cost of good production. Material Cost of abnormal scrap /defectives should not be included in material cost but treated as loss after giving credit to the realisable value of such scrap/ defectives.***

Scrap results from the processing of material. It is unavoidable residue material arising in the process of manufacture. It may have some value. Example of scrap is border material from stamping, shavings, filing, boring, turning operations and the like. The scrap is accumulated in storage yard so that it can be sold to scrap dealers.

In some cases scrap can be reprocessed into useful raw material for subsequent production of basic products. For example the scrap material from sheets of metal from which parts have been stamped, may be melted and again formed into sheets from which more units may be stamped. Similarly scrap generated in steel foundry is put into furnace to melt and form steel castings. Another example is runners and risers generated in the course of dressing up of castings in foundry. Runners and risers are valued at weighted average cost at pouring stage (i.e. raw material cost plus conversion cost of molten metal). The material cost of abnormal scrap will not form part of the material cost.

Normal scrap generated during process of manufacture is to be treated as a part of material cost. Scrap have generally low recovery value as in the case of steel but it may have significant value as in the case of gold. Thus its recovery value depends upon the type of material. There are several methods of accounting of scrap as detailed below:

1. Scrap sales credited to revenue
2. Scrap sales credited to production overhead
3. Scrap identifiable with a job, and its realizable value is credited to the job.

Defective /Spoiled material arises when the material does not meet the exact specification of the material required. Normal Defective/spoilage of material is to be absorbed by good production and abnormal spoilage is to be charged to Profit and Loss Account.

For example:

Metal poured, due to time lost in pouring, is incomplete on account of loss of temperature. This has to be disposed off as such by re-melting or sold as scrap.

In certain types of processes and operations, some material physically disappears on account of shrinkage, evaporation and the like with the result that the quantity of output is less than the quantity of input. In other cases residue such as smoke, dust, gases, slag and the like arises in the course of operation and has practically no measureable value or utility. In some cases, disposal of waste results in further cost to comply with regulatory requirements. In some cases waste may have value.

Assignment of Cost

6.1 Assignment of costs – Materials

6.1.1 Assignment of material costs to cost objects: ***Material costs shall be directly traced to a Cost object to the extent it is economically feasible and /or shall be assigned to the cost object on the basis of material quantity consumed or similar identifiable measure and valued as per the principles laid under Paragraph 5.***

Assignment of material cost involves establishing a suitable procedure to identify and record the resources consumed by the cost object.

Cost Object or Cost Centre is the logical sub-unit for accumulation of cost. Cost Centre may be classified in different ways like function-wise and nature wise:

Function wise	Production / Process Cost Centres: for example Machine Shop, Welding shop, Assembly shop and the like. Service Cost Centre: for rendering service to Power house, Maintenance, stores and the like.
Nature wise	Personal: for example Works manager, maintenance crew. Impersonal: for example machine shop.

Cost Object may be any customer, product service, contract, project, activity or other work unit for which a separate cost measurement is desired. For example, if it is desired to determine what it costs to produce a car, then the cost object is car. If it is desired to determine the operating cost of maintenance department within a plant, the cost object is maintenance department.

Different costs can be assigned to the same cost object, depending on the purpose. For example, costs from all parts of the value chain may be assigned to a product for pricing decisions. The direct cost of one cost object may be the indirect cost of another cost object.

For assigning direct material cost to a cost object, the source document is material requisition. Details of material issued for manufacturing a cost object/ product are recorded in it. It records the job number, type of material, and items listed are priced as per the method of valuation adopted for issues. Thus material requisition represents the source of information for assigning the cost of material to cost object.

The quantity of material consumed is to be worked out from material issue records of stores for a product and return of unused material, if any. Such consumption in quantity may be derived by two methods.

Method (i): Based on actual issues for batch, unit or job:

This method is preferred as it establishes direct relationship of actual material usage for the product.

Method (ii): Based on any method other than actual, for example, Standard:

Under this method material is issued as Standard Bill of material. The standard cost for each direct material is defined at the beginning of the year. The variances from standard on account of price / consumption and the like are adjusted to consumption at the year end. Some organizations follow "Back flush Costing" system. It eliminates detailed accounting transaction. It focuses first on the output of the organization and then works backwards when allocating cost between goods sold and inventories. As soon as a finished good is ready for stock, material is Back flushed (issued) as per the bill of material for that product. Any variation between the actual issues (both quantity and value) and the standard as accumulated over the period is charged off to consumption.

Standard Bill of material method is to be used in case of goods, where the direct link of actual consumption for product is not available. The manufacturer using this method should certify the quantitative requirement considered for calculation of material consumption as per Bill of Material. It may be ensured that usage variance is within reasonable limit and it should be adjusted in calculation of cost of production.

For tracing of material cost direct to a cost object, concept of "to the extent economically feasible" is also to be taken into account. This requires an exercise to analyse the cost involved, benefit to accrue and over-riding requirement to identify material with the object. In other words material cost if not directly identified with the cost object on economic feasibility consideration, it shall not result in misstatement of material cost of cost object.

It is advisable to reconcile the cost of the material consumed as per cost records is reconciled with financial books. For major direct materials, reconciliation is to be ensured both in quantity and value.

6.1.2 *Where the material costs are not directly traceable to the cost object, these may be assigned on a suitable basis like technical estimates.*

Materials which are not directly traceable to cost object, are to be assigned on some rational basis consistently. Technical estimates help in arriving at such rational basis. For Example, Grease or lubricants used for maintenance work may be consumed by all the departments. It may not be economical to issue individual requisition to charge each time. It may be decided to take the total consumption per month and divide the cost between all the user cost centres based on a technical estimate on a sample survey of usage during a selected period. Such studies may be reviewed periodically to correct for changes taking place affecting the consumption.

6.2 Assignment of costs – Direct Expenses

6.2.1 *Where a material is processed or part manufactured by a third party according to specifications provided by the buyer, the processing/ manufacturing charges payable to the third party shall be treated as part of the material cost.*

It relates to a production operation outsourced. The material undergoes change and enters the work in process stage or semi finished goods stage. A part of the production operation is outsourced. The outsourcing charges paid to third party is treated as part of material cost.

Example (1): Casting requires trimming, machining and polishing, heat treatment after pouring and the like. One of these operations is subcontracted. The activity subcontracted and its cost is part of the material cost.

Example (2): A metal sheet is given to another unit for conversion into specific measurement for use in a press; the material cost is increased to take care of the change in shape done before using in production. Such cost is part of the material cost, as the material is made fit for the operation.

6.2.2 *Wherever part of the manufacturing operations / activity is subcontracted, the subcontract charges related to materials shall be treated as direct expenses and assigned directly to the cost object.*

This provision covers a situation where the manufacturer gets part of the manufacturing operation subcontracted. For example steel strip is sent to slitter for smaller size, slitting charges paid to subcontractor is to be treated as direct expenses and assigned directly to cost object.

6.3 Assignment of costs– Indirect materials

6.3.1 *The cost of indirect materials shall be assigned to the various Cost objects based on a suitable basis such as actual usage or technical norms or a similar identifiable measure.*

The cost of indirect materials shall be directly assigned to the cost centre where possible under suitable heads as may be economical to aggregate and report under heads like lubricants, tools, consumable stores (building stores, mechanical stores and electrical stores) spares and the like. All the costs under different heads for the cost centres aggregated and accumulated shall be distributed to the production cost centres on a rational basis.

6.3.2 ***The cost of materials like catalysts, dies, tools, moulds, patterns etc., which are relatable to production over a period of time shall be amortized over the production units benefited by such cost.***

Indirect materials like cost of catalysts, dies, tools, patterns and the like have longer service life. Some special patterns are charged to the cost of the specific jobs and such indirect materials shall be amortized over the production units benefited by such cost.

In a steel plant, indirect materials like refractory, rolls and other process materials are in the nature of catalysts and their useful life is determined by many parameters like production, quality, metallurgical requirement and many other techno operational parameters. In such cases these may be charged off as and when issued for consumption.

6.3.3 ***The cost of indirect material with life exceeding one year shall be included in cost over the useful life of the material.***

It gives a general principle where the life of any indirect material is estimated beyond a year, (life of the material should be estimated on technical basis) to amortise its cost over the estimated life.

Presentation

7.1 ***Direct Materials shall be classified in the cost statement under suitable heads.***

Cost Statements shall depict Direct Material costs as detailed below:

a. Raw materials,

b. Components,

c. Semi finished goods and

d. Sub-assemblies

7.2 ***Direct Materials shall be classified as Purchased - indigenous, imported and self manufactured.***

Direct Materials should be presented in the Cost statement by types of material - raw material, components, semi-finished goods and sub-assemblies. It further specifies classification of material on the basis of source of supply viz. indigenous, imported and self manufactured. For example raw material used may be indigenous, imported material or self manufactured. Raw Material cost is to be indicated separately for indigenous and imported raw material consumed. This requirement of presentation by source wise also applies to other types of material viz. components, semi-finished and sub-assemblies also. In process industry direct material is classified as raw material, additives / filler, process chemicals and dyes.

Illustration of the manner in which material cost should be presented is in Annexure VIII a to VIII c.

7.3 ***Indirect Materials shall be classified in the cost statement under suitable heads.***

Indirect material consumed should be grouped under major heads like tools, stores and machinery spares, jigs and fixtures, consumable stores, and the like. These items are to be presented in the cost statement under the above broad groups, if they are significant.

Disclosures

The following information should be disclosed in the cost statements dealing with determination of material cost.

8.1 ***Quantity and rates of major items of materials shall be disclosed. Major items are defined as those who form 5% of cost of materials.***

Major items of raw materials indicating quantity and rates are to be disclosed in the cost statement which constitutes more than 5% of the total cost of materials. An item of cost is considered as major and significant if that item forms at least 5 % of the total cost of materials. Criteria of 5% of disclosure of material has been prescribed taking into account total items to be disclosed in the cost statement shall not exceed 20 items. For instance, imported direct materials is say 4 % of the total direct material cost, it is not material and significant to warrant a separate disclosure. Significant items should be classified and disclosed separately while the other items could be aggregated.

Illustrations of presentation and disclosure of material cost under major items for Engineering industry and Process industry are Annexure VIII a, VIII b and VIII c.

In the *Annexure VIII b*, Process Industry, Material Broke, Filler, sizing, alum dyes has been indicated separately which are individually less than 5% of the total material cost, but considering their significance these items have been presented and disclosed separately. Other chemicals which were not significant have been grouped under item B-5 of the above Annexure.

Each major item of material which forms 5% of the cost of materials is considered material and should be disclosed in the cost statement; whereas items below 5% of the cost of materials should be aggregated preferably under respective classification of materials. If any item of material is less than 5 % of the total cost of materials, and warrants a separate disclosure due to its significance / nature, same shall be disclosed separately.

8.2 *The basis of valuation of materials shall be disclosed.*

The standard provides various methods of valuation of issues of material such as FIFO/ LIFO/ Weighted Average. Method adopted for valuation of material cost shall be disclosed in the cost statement.

Example

Periodic quarterly Weighted Average is used for pricing the issues of material. In the Cost accounting records, all major and significant items are included in the direct materials identified with the product. Direct materials forming more than 5 % of the total material cost have been separately classified. Items forming less than 5 % of the total material cost have been suitably grouped and shown under others direct material. Components which are individually small but collectively form more than 5 % of the material cost are classified as components. Direct materials constitute 75 % of the total material cost.

8.3 *Any change in the cost accounting principles and methods applied for the determination of the material cost during the period covered by the cost statement which has a material effect on the cost of the material shall be disclosed. Where the effect of such change is not ascertainable wholly or partly, the fact shall be indicated.*

The cost accounting principles and methods adopted for determining the material cost is to be followed consistently from one period to subsequent period. If there is any change in the cost accounting principles and methods during the period resulting in material effect on the cost, the same shall be disclosed indicating its impact in the cost statement.

8.4 *Any abnormal cost excluded from the material cost shall be disclosed.*

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 and charged to Profit & Loss Account.

Materials lost / damaged due to fire and natural calamities which are not considered fit for use are examples of abnormal cost, hence excluded from cost of material.

Example:

Abnormal cost of ₹ 3 lacs has been excluded in calculating the material cost. This cost is considered abnormal due to a fire accident which took place on 12.02.20XX due to which materials issued for production was lost. The loss of material has been assessed by a surveyor. As the position of allowable claim has not yet been ascertained no credit has been taken for claims recoverable.

8.5 *Any demurrage or detention charges, penalty levied by transport or other authorities excluded from the material cost shall be disclosed.*

As discussed in earlier para, any demurrage, detention, penalty is to be excluded from material cost.

Example

Demurrage of ₹ 6.5 lacs have been paid to the Railways in view of the delay in clearing the goods. This was an exceptional cost due to heavy rains and non availability of cranes for moving the goods.

8.6 ***Any Subsidy / Grant / Incentive or any such payment reduced from material cost shall be disclosed.***

Any subsidy / grant / incentive received relating to materials is to be reduced from the cost of materials and disclosure made accordingly.The State Government has been subsidizing the transport cost of moving the goods in view of the location for a period of five years. Such subsidies received and receivable are reduced from transport cost of the materials specified by the Government.

8.7 ***Cost of Materials procured from related parties shall be disclosed.***

If any material is procured from related parties, (as defined under the Companies Act, 2013) its relationship , nature of transaction viz. quantity, rate, other terms / conditions of procurement are to be disclosed. The objective of disclosure is to ascertain that the transaction is at arm's length and on purely commercial terms.

Example:

<u>Related party</u> → XYZ Ltd

<u>Nature of relationship</u> → Company and associates own 51 percent of their Equity.

<u>Nature of transactions:</u> XYZ Ltd supplies the engines for the assembly of equipments manufactured by the Company. The engines are specially designed for this purpose and engines of four specific hp are supplied. There are no other parties supplying similar engines.

<u>Volume of transaction:</u> During this year 2500 engines valuing ₹ 215 lacs were supplied by XYZ Ltd. Of these, 2200 engines valuing ₹ 198 lacs were consumed and they are shown under the bought out components in the direct material cost in the cost statement. The price fixed is based on the assessable value for Excise duty plus 10 % mark-up on that. This valuation has been consistent and considered as reasonable by the management.

There are no other related party transaction relating to purchase of material.

8.8 ***Any cost imputed in arriving at the material cost shall be disclosed.***

As defined in the standard, imputed cost is a notional cost. It does not involve any cash outlay. It is computed only for the purpose of decision making. If any cost is imputed in arriving at material cost, it is to be disclosed to provide information that there is no cash outlay and it is only for decision making.

For example:

In the production of caustic soda, Hydrogen is produced as by-product. It is used as fuel to be burnt in the boiler besides sales. For the quantity burnt as fuel, hydrogen is priced after converting the quantity to thermal equivalent quantity of LSD oil and valued at the price of the LSD Oil.

8.9 ***Disclosures shall be made only where significant, material and quantifiable.***

Standard provides that any item of materials forming 5% of the total cost of material is to be disclosed both in quantity, rate and value. Further materiality and significance of information depends on nature, size and complexity of manufacturing operation. An item of material for use in the production of a product may have significance considering the nature of the product. For example, a critical part has been imported under export incentive scheme. It is to be used in the products to be exported. Though its value is less than 5% of the total cost of material, it is to be disclosed in terms of export requirement. Hence it is significant in the context of cost statement. Materiality is to be judged in terms of quantity and nature of material and in particular context of its omission. Information is material, if its non-disclosure could influence the decision of the user.

8.10 *Disclosures may be made in the body of the Cost statement or as a footnote or as a separate schedule.*

Disclosures may be made in the body of the cost statement as foot note. If there are many items of disclosures, the same may be included in Schedule of Notes to the cost statement.

Annexure I

Illustrative list of industries and raw materials used

S.No.	Description	Names of important raw materials
1	Sugar	Sugarcane and/or Beetroot
2	Milk powder	Whole fresh milk/skimmed milk as the case may be
3	Tea	Green Tea leaves
4	Motor Spirit	Crude Oil
5	Diesel oil	Crude Oil
6	Furnace Oil	Crude oil
7	Bitumen	Crude oil/coal
8	Soda Ash	Common salt
9	Caustic soda	Common salt
10	Sodium silicate	Soda Ash and Soluble glass
11	Sulphuric acid	Sulphur and/pyrite
12	Urea	Raw naphtha/ammonia/lignite/coal
13	Rayon and Synthetic Fibre & Yarn	Wood pulp/staple fibre
14	Cotton Yarn	Cotton
15	Wollen Fabrics	Woollen Yarns
16	Cement	Lime stone and gypsum
17	Zinc	Zinc ore
18	Aerated water	Concentrate
19	Coffee powder	Coffee beans
20	Gear, Pinion, shaft	Rough forging for such items

Annexure II

Illustration on valuation of receipt of indigenous supply

XYZ co
Faridabad
Inv.No.KKM/29[20XX]

To
M/s KLM,Nioda

Item	Quantity Nos	Rate ₹ /Unit	Amount (₹)
1.Bottom Cap	2200	2.79	6138
2.Top Cap	2200	2.26	4972
Total Assessable value			11110
Excise Duty		8%	889
Education Cess		2%	18
Secondary and Higher Education Cess		1%	9
Taxable Value			12026
VAT		4%	481
Freight & Cartage			0
Total			12507

Accounting entries in regard to above procurement will be as under:

Accounting Entries	Amount (₹)		
Purchases – Material	Dr	11110	
Basic Excise Duty Receivable A/c	Dr	889	
Education Cess Receivable A/c	Dr	18	
Secondary and Higher Education Cess Receivable A/c	Dr	9	
VAT recoverable	Dr	481	
To Supplier	Cr		12507
On Payment Supplier	Dr	12507	
To Bank	Cr		12507

On manufacture, excise duty payable will be adjusted against the above account viz. Excise Duty payable will be debited and Basic Excise Duty receivable account will be credited to discharge the payment liability of excise.

In certain purchases there may be no excise duty and the like and only VAT is paid. Entry will be in regard to purchase price and VAT paid will be adjusted against VAT payment liability.

VAT is a state subject. Provisions, rules and regulations governing this tax differ from state to state. A registered dealer can set-off VAT paid on inputs such as raw-materials and other supplies, (VAT credit) against VAT payable on outputs such as finished goods or traded goods (Vat liability). The underlying principle is similar to, CENVAT Scheme. In certain situation VAT credit is not available. These include:

- Dealers who are not registered under VAT.
- Dealers having a turnover below the threshold limit as fixed under the State Laws on VAT.
- Dealers engaged in works contract and option to pay tax by way of composition.
- Purchase of goods from unregistered dealers.
- Goods purchased in the course of inter-state trade where VAT is disallowed.

Annexure III a

Landed Cost of imported material on FOB Basis

Calculation of landed cost of Imported material on FOB Basis				
Party's name	XYZ			
Invoice No. MRR Date LC/TT No.	49 15.9.20XX XXX			
FOB/CIF	FOB			
Bill of Entry No. and date	XXX dated 8.10.20XX			
Item	**Qty (Kg)**	**Rate per unit**	**Bill Value**	**($ = ₹ 50.55)**
P. Black	10800	$3.00	$ 32,400	1637820
			Amount(₹)	
a. Assessable value B/E (101% of value)			1654198	
b. Basic Custom Duty (BCD)	7.50%		124065	
c. Education Cess on BCD	2%		2481	
d. Secondary and Higher Education Cess on BCD	1%		1241	
e. CVD (on AV+BCD)	8%		142261	
f. Education Cess on CVD	2%		2845	
g. Secondary and Higher Education Cess on CVD	1%		1423	
h. Custom Edn cess (CVD+EC)	2%		2902	
i. Custom Higher Edn cess(CVD+EC)	1%		1451	
j. Special Addl. Duty (on a to i)	4%		77315	
TOTAL CUSTOM DUTY				355984
Other duty, if any				
Freight				23751
Insurance				124035
Clearing & Forwarding expenses				6801
Total Purchase value	10800 kg			2148391
Less CVD			142261	
Less Education Cess on CVD			2845	
Less Secondary and Higher Education Cess on CVD			1423	
Less Special Addl. Duty**			77315	(-)223844
Net Purchase Value				1924547
** applicable to manufacturer only and not service provider				
Landed Cost per unit				178

Annexure III b

Landed Cost of imported material on CIF Basis

Calculation of landed cost of Imported material on CIF Basis				
Party's name	XYZ			
Invoice No. MRR Date LC/TT No.	49 5th April, 20XX XXX			
FOB/CIF	**CIF**			
Bill of Entry No. and date	XXX Dated			
Item	**Qty (Kgs)**	**Rate per unit**	**Bill Value $**	**($ = ₹ 51.15)**
H Melt	300	$ 7.70	$2310	118157
			Amount (₹)	
Assessable value B/E(101% of value)			119338	
Basic Custom Duty	20.00%		23868	
Education cess on BCD	2%		477	
Secondary and Higher Education cess on BCD	1%		239	
CVD (on AV +BCD)	8%		11456	
Education cess on CVD	2%		229	
Secondary and Higher Education Cess on CVD	1%		115	
Education cess on Custom (CVD + EC)	2%		234	
Secondary and Higher Education Cess on Custom	1%		117	
Special Addl. Duty	4%		6243	
TOTAL CUSTOM DUTY				42978
Freight				0
Insurance				0
Clearing & Forwarding expenses				5530
Total Purchase value	300kg			166665
Less CVD			11456	
Less Education Cess on CVD			229	
Less Secondary and Higher Education Cess on CVD			115	
Less Special Addl.Duty			6243	(-)18043
Net Purchase Value				148622
Landed Cost per unit	300 KG			495

Annexure IV

Illustration showing the treatment of driage loss in sugar industry					
		Quantity (Tonnes)			
	Sugarcane	**Purchased**	**Received**	**Loss**	**% of loss**
(a)	Own farm	0	0	0	0
(b)	Gate	609073	609073	0	0
(c)	Road	362593	360548	2045	0.564
(d)	Rail	0	0	0	0
(e)	Other means of transport	0	0	0	0
		971666	969621	2045	0.210
	Particulars	**Unit**	**Quantity**	**Rate (₹)**	**Amount (₹)**
1	Total sugarcane purchased incl. from own farm	MT	971666		
	Less--normal losses such as driage	MT	2045		
	Actual	MT	969621	555.522	538645797
2	Commission paid			17.193	16670694
3	Other expenditure at cane collecting Center				
	(a) Salaries and wags			7.257	7036539
	(b) Stores and stationery			1.128	1093732
	(c) Repairs and maintenance			0.609	590499
	(d) Other expenses			3.187	3090182
4	loading and unloading charges			3.922	3802853
5	Net harvesting charges			0	0
6	Taxes and levies				
	(a)Cane cess /purchases tax			17.537	17004243
	(b) Octroi			0	0
	(c) Other levies			0	0
	Total	MT	969621	606.355	587934541
7	Transport charges				
	(a) Transport cost			0	0
	(b) Others			12.765	12377212
8	Cane development expenses				
	(a) Salaries and wages of cane dev. Staff			1.429	1385588
	(b) Others			2.378	2305758
	Total	MT	969621	622.927	604003100
9	Stock Adjustment if any				
	Add- opening stock	MT	156	476.692	74364
	less- closing stock	MT	294	584.844	171944
10	**TOTAL**	MT	969483		603905520

Annexure V

Illustration on treatment of FOREX component

XYZ imported Quantity 5000 kilos @ US $ 30 per kilo.

Total contracted rate US $ 150000 CIF Chennai

Letter of credit established demand bill basis documents against payment.

Date of dispatch of goods 1st Dec XXXX.

(Conversion rate per US Dollar = ₹ 44) Market rate published by RBI,

Date of dispatch of Documents 2nd Dec XXXX (₹ 45 per $ as per market rate published by RBI)

Date of receipt of Documents 6th Dec XXXX (₹ 43 per $)

Date of payment by the Bank 8th Dec XXXX (₹ 42 per $ used by the Bank in India)

The cost of materials will be taken @ ₹ 45 per US$ being the date of dispatch of documents. The rate used by their bank for debit is the market rate at the time of conversion within a day which need not tally with the published rate.

The difference between ₹ 45 and ₹ 42 per $ will be considered in financial accounts as under:

Us $ 150000 @ 45 per $= ₹ 6750000

US $ 150000 @42 per $ = ₹ 6300000

The short / (gain) of ₹ 450000 will be credited to exchange rate fluctuations / adjustment account. It does not form part of material cost.

The bank charges are in the nature of Administrative Overheads and will not form part of material cost.

Annexure VI

Illustration on FIFO/LIFO/Weighted average method of issue of material

The following is the receipts and issues of January 20XX:

Date	Receipts		Date	Issue (Qty)
	Units(tonnes)	Rupees/unit		
2-1-20XX	300	4	7-1-20XX	200
16-1-20XX	500	6	18-1-20XX	400
23-1-20XX	450	5	29-1-20XX	100

FIFO method:

Receipt				Issue			Balance		
Date	Qty	Rate (₹)	Amt (₹)	Qty	Rate (₹)	Amt (₹)	Qty	Rate (₹)	Amt (₹)
1-1-20XX							-	-	-
2-1-20XX	300	4	1200				**300**	**4**	**1200**
7-1-20XX				200	4	800	**100**	**4**	**400**
16-1-20XX	500	6	3000				100	4	400
							500	6	3000
							600		**3400**
18-1-20XX				100	4	400	**200**	**6**	**1200**
				300	6	1800			
23-1-20XX	450	5	2250				200	6	1200
							450	5	2250
							650		**3450**
29-1-20XX				100	6	600	100	6	600
							450	5	2250
							550		**2850**

LIFO method:

Date	Receipt			Issue			Balance		
	Qty	Rate (₹)	Amt (₹)	Qty	Rate (₹)	Amt (₹)	Qty	Rate (₹)	Amt (₹)
1-1-20XX							-	-	-
2-1-20XX	300	4	1200				**300**	**4**	**1200**
7-1-20XX				200	4	800	**100**	**4**	**400**
16-1-20XX	500	6	3000				100	4	400
							500	6	3000
							600		**3400**
18-1-20XX				400	6	2400	100	4	400
							100	6	600
							200		**1000**
23-1-20XX	450	5	2250				100	4	400
							100	6	600
							450	5	2250
							650		**3250**
29-1-20XX				100	5	500	100	4	400
							100	6	600
							350	5	1750
							550		**2750**

Weighted average method:

Date	Receipts			Issue			Balance		
	Qty	Rate (₹)	Amt (₹)	Qty	Rate (₹)	Amt (₹)	Qty	Rate (₹)	Amt (₹)
1-1-20XX							**-**	**-**	**-**
2-1-20XX	300	4	1200				**300**	**4**	**1200**
7-1-20XX				200	4	800	**100**	**4**	**400**
16-1-20XX	500	6	3000				**600**	**5.667***	**3400**
18-1-20XX				400	5.667	2000	**200**	**5.667**	**1133**
23-1-20XX	450	5	2250				**650**	**5.2****	**3380**
29-1-20XX				100	5.2	520	**550**	**5.2**	**2860**

Weighted average method:

* issue on18-1-20XX →(3400/600 = 5.667)   ** issue on 29-1-20XX →(1133+2250)/650 = 5.2

Annexure VII

Illustration of material cost variance (price, use, mix and yield)

Examples of material cost variance (price, use, mix and Yield):

Material 'A' and 'B' are mixed in the proportion of 60% and 40% respectively and a standard loss of 5% is fixed. Standard and actual cost for a period is as under:

	Standard Cost			Actual Cost		
Item	**Qty (KG)**	**Rate per unit**	**Total**	**Qty (KG)**	**Rate per unit**	**Total**
Material A	6000	6.00	36000	5000	6.50	32500
Material B	4000	4.00	16000	4500	3.50	15750
Total Loss 5%	10000 500	5.20	52000	9500	5.08	48260
Output	9500			9000		

Variances calculation:		
Material price variance : Actual qty(Standard Price –Actual price)		(₹)
Material A :5000x(6.00-6.50) =2,500	(Adverse)	(2500)
Material B 4500x(4.00-3.50) = 2250	Favourable	2250
	Total	(250)
Material Usage variance:		
(Actual production x standard material per unit – actual material)x standard price per unit		
{(9000x0.6)/0.95 – 5000} x ₹ 6.00 = 4105	Favourable	4105
{9000x.0.4)/0.95 - 4500} x ₹ 4.00 = 2842	Adverse	(2842)
	Total	1263

Material Mix Variance (Actual quantity of material – quantity of material based on total material quantity split in standard proportion)x (weighted average cost per unit (Kg) – standard cost per unit(Kg)) A(5000 – 5700) x (5.079 – 6.00) = 644 B((4500 -3800) x (5.079 - 4.00) = 755		644 755 1399
Material Yield Variance Standard material quantity allowed for actual output – actual material quantity input)x standard weighted average cost per unit (Kg) (9000/0.95 - 9500) x 5.08 = (136)		(136)

Total Material Cost Variance = ₹ 1013

Total Price variance = (-) ₹ 250

Total Material Usage Variance = ₹ 1263

Total Material Mix variance = ₹ 1399

Total Material Yield Variance = (-) ₹ 136

Annexure VIII a

Illustration of presentation of material cost – Engineering Industry

S.No.	Description	Unit	Qty	Rate	Amount
A	Direct Material			₹	₹
1.	Sheet	Kg.	10	200	2000
2. 2(a)	Bought out components **Imported**				
	Crank shaft	No.	1	6900	6900
	Cylinder block	No	1	12500	12500
	Hydraulic lift value	No.	1	7200	7200
	Wheel Assembly Rear	No.	2	3230	6460
2b)	**Indigenous**				
	Injection pump	No.	1	18500	18500
	Tyres	No.	5	3000	15000
	Battery	No.	1	7500	7500
3	Others constituting less than 5% of the Total material cost				175000
4	**Total**				251060

Annexure VIII b

Illustration of presentation of material cost – Process Industry (Paper)

S.No.	Description	Unit	Qty	Rate	Amount
A	**Direct Material – Raw material**				
1.	Wood pulp (self manufactured)	MT	250	20000	5000000
2.	Imported pulp	MT	10	35000	350000
3.	Broke	MT	10	12000	120000
B	**Process chemicals/additives**				
1	Filler	MT	12	8500	102000
2	Sizing	MT	3	19000	57000
3	Alum	MT	10	9400	94000
4	Dyes Fluorescent	KG	13	150	1950
5	Other chemicals				105210
	Total				5830160

Annexure VIII c

Illustration of presentation of material cost – Caustic Soda

(Power used for electrolysis process is treated as part of material cost)

Sl. No.	Particulars	Unit	Quantity	Rate ₹ /Unit	Amount (₹)
A	**Materials consumed**				
1	**Direct Material**				
	a) Purchased				
	- Indigenous Salt (Industrial Grade)	MT	997500	750	748125000
	- Imported	0	0	0	0
	b) Self Manufactured - Power consumed in electrolyser	KWH	15250000	5	76250000
	Total Direct Material				**824375000**
2	**Process material**				
	a) Barium Carbonate	KG	876600	19	16655400
	b) Sodium Sulphite	KG	94300	16	1508800
	c) Soda Ash	KG	42850	12	514200
	d) Alpha Cellulose	KG	6750	96	648000
	e) Flocculent	KG	1700	315	535500
	Total process material				**19861900**

Annexure IX

(CAS-6)

COST ACCOUNTING STANDARD ON MATERIAL COST

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 "MATERIAL COST". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

1.1 This standard deals with principles and methods of determining the Material Cost.

Material for the purpose of this standard includes raw materials, process materials, additives, manufactured / bought out components, sub-assemblies, accessories, semi finished goods, consumable stores, spares and other indirect materials. This standard does not deal with Packing Materials as a separate standard is being issued on the subject.

1.2 This standard deals with the principles and methods of classification, measurement and assignment of material cost, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.

1.3 The Standard deals with the following issues.

- Principle of Valuation of receipt of materials.
- Principle of Valuation of issue of materials.
- Assignment of material cost to cost objects.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the material cost with reasonable accuracy.

3. Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of material costs including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation[1].***

4.2 Administrative overheads: ***Expenses in the nature of indirect costs, incurred for general management of an organization[2].***

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.4 Defectives: ***End Product and/or intermediate product units that do not meet quality standards. This may include reworks or rejects.***

4.4.1 Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***

Rework includes repairs, reconditioning and refurbishing.

4.4.2 Rejects: ***Defectives which cannot meet the quality standards even after putting in additional resources.***

Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

4.5 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed only for the purpose of the decision making[3].***

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1 Adapted fromCAS-1 Para 6.5.19

2 Adapted from CAS-1 Para 6.3.5

3 CAS 1- Para 6.5.13

4.6 Materials:

4.6.1 Direct Materials: ***Materials the costs of which can be attributed to a cost object in an economically feasible way[4].***

4.6.2 Indirect Materials: ***Materials, the costs of which cannot be directly attributed to a particular cost object[5].***

4.7 Material Cost: ***The cost of material of any nature used for the purpose of production of a product or a service[6].***

4.8 Production overheads: ***Indirect costs involved in the production process or in rendering service[7].***

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

4.9 Scrap: ***Discarded material having some value in few cases 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[8].***

4.10 Standard Cost: ***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 for deviation is placed.[9] 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.

4.11 Waste and spoilage:

4.11.1 Waste: ***Material loss during production or storage due to various factors such as evaporation, chemical reaction, contamination, unrecoverable residue, shrinkage, etc., and discarded material which may or may not have value[10].***

4.11.2 Spoilage: ***Production that does not meet with dimensional or quality standards in such a way that it cannot be rectified economically and is sold for a disposal value. Net Spoilage is the difference between costs accumulated up to the point of rejection and the salvage value.***

5. Principles of Measurement

5.1. Principle of valuation of receipt of materials:

5.1.1 ***The material receipt should be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities) that can be quantified with reasonable accuracy at the time of acquisition.***

Examples of taxes and duties to be deducted from cost are cenvat credits, credit for countervailing customs duty, sales tax set off/ vat credits and other similar items of credit recovered/ recoverable.

5.1.2 ***Finance costs incurred in connection with the acquisition of materials shall not form part of material cost.***

4 Adapted from CAS 1-6.2.3
5 Adapted from CAS 1– 6.2.8
6 CAS-1-6.1.2
7 Adapted from CAS-1 Para 6.3.3 and 6.3.4
8 Adapted from Glossary of Management Accounting Terms- Page 62
9 Adapted from CAS 1_ Para 6.7.5
10 Adopted from Glossary of Management Accounting Terms page 70

5.1.3 ***Self manufactured materials shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads. In case of captive consumption, the valuation shall be in accordance with Cost Accounting Standard 4.***

5.1.4 ***Spares which are specific to an item of equipment shall not be taken to inventory, but shall be capitalized with the cost of the specific equipment. Cost of capital spares and/or insurance spares, whether procured with the equipment or subsequently, shall be amortised over a period, not exceeding the useful life of the equipment.***

5.1.5 ***Normal loss or spoilage of material prior to reaching the factory or at places where the services are provided shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.***

5.1.6 ***Losses due to shrinkage or evaporation and gain due to elongation or absorption of moisture etc., before the material is received shall be absorbed in material cost to the extent they are normal, with corresponding adjustment in the quantity.***

The adjustment for moisture will depend on whether dry weight is used for measurement.

5.1.7 ***The forex component of imported material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the material cost.***

Explanation: The date on which a transaction (whether for goods or services) is recognised in accounting in conformity with generally accepted accounting principles

5.1.8 Any ***demurrage or detention charges, or penalty levied by transport or other authorities shall not form part of the cost of materials.***

5.1.9 ***Subsidy/Grant/Incentive and any such payment received/receivable with respect to any material shall be reduced from cost for ascertainment of the cost of the cost object to which such amounts are related.***

5.2. Principle of valuation of issue of material

5.2.1 ***Issues shall be valued using appropriate assumptions on cost flow.***

E.g. First In First Out, Last In First Out, Weighted Average Rate.

The method of valuation shall be followed on a consistent basis.

5.2.2 Where materials are accounted at standard cost, the price variances related to materials shall be treated as part of material cost.

5.2.3 Any abnormal cost shall be excluded from the material cost.

5.2.4 Wherever, material costs include transportation costs, determination of costs of transportation shall be governed by CAS 5 – Cost Accounting Standard on Determination of Average (Equalized) Cost of Transportation.

5.2.5 Material cost may include imputed costs not considered in financial *accounts.*

Such costs which are not recognized in financial accounts may be determined by imputing a cost to the usage or by measuring the benefit from an alternate use of the resource.

5.3 ***Self manufactured components and sub-assemblies shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads. In case of captive consumption, the valuation shall be in accordance with Cost Accounting Standard 4.***

5.4 The material cost of normal scrap/ defectives which are rejects shall be included in the material cost of goods manufactured. The material cost of actual scrap / defectives, not exceeding the normal shall be adjusted in the material cost of good production. Material Cost of abnormal scrap /defectives should not be included in material cost but treated as loss after giving credit to the realisable value of such scrap / defectives.

6. Assignment of costs

The basis of assignment of costs to the cost of product or service is dealt within this section.

6.1 Assignment of costs – Materials

6.1.1 Assignment of material costs to cost objects: ***Material costs shall be directly traced to a Cost object to the extent it is economically feasible and /or shall be assigned to the cost object on the basis of material quantity consumed or similar identifiable measure and valued as per the principles laid under Paragraph 5.***

6.1.2 ***Where the material costs are not directly traceable to the cost object, these may be assigned on a suitable basis like technical estimates.***

6.2 Assignment of costs – Direct Expenses

6.2.1 ***Where a material is processed or part manufactured by a third party according to specifications provided by the buyer, the processing/ manufacturing charges payable to the third party shall be treated as part of the material cost.***

6.2.2 ***Wherever part of the manufacturing operations / activity is subcontracted, the subcontract charges related to materials shall be treated as direct expenses and assigned directly to the cost object.***

6.3 Assignment of costs– Indirect materials

6.3.1 ***The cost of indirect materials shall be assigned to the various Cost objects based on a suitable basis such as actual usage or technical norms or a similar identifiable measure.***

6.3.2 The cost of materials like catalysts, dies, tools, moulds, patterns etc, which are relatable to production over a period of time shall be amortized over the production units benefited by such cost.

6.3.3 The cost of indirect material with life exceeding one year shall be included in cost over the useful life of the material.

7. Presentation

Cost Statements governed by this standard, shall present material costs as detailed below:

7.1 ***Direct Materials shall be classified in the cost statement under suitable heads.***

E.g.

- Raw materials,
- Components,
- Semi finished goods and
- Sub-assemblies

7.2 ***Direct Materials shall be classified as Purchased - indigenous, imported and self manufactured.***

7.3 ***Indirect Materials shall be classified in the cost statement under suitable heads.***

Indirect materials may be grouped under major heads like tools, stores and spares, machinery spares, jigs and fixtures, consumable stores, etc., if they are significant.

8. Disclosures

The following information should be disclosed in the cost statements dealing with determination of material cost.

8.1 ***Quantity and rates of major items of materials shall be disclosed. Major items are defined as those who form 5% of cost of materials.***

8.2 ***The basis of valuation of materials shall be disclosed.***

8.3 ***Any change in the cost accounting principles and methods applied for the determination of the material cost during the period covered by the cost statement which has a material effect on the cost of the material shall be disclosed. Where the effect of such change is not ascertainable wholly or partly, the fact shall be indicated.***

8.4 ***Any abnormal cost excluded from the material cost shall be disclosed.***

8.5 ***Any demurrage or detention charges, penalty levied by transport or other authorities excluded from the material cost shall be disclosed.***

8.6 ***Any Subsidy/Grant/Incentive or any such payment reduced from material cost shall be disclosed.***

8.7 ***Cost of Materials procured from related parties[11] shall be disclosed***

8.8 ***Any cost imputed in arriving at the material cost shall be disclosed.***

8.9 ***Disclosures shall be made only where significant, material and quantifiable.***

8.10 ***Disclosures may be made in the body of the Cost statement or as a footnote or as a separate schedule.***

Disclaimer
There are some provisions though spelt under the Companies Act, 2013, but not yet notified/enforced "till date of publication of this Study Material". Hence, for such provisions, the relevant and corresponding Sections/Provisions of the Companies Act, 1956 is applicable. All concerned are requested to follow both – the MCA, GOI website as well as Clarification/Circular issued/to be issued by the Institute from time to time – on applicability of sections of Companies Act for CMA Examinations.

11 Related party as per the applicable legal requirements relating to the cost statement as on the date of statements

2.4 GUIDANCE NOTE ON COST ACCOUNTING STANDARD ON EMPLOYEE COST (CAS-7)

The Council of the Institute of Cost and Works Accountants of India (ICWAI) has issued the Cost Accounting Standard 7 (CAS-7) on Employee Cost which lays down a set of principles and methods of classification, measurement and assignment of Employee cost, for determination of the cost of product or service and the presentation and disclosure in the cost statements.

The Guidance Note deals with principles and methods as provided in the CAS-7 and practical aspects in connection with the determination of employee cost of a product or service.

In the preparation of cost statements including those requiring attestation, employee cost shall be determined as per CAS-7.The Cost Accounting Standards have been set in ***bold italic*** type and reference number of the standard has been retained.

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 state that for the purposes of sub-section (1) of section 148 of the Act, the class of companies, including foreign companies defined in clause (42) of section 2 of the Act engaged in the production of the goods or providing services, specified in the Table below, having an overall turnover from all its products and services of rupees **thirty five crore or more** during the immediately preceding financial year, shall include cost records for such products or services in their books of account.

Rule 4(a) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (A) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **fifty crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **twenty five crore or more**.

Rule 4(b) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (B) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **one hundred crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **thirty five crore or more**.

Introduction

Employee cost is a significant factor of cost of production. But, its significance is decreasing due to automation in production. However in knowledge based industry such as software industry, employee cost is the single most important factor of cost of product / service.

The term "employee costs" refers to the expenditure incurred by an entity towards the services performed by the employees of such an entity. In normal parlance employee costs include wages/ salaries, allowances and bonuses, paid by an employer in cash or in kind to employee in return for the work done. However such costs also include employer contribution to social saving schemes, payments for days not worked and remunerations in kind such as provision of free or concessional food, drink, fuel and other amenities. There are a number of other costs which do not appear in the payroll but are employee related cost such as: recruitment costs, training costs, relocation costs, support / social costs, and personnel administration costs. The employee cost is also sometimes termed as "Labour cost".

Type of Employees:

Employees in an entity may be categorized as:

a. Daily rated worker / badli worker, piece rated worker,

b. Monthly paid worker,

c. Contract basis,

d. Temporary or regular,

e. Skilled or unskilled,

f. Executive / non executive.

The employees are paid remuneration as per their terms of employment. Employees may be paid on monthly, weekly or piece rate basis. In case of piece work employees' quality and quantity is ensured. Payments made to employees are classified as casual labour cost, supervisory employee cost and the like. The attendance of employees is closely monitored by various methods for example biometric / clocking system / manually.

Payments made in cash or kinds to employees are categorized as:

(i) Salaries / wages

(ii) Allowances: Dearness allowance, House Rent allowance, Education Allowance, transport allowance,

(iii) Bonus: Remuneration packages often include profit sharing or production bonus plans subject to fulfilment of certain pre-conditions. Payments under this head are:

   a. Statutory minimum bonus / sharing in surplus profit. The Payment of Bonus Act, 1965 deals with profit sharing bonus. It represents an additional payment.

   b. Productivity linked or other efficiency related bonus including bonus payment based on agreement with trade unions (not linked to profits)

   c. Incentives: quality incentive, merit incentive, service loyalty incentive, etc. An incentive is a monetary inducement for better performance in addition to regular and overtime wages. It is an extra pay for extra performance. Scheme of incentives varies from entity to entity. However incentive payments made to employees form part of employee cost.

(iv) Contribution to provident and other funds: Entity covered under Provident fund and Employee's State Insurance scheme has to deduct specified contribution from the employee's wages and salaries. Such deductions are to be deposited with the Government agencies accompanied by corresponding contribution from the employer. For example if total deduction from employees during a period is ₹ 1.20 lakhs, the entity has to deposit ₹ 2.40 lakhs (₹ 1.20 lakhs from employees and corresponding contribution from employer of ₹ 1.20 lakhs) within the specified time.

(v) Instead of depositing the contribution with Provident Fund Commissioner, many large and medium enterprises operate their own Provident Funds, by establishing an independent Trust for managing the assets as per provisions of the Employees Provident Fund & Misc Provision Act 1952. It is a statutory requirement that the employees covered by such PF scheme should derive a specified return on the contribution made. If the actual yield on funds deployed happened to be lower than the notified rate, the shortfall is met by the employer. Thus an obligation is cast on employers to bear the difference, if any, between the notified rate, and the return generated by assets of such PF. Such shortfall forms part of employee cost.

(vi) Employee welfare: These include facilities like subsidized canteen, cooperative stores, laundry and washing services, sports, housing schemes, transport and educational facilities. These facilities are as good as higher wages offering incentive to the workers to stay with the entity.

(vii) Other benefits: Payment to employees for the following items also form part of the employees cost:

   - Paid holidays.
   - Leave with pay / maternity leave.
   - Statutory provisions for insurance against accident or health scheme:

(a) **E.S.I. (Employees State Insurance) Scheme** is a contributory scheme for the employees in the factories or establishments to which the Act applies. The employees are insured in a manner provided by the Employees' State Insurance Act 1948. The contribution payable to the E.S.I Corporation in respect of an employee shall comprise of employer's contribution and employee's contribution at a specified rate. The rates are revised from time to time. Presently, the employees' contribution is 1.75% of the wages and that of employers' is 4.75% of the wages paid or payable in respect of the employees in every wage period. The Scheme covers employees engaged on a monthly remuneration not exceeding ₹ 6500 ***(enhanced to ₹ 15000 w.e.f. 1st May 2010***) in a factory / establishment to which the Act applies. The employees so covered are entitled to benefits such as periodical payments in case of a sickness, periodical payments to women in case of confinement or miscarriage or sickness arising out of pregnancy etc., periodical payments for suffering from disablement as a result of an employment injury and medical treatment etc. Dependants of the employees are also entitled to the benefits provided under the Act.

(b) ***Statutory provisions for workman's compensation:***

In case a personal injury is caused to a workman by an accident arising out of and in the course of his employment, the employer is liable to pay compensation in accordance with the provision of the Workmen's Compensation Act, 1923. The amount paid towards such compensation also form part of employee cost.

- Medical benefits to the employees and dependents.
- Free or subsidised food.
- Free or subsidised housing.
- Free or subsidised education to children.
- Free or subsidised canteen, crèches and recreational facilities.
- Free or subsidised conveyance.
- Leave travel concession.
- Any other free or subsidised facility.
- Cost of Employees' stock option: The employees in case of certain entities are given a right to acquire shares in the entity at a future date at a predetermined price. The offer may be free of cost, or at concessional rates. Such benefit is in the form of:

(a) shares, share options and other equity instrument issued to employee at less than fair value at which these instruments are issued to third parties; and

(b) Cash payment, the amount of which will depend on the future market price of enterprise shares.

The aggregate amount of such expenditure which would form part of the Employee cost on account of Employee stock option plan as ascertained at the year end is carried forward as Deferred Employee Compensation Benefit to be written off over the related vesting period of individual options.

- Future Benefits Employee Cost: Employer has to provide for certain future benefits payable to employees, such as Gratuity, Superannuation benefits and the like.

✓ ***Gratuity:*** It is a lump sum payment made based on the total service of an employee either on retirement or death. The gratuity is paid on the basis of the employee's basic plus dearness allowance if any. As per the Payment of Gratuity Act 1972, the gratuity amount is 15 days' wages multiplied by the number of years service put in. It is calculated based on last salary drawn divided by 26 to work out per day rate. An employee should have minimum service of 5 years' service to earn gratuity. The maximum gratuity payable is 16 ½ months emoluments for the maximum of 33 years of service and for lesser service it is proportionately paid.

For employees who do not fall under the Gratuity Act, the amount due for them is half of the average ten months' salary multiplied by the number of years of service or as per term of employment.

To meet its liabilities towards gratuity, a company funds the money, or opens a trust. This fund is then managed either by an insurer or on actuarial basis. The gratuity liability at the end of the year is determined on the basis of actuarial valuation.

The superannuation liability is also assessed and provided on the above basis.

- Short term compensated absence (such as paid annual leave and paid sick leave) Employee is entitled for leave as per his term of employment. A part of leave lapses during the year and other part of leave is accumulated over a period as per policy of the entity. Leave may also be encashed during the service. Employee is also entitled for leave encashment at the time of termination of employment. It is the amount payable for the employee's leave period, depending upon the leaves to his credit and his salary at the time of termination of employment.
- Voluntary Retirement Scheme (VRS): To reduce the surplus strength, Voluntary retirement scheme is introduced providing a lump sum payment for the remaining year of service on seeking voluntary retirement besides other terminal benefits.

The various employee benefits are to be provided in the accounts as per AS-15. These benefits form part of employee cost and their treatment is required to be indicated in the Cost Accounting Records.

Classification of Employee cost:

Employee cost, on the basis of relation with a cost centre / cost object is classified direct employee cost, or indirect employee cost of product / service.

Direct employee cost is that portion of wages and salaries which can be identified with and charged to a cost object. It may be classified as direct when:

1. There is a direct relationship to the product through a process or a costing unit;
2. The cost may be measured in light of this relationship; and
3. The cost is significant in amount.

The general rule is that direct employee cost is the labour spent in the actual production of the finished product which is economically identifiable with product costs. "Economically" means cost benefit ratio be looked into before going into a detailed exercise ascertaining direct employee cost.

All factory employees cost other than for direct employees are classified as indirect employee costs. The distinction between direct and indirect employee is sometime difficult to establish. Early stages of technology witnessed a major role for the workmen in the manufacturing process with output being controlled mainly by the workmen's efforts. Hence elaborate systems were built to log workmen's time for an individual jobs or products and operations and employee cost was assigned on the basis of time booking and identified as direct employee cost. As technology developed, the importance of machines in production grew with decreasing nexus between workmen's efforts and production. Work men were assigned to more than one machine producing more than one product with their role being reduced to attending to controls.

However, in case where technology is at an early stage, it is still common for direct employee cost to be assigned to products and operations on the basis of time booked for the job. This is applicable for engineering shops with conventional machines such as lathes, drilling machines, milling machines etc., and simple processing shops.

In case where fully automatic machinery is used, the worker becomes in effect a machine tender. The machine alters the size or shape of the product, while the worker merely feeds the machine at intervals and makes minor adjustments. A question may arise a machine adjuster is a direct employee or an indirect employee. A distinction is to be made that if a man is tending a productive machine, his labour is as direct as the labour of an employee producing goods manually. But if the he is repair man or set-up man, he may be classified as indirect employee.

Further, in certain cases employee may be direct in nature, but for practical reasons, may not be charged directly to a given product, being prorated as direct employee cost over several products or even treated as indirect employee cost. Instances of such border line cases are spray painting, inspection and short operations e.g. buffing, polishing, etc. Spray painting can, in some instances, be easily identified with and charged to specific jobs but in many cases the spraying is done on a conveyor belt with items from various jobs being sprayed as needed. In the latter case, to charge the paint spraying employee cost directly to the separate job may entail too much clerical detail and the employee cost may be allocated to various jobs on some equitable basis.

Inspection employee may be considered direct employee or indirect employee depending upon the circumstances. It is often considered direct employee in cases where each unit must be tested or measured to ascertain that the product meets predetermined specification as in the case of manufacture of drugs where each item must be tested to guard against error. Inspection should, in other cases be considered as indirect employee if inspection is done on an intermittent or selective basis. If inspector divides his time between two or more departments or jobs, proration of his wages may be accomplished more easily by treating them as indirect employee cost than by attempting to make a direct allocation through time tickets or time cards.

The distinction between direct and indirect employee is necessary because direct employee efficiency is measured by the number of acceptable units completed, while the efficiency of other type of employee frequently has little relationship to the number of units produced. Therefore in the measurement of the efficiency of a particular worker, group of workers or a department, their employees must be divided, so far as practicable, into direct and indirect employee. Measurement of Employee Cost involves determining the basis of cost measurement method and establishing criteria for use of alternative cost measurement techniques.

Examples of cost measurement are:

- Use of historical cost,
- Use of actual or standard cost,
- Designation of items of cost which must be included or excluded from the Employee Cost,
- Employee Cost is measured in terms of time (man hours / man days) and rate of payment.

Measurement of Employee Cost is detailed under Chapter 3.

Assignment is tracing the employees cost to a product or service and is dealt in Chapter 4.

The principles and methods adopted for computation of employee cost in a cost statement shall be applied consistently from one period to another and for reasonable uniformity between different products / units. For example Employees working on machining operation are to be classified as Direct Employee from one period to another and those engaged in repair to be classified as indirect.

Definitions

The following terms are used in this guidance note with the meaning specified:

Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and / or due to some abnormal situation of the production or operation.***

Abnormal Idle time***: An unusual or atypical employee idle time occurrence of which is usually irregular and unexpected or due to some abnormal situations.***

Administrative overheads: ***Expenses in the nature of indirect costs, incurred for general management of an organization.***

Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which cost are ascertained.***

Direct Employee Cost: ***The cost of employees which can be attributed to a Cost Object in an economically feasible way.***

Distribution Overheads: ***Distribution overheads, also known as Distribution Cost, are the costs incurred in handling a product from the time it is ready for despatch until it reaches the ultimate consumer.***

Employee cost: ***The aggregate of all kinds of consideration paid, payable and provisions made for future payments for the services rendered by employees of an enterprise (including temporary, part time and contract employees). Consideration includes wages, salary, contractual payments and benefits, as applicable or any payment made on behalf of employee. This is also known as Labour Cost.***

Idle time: ***The difference between the time for which the employees are paid and the employees' time booked against the cost object.***

Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***

Indirect Employee Cost: ***The cost which cannot be directly attributed to a particular cost object.***

Marketing overheads: ***Marketing Overheads are also known as Selling and Distribution Overheads.***

Overtime Premium: ***Overtime is the time spent beyond the normal working hours which is usually paid at a higher rate than the normal time rate. The extra amount beyond the normal wages and salaries paid is called overtime premium.***

Production Overheads: ***Indirect costs involved in the production process or in rendering service.***

Selling Overheads: ***Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***

Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Principles of Measurement

5.1 ***Employee Cost shall be ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all the benefits.***

The gross pay and allowances payable to an employee are indicated in the pay slip of an employee. The payroll department computes the gross pay, including gross amount earned and the net amount payable to employees after deductions (for PF, FPS, ESI and so on) based on the attendance details received from HRD / Time Office. Pay slip contains inter alia the personal details of an employee besides payment details. An illustration of pay slip is at ***Annexure I.***

Based on Pay slips (which indicate department code), summary of gross earnings, deductions, working days and the like are prepared department wise / cost centre wise. Gross earning of an employee is the employee cost to the entity. An illustration of summary of gross earnings of employees cost centre wise is indicated at ***Annexure II.***

Gross Employees costs generally exceed the cost of gross wages or salaries paid to employees. Employers are required to match the employee's contribution to PF, FPS, ESI, Workmen Compensation, paid holidays, leave, pension gratuity and the like.

Employer's contribution to PF, FPS and ESI are identifiable with each employee. Contribution to Provident fund is to be made as per the PF Rules and the same is paid to a PF Commissioner or fund administered through a separate trust. Thus contribution to Provident Fund, Employee State Insurance Scheme and FPS are charged as incurred.

Share of employers' contribution to PF, FPS and ESI shall be identified to cost centre / department where the employee is working. In cases where it is not feasible, it shall be allocated based on employees gross earning.

To cover the cost of worker's compensation under Workmen Compensation Act for injury to employees on the job, Accident Insurance policy is taken resulting in additional employee cost. It shall be treated as Production overhead as it is not specific to any cost centre.

Non financial benefits are offered to employees in several ways.

These are the benefits in the form of amenities or facilities which do not offer cash reward to the employee for any specific or measured work done. Such non monetary benefits make the working conditions and terms of employment lucrative so as to induce the employee to increase his efforts/productivity. The benefit goes to all the employees in the undertaking and is not limited to any individual, class, or group.

For example:

- Free or subsidised food.
- Free or subsidised housing.
- Free or subsidised education to children.
- Free or subsidised canteen, crèches and recreational facilities.
- Free or subsidised conveyance.
- Leave travel concession.
- Any other free or subsidised facility.
- Recreational facilities
- Protective clothing, liveries, uniforms etc.
- Tea milk etc

They are non-financial only so far as the employee is concerned, but the employer has to incur expenditure to provide for the incentives. The above payments to employees are ascertainable at the end of each month. In case of subsidized benefits, token money recovered from the employee is credited to the relevant benefit scheme. Net cost of benefits is allocated to the departments / cost centre on the basis of gross earning / number of employee or may be treated as overhead.

There are group benefits extended to employees such as Group Personal Accident Insurance, Group Medical Insurance Scheme etc. It is difficult to relate such costs to individual employees and therefore to cost centres or objects. These can only be allocated to cost centres or cost objects on the basis of no. of employees or employee cost of each cost centre or cost object.

Cost Object or Cost Centre is the logical sub-unit for collection of cost. Cost object may be any customer, product service, contract, project, activity or other work unit for which a separate cost measurement is desired. For example, if it is desired to determine what it costs to produce a car, then the cost object is car. If it is desired to determine the operating cost of maintenance department within a plant, the cost object is maintenance department. Different costs can be assigned to the same cost object, depending on the purpose.

Employee welfare expenses similarly represent a motley of benefits including canteen facilities, recreation facilities, gifts to individual employees on birthdays / marriage, dispensary facilities etc., These are legitimately treated as part of employee cost and allocated to cost centres or cost objects on the basis of no. of employees or employee cost of each centre or cost object.

Post-employment benefit schemes can take any two forms:

a. Fixed contribution to a fund by the employer with varying benefits to employees.

b. Variable contribution to a fund by the employer to assure given benefit to the employees.

The fixed contribution plans involves a defined cost per employee and can be readily assigned to cost centres or objects. The contribution under variable contribution plans are generally determined on an actuarial valuation The treatment of such benefits in Cost Accounts will be on the same basis as in financial accounts which is governed by AS-15 in India.

The allocation of the cost of such employee benefits to cost centres / Cost objects will be on the basis of no. of employees or employee cost.

Provision for gratuity, leave encashment, superannuation, termination benefit, medical benefits and the like are provided in the accounts as per AS-15 and these will form part of employee cost. The allocation of the cost of above employee benefits to cost centre / cost object shall be on the basis of number of employees or employee cost.

Employee Rate per Hour

The measure of cost to keep an employee at work an hour or a day must include all of these elements where they exist. Hourly rates are to be calculated using the available hours as the denominator. Normal health breaks or rest allowances are excluded from available hours.

In brief Employee cost includes remuneration paid or payable and provisions made for future payments. However the following payments to employees will not form part of employee cost.

As per CAS-7.4.7, the employee cost will not include the compensation paid to employees for the past period on account of any dispute / court orders for the reason that there is no contribution by the concerned employee to the production activity of the entity during the current period. Such payments for past period are items of reconciliation between cost and financial accounts.

Similarly as per explanation 3 of CAS-7.4.7, under provisions of prior period made up in current period shall not form part of employee cost in the current period and will be an item of reconciliation between cost and financial accounts.

Employee cost does not include workers hired through contractor or agents as they are not on the roll of the entity and payments are made to the contractor and not to such workers.

5.2 ***Bonus whether payable as a Statutory Minimum or on a sharing of surplus shall be treated as part of employee cost. Ex gratia payable in lieu of or in addition to Bonus shall also be treated as part of the employee cost.***

Remuneration packages often include profit sharing or production bonus plans subject to fulfilment of certain pre-conditions. Payments under this head are:

a) Statutory minimum bonus / sharing in surplus profit. The Payment of Bonus Act, 1965 deals with profit sharing bonus. It represents an additional payment.

b) Productivity linked or other efficiency related bonus including bonus payment based on agreement with trade unions (not linked to profits)

c) Incentives: quality incentive, merit incentive, service loyalty incentive, and the like. An incentive is a monetary inducement for better performance in addition to regular and overtime wages. It is an extra pay for extra performance. Scheme of incentives varies from entity to entity. However incentive payments made to employees form part of employee cost.

   Bonus under the Payment of Bonus Act must be distinguished from performance incentives which are generally related to output and not profits. These may take the form of incentives at

   - Individual employee level – based on his or her performance.
   - Group of employees level – based on performance of a group of employees or team
   - Unit level – where the incentives are paid on the basis of performance of the factory or other unit.

   In some cases, incentives are paid to production employees based on sales as cost of production. Such incentive payment either computed on sales value of production or payable only on sales of the product shall form part of the employee cost if such payment was originally conceived as an incentive for higher production.

Any payment of bonus either as a Statutory Minimum or on a sharing of surplus / incentive shall form part of the employee cost. The bonus paid to employees shall be identified with each cost centre / department. For determining labour hour rate, bonus shall be estimated on the basis of past results and future forecast.

5.3 ***Remuneration payable to Managerial Personnel including Executive Directors on the Board and other officers of a corporate body under a statute will be considered as part of the Employee Cost of the year under reference whether the whole or part of the remuneration is computed as a percentage of profits.***

Remuneration to officers, managers and executive director of a corporate body paid as a fixed amount or paid whole or part of the remuneration as percentage of profits will be treated as employee cost. Remuneration covers fixed salary, PF contribution, leave, superannuation and severance payment, and other benefits, besides commission, etc. Other benefits include free furnished residential accommodation or house rent allowance, leave travel concession, reimbursement of medical expenses for self and family, personal accident insurance, fully maintained company's car with driver, gardener, watchmen, electricity.

Remuneration paid to managerial personnel will be identified as production, administrative or selling overhead on the basis of services provided by them. However remuneration paid to non-executive directors will be treated as Administrative Overheads.

Salary paid to an owner in the case of sole proprietorships, and fixed salary paid to a working partner in the case of a partnership shall be treated as cost to be identified as production, administrative or selling overhead on the basis of services provided by them.

5.4 ***Separation costs related to voluntary retirement, retrenchment, termination etc. shall be amortized over the period benefitting from such costs.***

These benefits are amortized over the period benefitting from such additional cost resulting in reduction of current employee cost. Lump sum payment under the above scheme shall be amortized normally over 5 years and will form part of employee cost.

The accounting for the unamortised is an issue, since there is no Costing Balance Sheet available for carrying forward the amount in the future periods. Memoranda account shall be maintained for the purpose.

5.5 ***Employee cost shall not include imputed costs.***

In economics, 'imputed' indicates an ascribed or estimated value when there is no criteria of absolute monetary value for such purpose. In simple words, it is a cost which does not involve at any time any outright expenses or cash outlay. As such it does not appear in the financial books. In farming operations, the wages or salaries of owner are imputed. Imputed costs are similar to opportunity costs.

Imputed cost of an employee shall not form part of the employee cost as there is no cash payment and it is being used for the purpose of decision making.

5.6 ***Cost of Idle time is ascertained by the idle hours multiplied by the hourly rate applicable to the idle employee or a group of employees.***

Idle time happens due to various causes for which an employee is not responsible but full payment may be required to be made. Idle time may arise due to:

Time lost between gate and place of work, break for tea, personal needs, time interval between one job and another, time for tool setting, adjustment of machine, and the like is treated as normal idle time. Normal idle time is built in the labour hour rate and forms part of the cost object. It is to be measured on the basis of the hourly rates of individual employee or at an average rate for closely associated group of employees or some statistical basis such as factor hours Use of individual pay rates is the most accurate but requires more clerical effort.

In addition to above, there is loss of time due to breakdown of machinery, power failures, non-availability of material, lock out, atmosphere conditions, flood etc. It is abnormal idle time lost and is not part of the cost object. However, it shall be analysed cause wise as per Annexure III for corrective action, if any. Payment for such abnormal idle time is not included in costs and is charged to Costing Profit and Loss account.

5.7 ***Where Employee cost is accounted at standard cost, variances due to normal reasons related to Employee cost shall be treated as part of Employee cost. Variances due to abnormal reasons shall be treated as part of abnormal cost.***

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 for deviation is placed. 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.

When standard costing system is in vogue, there can be employee cost variance, besides material cost and other variances relating to usage of resources during the course of production. Variance is the difference between an actual amount and a target or planned amount. Variances may be due to normal or abnormal reasons. Variances due to normal reasons shall be treated as cost while the variances due to abnormal reasons are treated outside the cost of production. Direct employee cost standard consists of two phases:

1) Fixation of employee time (i.e. quantity); and

2) Setting of the employee wage rate standards for each product manufactured.

The standard time for each operation multiplied by the standard employee wage rate gives the standard employee cost for the operation. Employee time standards may be set up in any of three ways:

a. Using past records of performance

b. Time and motion study

c. Taking trial runs.

Employee rate standard

The operations to be performed; the grades of employee required to perform the various operations and the rates of pay expected to be paid to the employee is taken into consideration for fixation of employee rate standards. In case of piece work system of payment, the setting of rate standard is simple because the piece rate fixed itself form the standard rate. In case of day work system, an hourly rate of pay is fixed for each grade of employee with reference to the standard employee rate.

Direct employee cost variance is the difference between standard direct employee cost specified for the activity achieved and the actual direct employee wages paid.

Examples of employee cost variance are at ***Annexure IV***.

5.8 ***Any Subsidy, Grant, Incentive or any such payment received or receivable with respect to any Employee cost shall be reduced for ascertainment of cost of the cost object to which such amounts are related.***

Subsidy, grant or incentives are provided for specific purpose. For example, generation of employment in specified areas, subsidy, grant or incentives are given by government to attract setting up units in those areas. Any subsidy, grant received / receivable relating to employee cost shall be reduced from the employee cost.

5.9 ***Any abnormal cost where it is material and quantifiable shall not form part of the Employee cost.***

Abnormal cost arises due to major breakdown of equipment for considerable period, non-availability of raw materials, lack of business, faulty supervision, abnormal process loss, strike, or lock-outs, fire, flood, storm, or other similar causes. Payment made to employees for time lost due to fire and natural calamities are abnormal employee cost.

It not considered in the cost of production and charged to Costing profit & loss account. It is the cost that is not normally associated with a level of activity in existing circumstances. It is to be excluded if it is material and quantifiable. The materiality has not been defined in the standard. It will depend upon situation to situation. The rationale of exclusion is that inclusion of such items in the cost will make the cost not comparable with a normal situation. It shall not form part of cost of the production as not to distort the cost due to abnormal reasons. It is dealt with in the costing profit and loss account.

5.10 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the Employee cost.***

Penalties / damages are levied by statutory authorities or third parties for failure to comply or for late compliance with statutory / contractual requirements, such as non-payment of PF contribution in time, non-compliance with any labour legislation, and the like. Since penalties / damages are abnormal items of expense, it will not form part of the employee cost and will be an item of reconciliation with financial accounts.

5.11 ***The cost of free housing, free conveyance and any other similar benefits provided to an employee shall be determined at the total cost of all resources consumed in providing such benefits.***

Free housing accommodation is provided to certain staff. Accommodation may be on lease or owned by the entity total expenses incurred for maintenance, repairs , depreciation, lease rent paid and any other related cost of housing is be assessed and form part of employee cost.

The above treatment is also applicable for free conveyance provided which may be leased or owned. For leased vehicle hire charges and for owned vehicles, related expenses such as petrol / diesel, maintenance and repair, depreciation of vehicles will form part of free conveyance provided to the employees.

5.12 ***Any recovery from the employee towards any benefit provided e.g. housing shall be reduced from the employee cost.***

Amount recovered from employee towards housing, supply of electricity, water, or for any other subsidized benefits such as canteen facility and the like shall be adjusted against the relevant cost of the benefit. Net cost of benefits provided will form part of the employee cost.

5.13 ***Any change in the cost accounting principles applied for the determination of the cost should be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.***

Principles applied for determining the employee cost should be followed consistently. For example profit sharing bonus paid to employees was required to be separately disclosed in the cost audit Proforma, after "Total cost of Sales" under previous Cost Audit Report Rules 1996.This principle was not followed under Companies (Cost Records and Audit) Rules, 2014 bonus is now part of the employee cost and no separate disclosure is required. Thus change in cost accounting principle / law for determining the cost can be made when required by any law as illustrated above or for compliance with cost accounting standards or it results in appropriate presentation of cost statement.

Assignment of Cost

6.1 ***Where the Employee services are traceable to a cost object, such employees' cost shall be assigned to the cost object on the basis such as time consumed or number of employees engaged etc. or similar identifiable measure.***

Documents commonly used for assignment of employee cost are the "**time card**" and the "**Employee job ticket**".

A time card (clock card) is inserted in a time clock by the employee several times each day: upon arrival, going to lunch, taking a break, and when leaving for the day. By mechanically / biometrically keeping a record of total hours worked each day by employees, this procedure provides a reliable source for computing and recording total payroll costs by employee wise and cost centre wise.

Depending upon process of production, employee job tickets are prepared daily by employees for each job worked on. Employee job tickets indicate the number of hours worked, a description of the work performed, and the employee's wage rate (inserted by the payroll department). The sum of the employee cost and hours for different jobs (as shown on employee job tickets) should be equal to the total employee cost and employee hours for the period (as shown on time cards).

Time booked as Job tickets when multiplied by employee hour rate indicate the cost against jobs or production order or standing order Number as the case may be. (Standing order number is the sub-division of overhead cost for purpose of accounting and control). Valuation of the time tickets is done on the basis of the current hourly rates when a group or a number of employees work interchangeably on similar operations. In this method, an average hourly wage rate of all such workers or of the group is computed and hours in the time tickets are valued with this rate without reference to the hourly rate of the particular workers who actually perform the work.

Another method which is applicable where a worker runs several automatic machines is known as the Factor Hours Method. Each machine is known as a factor and the hours for which is referred to as factor hours. Under this method, a standard factor hour cost worked as under:

Worker's wage rate	**₹ 300 per day**
Working hours per day	8
Machine or factors handled	3
Factor hours per day (3 x8)	24
Standard cost rate per factor hour	300/24 = ₹ 12.5

In brief, for job costing, time records are arranged according to production, job order or standing order no. Thus Information from time tickets, time sheets and daily production records are used as a basis for distributing the payroll cost to products, processes or to indirect labour accounts.

In process industry, there is no job card system, as employees are identified with each process and their employee cost is assigned accordingly.

It is usual for employee cost, particularly direct employee cost, to be converted to hourly rates for ease of assignment to jobs or products. Such hourly rate may reflect only payroll costs i.e., only basic + dearness allowance + allowances or be comprehensive and include all benefits. The ultimate objective is to reflect the Cost to Company (CTC). Where the rate excludes some elements of employee cost, these will be treated as overheads and absorbed in cost.

Where direct workmen are expected to carry out maintenance on the machines attended by them, it is usual to log such time separately against maintenance work orders and treat the same as Repairs and Maintenance Cost.

6.2 *While determining whether a particular Employee cost is chargeable to a separate cost object, the principle of materiality shall be adhered to.*

CAS 7 provides that the principle of materiality shall be kept in view while assigning a particular cost to a separate cost object. Materiality and significance of a piece of information depends on nature, size of operation and the like. For example Employee Cost for generation of solar power is not significant in terms of product cost and forms part of overhead, but for subsidy requirement, it may be indicated separately.

6.3 *Where the Employee costs are not directly traceable to the cost object, these may be assigned on suitable basis like estimates of time based on time study.*

Some employees work in such a manner that it is not possible to identify them with any cost centre or department. Their employee cost is to be assigned on technical estimates, such as factor hours for machine operator attending to more than one machine/ work study and the like.

For example:

In bulk drug industry workers attend to different equipments in a sequence. Degree of attention devoted to different process equipment varies and is therefore not in constant ratio to equipment hours. For this purpose some weights are pre-determined for different equipment. Allocations of employee cost are made on the basis of equipment hours after adjustments are made with such predetermined weights.

Another example is of group benefits extended to employees such as Group Personal Accident Insurance, Group Medical Insurance Scheme etc. It is difficult to relate these costs to individual employees and therefore to cost centres or objects. These can only be allocated to cost centres or cost objects on the basis of no. of employees or employee cost of each cost centre or cost object.

6.4 *The amortised separation costs related to voluntary retirement, retrenchment, and termination etc. for the period shall be treated as indirect cost and assigned to the cost objects in an appropriate manner. However unamortised amount related to discontinued operations, shall not be treated as cost.*

Voluntary retirement, retrenchment and termination cost are to be incurred, resulting in reduction in labour force and consequential reduced current employee cost. However this separation cost benefit is to accrue in future. It is therefore desirable that such payments shall be pro-rated over the years to be benefited by such payment, amortize the separation cost over a period, say five years, to cost objects on suitable basis, such as, direct employee hours or direct employee cost. However, unamortized separation cost shall not be amortized over the remaining period, if the relevant production operation has been discontinued. For example in a textile mill Dyeing activity has been discontinued after one year of the voluntary retirement scheme. Thus portion of unamortized separation cost relating to Dye activity is to be charged to Costing Profit and Loss account and will not be amortized for the balance period.

6.5 *Recruitment costs, training cost and other such costs shall be treated as overheads and dealt with accordingly.*

For recruiting employee, various activities are to be carried out such as:

(i) Pre-recruitment –

  (a) job specification; and

  (b) briefing personnel department setting up recruitment process search;

(ii) Advertising

(iii) Candidates evaluation

(iv) Interviewing, including travel and substance

(v) Placement agency cost

(vi) Induction training /orientation programme etc.

Cost incurred in regard to above activities is to be treated as overhead and assigned to the cost object on appropriate basis, such as number of employee recruited department wise.

6.6 *Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime.*

Overtime premium is the time spent beyond the normal working hours which is usually paid at a higher rate than the normal time rate.

The overtime premium is to be assigned in one of the following ways:

- Where the overtime working is caused by a “rush order” of the customer or other special requirement of a job, the overtime premium is assigned to the job or product.

- In all other cases, it is usual to treat the overtime premium as overheads and absorb the same as part of overheads.

6.7 Idle time cost shall be assigned direct to the cost object or treated as overheads depending on the economic feasibility and the specific circumstances causing such idle time.

The Idle time is the difference between the time for which the employees are paid and the employees' time booked against the cost object.

Idle time for reasons such as lunchtime, holidays, personal needs etc. are built in the cost per hour of an employee and it is a part of the employee cost for an object.

Idle time cost (other than stated above) should be recorded as separate time on time ticket and standing code numbers established for this purpose.

Idle time is to be assigned to the cost object to the extent economically feasible. In other cases it may be treated as overhead.

Presentation

7.1 ***Direct employee costs shall be presented as a separate cost head in the cost statement.***

Direct employees are those who work on a product directly, either manually or by using machines. They are directly involved in the production of a finished product, that can be easily traced to the product Examples are assembly-line workers in an automobile factory or employee working on spindle / loom in textile industry. Direct Employee cost is to be presented as a separate item in the cost statement.

7.2 ***Indirect employee costs shall be presented in cost statements as a part of overheads relating to respective functions e.g. manufacturing, administration, marketing etc.***

Indirect employee cost is not directly traceable to a cost object / product and forms part of overheads. The word 'overheads' is used for a type of cost that cannot be directly allocated to a cost object or product, but can be assigned to cost objects.

Employees whose services are indirectly related to production include product designers, job supervisors, foreman, product inspectors, and the like. Employee cost of such employees is considered part of Production overheads. Salaries of employees working on administrative activities such as administration, personnel, accounts, and the like are classified as part of administrative overheads. Similarly, salaries of employees engaged in marketing / selling activities and distribution activities are part of Selling and Distribution Overheads.

7.3 ***The cost statement shall furnish the resources consumed on account of Employee cost, category wise such as wages salaries to permanent, temporary, part time and contract employees, piece rate payments, overtime payments, employee benefits (category wise)etc wherever such items form a material part of the total employee cost.***

Direct employee cost is to be exhibited as a separate item in the cost statement as per CAS 7.

Disclosures

The following information should be disclosed in the cost statements dealing with determination of employee cost.

8.1 ***The cost statements shall disclose the following:***

1. ***Employees cost attributable to capital works or jobs in the nature of deferred revenue expenditure indicating the method followed in determining the cost of such capital work. The concept of deferred revenue expenditure will be obsolete as per new accounting standard.***

2. ***Separation costs payable to employees.***

3. ***Any abnormal cost excluded from employee cost.***
4. ***Penalties and damages paid etc excluded from Employee cost.***
5. ***Any Subsidy, Grant, Incentive and any such payment reduced from Employee cost.***
6. ***The Employee cost paid to related parties. Related Party should be defined in the guidance note for appropriate disclosure***
7. ***Employee cost incurred in foreign exchange.***

The above paragraph requires following disclosures to be made:

If an entity undertakes any capital works or job internally, the cost of such jobs is to be capitalized. It includes material consumed, employee cost and overhead. Employee cost attributable to such jobs is to be capitalized and will not form part of cost of production.

For example:

During the current year, modernization of assembly line was carried out departmentally amounting to ₹ 50 lakhs, out of which ₹ 2 lakhs is for employee cost.

Separation costs paid / payable during the period is to be disclosed indicating the basis adopted for charging off the cost. As detailed under paragraph 6.4, amortized separation cost is to be treated as indirect cost and will form part of the overhead cost. A disclosure shall be made about the amount amortised during the period and remaining unamortized amount indicating the period to be written off.

For example:

Under the Employee Separation Scheme of the Company, the net present value of the future liability for pension payable is amortized equally over five years. The increase in the net present value of the future liability for pension payable to employees who have opted for retirement under Employees Separation Scheme of the company is charged to the profit account. During the current year amount charged to Profit & Loss account is ₹ 15 lakhs.

Abnormal cost has been dealt with in paragraph. If there is abnormal cost relating to employee during period of cost statement, the same is to be disclosed.

For example:

Due to major breakdown in the plant, abnormal idle employee cost of ₹ 4 lakhs has been excluded from the cost of production.

Disclosure of Penalties and damages paid etc excluded from employee cost is to be disclosed in the cost statement.

For example:

Penalty of ₹ 50,000/- has been levied for delayed deposit of PF contribution with the concerned authority and the same has been excluded from the employee cost.

Any subsidy / grant / incentive and any such payment is to be reduced from the employee cost.

For example:

The State Government has given grant for training locally employed man power of ₹ 3 lakhs. The same has been excluded from the employee cost.

Disclosure is to be made for employee cost paid to related parties. The related parties have been defined under various Acts viz. Companies Act, 2013, Central Excise Act 1944, Income Tax Act 1961. If any employee cost is paid to related parties, its relationship, nature of transaction viz. amount and other terms / conditions relating to employee cost are to be disclosed. The objective of disclosure is to ascertain that the transaction is at arm's length and on purely commercial terms.

For example:

A is holding company of B Company. Employees of B Company attended training programme conducted by A Company. Share of training cost paid to A is ₹ 1 lakh.

Employee cost incurred in foreign exchange: Any paid in foreign exchange relating to employee cost is to be disclosed in foreign currency.

For example:

A sum of US$ 500000/- has been paid as salary to staff posted in USA branch.

8.2 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Employee Cost during the period covered by the cost statement which has a material effect on the Employee Cost. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

The cost accounting principles and methods applied for the measurement and assignment of employee cost is to be followed consistently from one period to subsequent period and applied uniformly for different products and divisions. If there is any change in the cost accounting principles and methods during the period resulting in material effect on the cost, the same shall be disclosed indicating its impact in the cost statement.

For example:

Indirect employee cost was being assigned on the basis of direct labour hours to the products. During the year, the indirect employee cost has been identified by activity wise and assigned to the product on the basis of relevant activity drivers. Material handling employee cost has been assigned on the basis of material handled for each product.

8.3 ***Disclosures shall be made only where material, significant and quantifiable.***

Standard provides that disclosure shall be made only where it is material significant and quantifiable. The materiality and significance of a piece of information depends on nature, size and complexity of operation. An item of employee cost of a product may have significance considering the nature of the product. For example, an employee working on critical operation at special machine is to be indicated in the cost statement as per contract agreement, it is to be disclosed to ensure compliance with the terms of contract.

In the context of cost statement, Materiality is to be judged in terms of quantity and nature of employee cost and in particular context of its omission. A piece of information is material, if its non-disclosure could influence the decision of the user.

For example:

Prior period employee cost amounting to ₹ 1.56 lakh has been excluded.

8.4 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

Disclosures may be made in the body of the cost statement or as a foot note. If there are many items of disclosures, the same may be in schedule of Notes to the cost statement.

Example of Employee cost resource wise	**₹ / Lakhs**
Direct employee cost (Time basis)	125
Piece Rate Wages	12

Annexure I

Illustration of Pay Slip

Personnel	Attendance	Monthly rate	Earning	Deductions
Department Code	Total working days	Basic	Basic	Provident Fund
Employee Number	No. of days present	Dearness allowance	Dearness allowance	E.S.I.
Employee Name	Weekly off	House rent allowance	House rent allowance	L.I.C.
Father's Name	Holidays	Transport Allowance	Transport Allowance	Income tax
Grade	Casual Leave	Wash Allowance	Wash Allowance	House rent
Bank Account Number	Earned leave / PL	Medical Allowance	Medical Allowance	Provident Fund Loan
PF Number	Medical Leave	Special Site allowance	Special Site allowance	Others
FPS Number	Special leave	Education allowance	Education allowance	Total Deductions
ESI Number	Absent			
Date of birth	Late deduction	Gross earning	Gross earning	
Date of joining	Pay days			

Annexure II

XYZ COMPANY

STATEMENT SHOWING EMPLOYEE EARNINGS

PERIOD FROM 01/04/20XX TO 30/04/20XX

DEPTT.	HAND	BASIC	DA	PL BASIC	PL DA	S.S. ALLOW	CONV	HRA	SPL. ALL	WASH. ALL.	OTHER	CASH CMP.	INCENTIVE	GWR	SHIFT-ALL	DUTY_ ALL.	MED ALL.	SPL_ PAY	SPL_ HRA	R. OFF	GROSS EARNING
2101	12	63600	38600	0	0	3500	10300	9500	0	500	0	3500	7400	9300	1400	0	1550	0	0	24	149174
2111	15	66000	41000	0	0	3800	11000	10000	0	520	0	7100	7600	15000	1800	0	1400	0	0	30	165250
2125	12	64200	38000	0	0	3500	11000	9700	0	500	0	4850	7150	18200	1600	0	1700	0	0	30	160430
2155	31	160520	98250	0	0	8900	26500	24400	0	1250	0	18700	14500	30300	4000	0	4200	0	0	90	391610
2260	28	149400	88600	0	0	8050	23700	22800	0	1100	500	13500	13700	32500	3650	0	4200	0	0	60	361760
6505	20	107200	63900	0	0	5800	17900	16200	0	800	0	11200	12500	49700	2500	0	2500	0	0	50	290250
TOTAL	**118**	**610920**	**368350**	**0**	**0**	**33550**	**100400**	**92600**	**0**	**4670**	**500**	**58850**	**62850**	**155000**	**14950**	**0**	**15550**	**0**	**0**	**284**	**1518474**

GROSS EARNING OF THE EMPLOYEEs COST CENTER WISE ARE IN THE ABOVE STATEMENT.

SIMILAR STATEMENT OF DEDUCTIONS FROM EMPLOYEE COST CENTRE WISE IS ALSO PREPARED.

Annexure III

Analysis of Idle time									
Department		**Idle time due to**							
	Total	**Productive**		**Maintenance**		**No material**		**Transport**	
	DLH	**DLH**	**%**	**DLH**	**%**	**DLH**	**%**	**DLH**	**%**
A	1000	800	80	150	15			50	5
B	1900	1710	90			85	4.5	105	5.5
C	850	765	90	45	5			40	4.7
D	300	255	85	15	5	15	5	15	5
DLH = Direct labour hour									
Maintenance = waiting for maintenance									
No Material = waiting for material									
Transport = Waiting for transport									

Annexure IV

Examples of employee cost variance (rate, efficiency and mix): Standard and actual employee cost for a period is as under:-						
	Standard Cost			**Actual Cost**		
Item	**hours**	**Rate per hr**	**Total**	**Hours**	**Rate per hr**	**Total**
Hours produced	**2000**	**40**	**80000**	**2800**	**28.00**	**78400**
Direct employee cost Variance	(Actual hrs x actual rate) – (standard hrs x standard rate)					

Variances calculation:		
Direct Employee cost variance: (Actual hrs x actual rate) – (standard hrs x standard rate) = (2800x 28) –(2000x 40)	₹ 1600	Favourable
Employee Rate Variance: Actual hours (Standard rate –Actual rate) 2800 x (40 -28)	₹ 33600	Favourable
Employee Efficiency Variance Standard rate x(Standard hours – Actual hours) 40 x (2000 – 2800)	₹ 32000	Adverse
Total employee Variance: (Employee Rate variance – Efficiency Variance) (₹ 33600 Favourable – ₹ 32000 Adverse)	₹ 1600	Favourable
Employee Mix Variance: The variance arises due to change in the composition of labour force.		

Standard Gang	Actual Gang worked
2 men @ ₹ 20 per hour 5 men @ ₹ 16 per hour 1 men @ ₹ 25 per hour	4 men @ ₹ 20 per hour 2 men @ ₹ 16 per hour 2 men @ ₹ 25 per hour
Standard cost per hour = (2 x ₹ 20 + 5 x ₹ 16+ 1 x ₹ 25) = ₹ 145 per hour	Actual cost per hour = (4 x ₹ 20 + 2 x ₹ 16 +2 x ₹ 25)= ₹ 162 per hr
Hours worked 48 hrs Standard employee cost 48 X ₹ 145 = ₹ 6960	Hours worked 48 hrs Actual employee cost 48 x ₹ 162 = ₹ 7776
Mix variance = Standard mix cost – actual mix cost ₹ 6960 – ₹ 7776 = ₹ 816 Adverse Variance	

Employee (wage) rate variance:

This is the portion of the wage variance which is due to the difference between the actual wage rate paid and the standard rate of pay specified.

Reasons for wage rate variances are:

a) Change in basic wage structure or change in piece rate

b) Engagement of workers of grades and rates of pay different from those specified due to shortage of labour of the proper category

c) Payment of guaranteed wages to works that are unable to earn their normal wages, if such guaranteed wages form part of direct labour cost.

d) Overtime and night shift work in excess of or less than the standard

e) Composition of a gang as regards the skill and rates of wages being different from that laid down in the standard.

Wage rate variance are uncontrollable except for the portion which arises due to deployment of wrong grade of employee or overtime work and such other controllable factors for which the departmental executive may be held responsible.

Employee Efficiency variance: It is the portion of the direct wages variances which is due to the difference between the standard employee hours specified and the actual employee hours expended. The employee efficiency variance is the result of taking more or less time than the standard for the performance of an operation or process

Reasons for variance are:

(a) Lack of proper supervision

(b) Poor working conditions

(c) Delays due to waiting for materials, tools, instructions etc if not treated as idle time.

(d) Defective machines, tools and other equipment

(e) Work on new machines requiring less time than provided.

(f) Basic inefficiency of works due to low morale, insufficient training, faulty instructions etc.

(g) Use of non-standard material requiring more or less operation time.

Variances are to be analyzed. Normal variances will form part of the employee cost and abnormal variance will not form part of the employee cost.

For example: Abnormal employee cost variance may be due to slow down tactics or waiting for material or breakdown of machinery.

Annexure V

CAS – 7

COST ACCOUNTING STANDARD ON EMPLOYEE COST

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 "EMPLOYEE COST". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material, which has been set in normal type.

1 Introduction

1.1 This standard deals with the principles and methods of determining the Employee cost.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of Employee cost, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.***

2 Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Employee cost with reasonable accuracy.

3 Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Employee cost including those requiring attestation.

4 Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.[1]

4.2 Abnormal Idle time*: An unusual or atypical employee idle time occurrence of which is usually irregular and unexpected or due to some abnormal situations.*

E.g.: Idle time due to a strike, lockout or an accident

4.3 Administrative overheads: ***Expenses in the nature of indirect costs, incurred for general management of an organization[2].***

4.4 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are finally ascertained.***

4.5 Distribution Overheads: ***Distribution overheads, also known as Distribution Cost, are the costs incurred in handling a product from the time it is ready for despatch until it reaches the ultimate consumer.***[3]

The cost of any non manufacturing operations such as packing, repacking, labelling, etc. at an intermediate storage location will be part of distribution cost.

4.6 Direct Employee Cost: ***The cost of employees which can be attributed to a Cost Object in an economically feasible way.***[4]

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1 Adapted from CAS 1 paragraph 6.5.19
2 Adapted from CAS 1 paragraph 6.3.5
3 Adapted from CAS 1 paragraph 6.3.9
4 Adapted from CAS 1 paragraph 6.2.4 (Direct labor cost)

4.7 Employee cost: ***The aggregate of all kinds of consideration paid, payable and provisions made for future payments for the services rendered by employees of an enterprise (including temporary, part time and contract employees). Consideration includes wages, salary, contractual payments and benefits, as applicable or any payment made on behalf of employee. This is also known as Labour Cost.***[5]

Explanation:

1 Contract employees include employees directly engaged by the employer on contract basis but does not include employees of any contractor engaged in the organisation.

2 Compensation paid to employees for the past period on account of any dispute / court orders shall not form part of Employee Cost.

3 Short provisions of prior period made up in current period shall not form part of the employee cost in the current period.

Employee cost includes payment made in cash or kind.

For example:

- **Employee cost**
  - Salaries, wages, allowances and bonus / incentives.
  - Contribution to provident and other funds.
  - Employee welfare
  - Other benefits
- **Employee cost – Future benefits**
  - Gratuity.
  - Leave encashment.
  - Other retirement/separation benefits.
  - VRS/ other deferred Employee cost.
  - Other future benefits

  Benefits generally include
  - Paid holidays.
  - Leave with pay.
  - Statutory provisions for insurance against accident or health scheme.
  - Statutory provisions for workman's compensation.
  - Medical benefits to the Employees and dependents.
  - Free or subsidised food.
  - Free or subsidised housing.
  - Free or subsidised education to children.
  - Free or subsidised canteen, crèches and recreational facilities.
  - Free or subsidised conveyance.
  - Leave travel concession.
  - Any other free or subsidised facility.
  - Cost of Employees' stock option.

5 Adapted from CAS 1 paragraph 6.1.4

4.8 Idle time: ***The difference between the time for which the employees are paid and the employees' time booked against the cost object.***

The time for which the employees are paid includes holidays, paid leave and other allowable time offs such as lunch, tea breaks.

4.9 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[6]

4.10 Indirect Employee Cost: ***The cost which cannot be directly attributed to a particular cost object.***[7]

4.11 Marketing overheads: ***Marketing Overheads are also known as Selling and Distribution Overheads.***

4.12 Overtime Premium: ***Overtime is the time spent beyond the normal working hours which is usually paid at a higher rate than the normal time rate. The extra amount beyond the normal wages and salaries paid is called overtime premium.***

4.13 Production Overheads: ***Indirect costs involved in the production process or in rendering service.***[8]

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

4.14 Selling Overheads: ***Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***[9]

4.15 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

5 Principles of Measurement

5.1 Employee Cost shall be ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all the benefits.

5.2 Bonus whether payable as a Statutory Minimum or on a sharing of surplus shall be treated as part of employee cost. Ex gratia payable in lieu of or in addition to Bonus shall also be treated as part of the employee cost.

5.3 Remuneration payable to Managerial Personnel including Executive Directors on the Board and other officers of a corporate body under a statute will be considered as part of the Employee Cost of the year under reference whether the whole or part of the remuneration is computed as a percentage of profits.

Explanation: Remuneration paid to non executive directors shall not form part of Employee Cost but shall form part of Administrative Overheads.

5.4 ***Separation costs related to voluntary retirement, retrenchment, termination etc. shall be amortised over the period benefitting from such costs.***

5.5 ***Employee cost shall not include imputed costs.***

5.6 ***Cost of Idle time is ascertained by the idle hours multiplied by the hourly rate applicable to the idle employee or a group of employees.***

5.7 ***Where Employee cost is accounted at standard cost, variances due to normal reasons related to Employee cost shall be treated as part of Employee cost. Variances due to abnormal reasons shall be treated as part of abnormal cost.***

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6 Adapted from CAS 1 paragraph 6.5.13

7 Adapted from CAS 1 paragraph 6.2.10

8 Adapted from CAS 1 paragraph 6.3.3

9 Adapted from CAS 1 paragraph 6.3.7

5.8 ***Any Subsidy, Grant, Incentive or any such payment received or receivable with respect to any Employee cost shall be reduced for ascertainment of cost of the cost object to which such amounts are related.***

5.9 Any ***abnormal cost where it is material and quantifiable shall not form part of the Employee cost.***

5.10 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the Employee cost.***

5.11 ***The cost of free housing, free conveyance and any other similar benefits provided to an employee shall be determined at the total cost of all resources consumed in providing such benefits.***

5.12 ***Any recovery from the employee towards any benefit provided e.g. housing shall be reduced from the employee cost.***

5.13 ***Any change in the cost accounting principles applied for the determination of the Employee cost should be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.***

6 Assignment of costs

6.1 ***Where the Employee services are traceable to a cost object, such Employees' cost shall be assigned to the cost object on the basis such as time consumed or number of employees engaged etc or similar identifiable measure.***

6.2 ***While determining whether a particular Employee cost is chargeable to a separate cost object, the principle of materiality shall be adhered to.***

6.3 ***Where the Employee costs are not directly traceable to the cost object, these may be assigned on suitable basis like estimates of time based on time study.***

6.4 ***The amortised separation costs related to voluntary retirement, retrenchment, and termination etc. for the period shall be treated as indirect cost and assigned to the cost objects in an appropriate manner. However unamortised amount related to discontinued operations, shall not be treated as employee cost.***

6.5 ***Recruitment costs, training cost and other such costs shall be treated as overheads and dealt with accordingly.***

6.6 ***Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime.***

6.7 ***Idle time cost shall be assigned direct to the cost object or treated as overheads depending on the economic feasibility and the specific circumstances causing such idle time.***

Cost of idle time for reasons anticipated like normal lunchtime, holidays etc is normally loaded in the Employee cost while arriving at the cost per hour of an Employee/a group of Employees whose time is attributed direct to cost objects.

7 Presentation

7.1 ***Direct Employee costs shall be presented as a separate cost head in the cost statement.***

7.2 ***Indirect Employee costs shall be presented in cost statements as a part of overheads relating to respective functions e.g. manufacturing, administration, marketing etc.***

7.3 ***The cost statement shall furnish the resources consumed on account of Employee cost, category wise such as wages salaries to permanent, temporary, part time and contract employees piece rate payments, overtime payments, Employee benefits (category wise)etc wherever such items form a material part of the total Employee cost.***

8 Disclosures

8.1 ***The cost statements shall disclose the following:***

1. ***Employee cost attributable to capital works or jobs in the nature of deferred revenue expenditure indicating the method followed in determining the cost of such capital work.***
2. ***Separation costs payable to employees.***
3. ***Any abnormal cost excluded from Employee cost.***
4. ***Penalties and damages paid etc excluded from Employee cost.***
5. ***Any Subsidy, Grant, Incentive and any such payment reduced from Employee cost***
6. ***The Employee cost paid to related parties[10].***
7. ***Employee cost incurred in foreign exchange.***

8.2 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Employee Cost during the period covered by the cost statement which has a material effect on the Employee Cost. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

8.3 ***Disclosures shall be made only where material, significant and quantifiable.***

8.4 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

10 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

2.5 GUIDANCE NOTE ON COST ACCOUNTING STANDARD ON COST OF UTILITIES (CAS-8)

The Council of the Institute of Cost Accountants of India has issued Cost Accounting Standard 8 (CAS-8) on Cost of Utilities which lays down a set of principles and methods of classification, measurement and assignment of Cost of Utilities for determination of the cost of product and presentation and disclosure of such costs in the cost statement.

The Guidance Note deals with practical aspects in connection with the determination of Cost of Utilities of a product. In this Guidance Note the Cost Accounting Standards have been set in **bold italic** type and reference number of the standard has been retained".

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 state that for the purposes of sub-section (1) of section 148 of the Act, the class of companies, including foreign companies defined in clause (42) of section 2 of the Act engaged in the production of the goods or providing services, specified in the Table below, having an overall turnover from all its products and services of rupees **thirty five crore or more** during the immediately preceding financial year, shall include cost records for such products or services in their books of account.

Rule 4(a) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (A) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **fifty crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **twenty five crore or more**.

Rule 4(b) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (B) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **one hundred crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **thirty five crore or more**.

Introduction

Production processes need several inputs other than raw material in the form of water, steam, electricity, and the like. These inputs are known as utilities. Utilities are classified according to the nature of utility, such as power, steam, water, compressed air and so on.

A distinction is to be made whether an input is a utility or production input. For example in case of manufacture of Caustic Soda, electricity is a principal input for electrolysis of brine. If there are multiple connections/source of supply of electricity and in production of Caustic soda one of the source is directly connected, it is to be treated as production input and not as utility. For other connection where utility power is distributed to one or more end users, it is to be treated as utility.

For example, one of the manufacturing processes requires heating. The heat can be generated and applied with help of steam or a stand alone thermic fluid heater attached to the process equipment. In such a case, if heat is applied to a given process with the help of stand-alone thermic fluid heater which is a part of process equipment and there is only single end user - this should be treated as a part of a process and not as a utility cost.

When different activities are required to be carried out on given input(s) to make it distributable and usable by one or more consuming sections, it should be recognized as a distinct utility.

Sub-set of a particular Utility:

A given utility may have more than one distinct utilities. For example supplier of electricity may be providing electricity at 11 KVA and thereafter it is converted to 460 V and given to different users. One of such user may employ step down process and bring the voltage level to 230 V. Depending upon the relevancy, the electricity in this case may be treated as two distinct utilities vz. 460 V(High Voltage) and 230 V (Low voltage) electricity, If there is variation in supply rate.

Sub-set of utility is also applicable for generating of steam. If steam is raised in a boiler at 48 Kg/cm^2 at 1800^{o}C temperature with 0% humidity (Superheated steam) given to certain process and in other boiler steam is raised at 18 Kg/cm^2 with 2% moisture at 1000^{o}C (saturated steam) which is given to different processes or to the same process and at different point of time, two different utilities shall be considered for steam viz High Pressure steam (48 Kg/cm^2) and Low Pressure steam (18 Kg/cm^2).

The above two examples highlight the importance of selection of appropriate sub sets of a given utility considering the special feature of a sub-set.

Sometimes an entity may have centralised utility or utility at department level. For example a manufacturing process may need some form of compressed air, whether for running a simple air tool or for more complicated tasks such as the operation of pneumatic control. Compressed Air Utility may be centralized services or it may be that individual air compression units are provided for each department depending upon the requirement. In case individual air compression units are provided it may be possible to merge the cost of operating the air compressor with the respective departmental expenses. But where centralized air compression and supply is made, a separate air compressed utility is to be accounted.

Classification of utility:

"Various types of utilities are used in manufacturing process as indicated in **Annexure-1**. These are classified according to the nature of utility, such as power, steam water, compressed air and the like".

Examples of cost measurement are:

- Use of historical cost;
- Use of actual or standard cost;
- Designation of items of cost which must be included or excluded from the utility cost.

Unit of Measurement of Utility:

Each utility has a different measurement unit considering its nature and cost is expressed in per unit of the related utility. Details of measurement of unit of different utility is given below:

Utility	Measure	Unit	Category
Power	Units per hr	KWH or MWH	H.T 440V L.T 220V
Steam- Low heat steam Super heat steam	Kg per tonne	KG/ Cm^2 at --- ^{o}C	Kg/sq.cm
Water – Chilled water Treated water Demineralised water	Volume	Ltrs/K.Ltrs	
Heating	Thermal unit	K cal or BTU	Output Temp 300 to 400Deg C
Air – Compressed air	Pressure Volume	M^3	Kg/sq.cm

Assignment is tracing the cost of utility to a product or service and dealt in Chapter 4.

The principles and methods adopted should be applied consistently from one period to another and for reasonable uniformity between different products/units. For example inputs of utility such as coal, furnace oil, etc are valued on the basis of FIFO (First-in-First out) method, the same should be followed consistently from one period to another and for different type of utility for valuing the inputs.

CAS-8 is applicable to the organization which is producing utilities for use in their manufacturing process. It is not applicable to the organizations which are primarily engaged in generation and sale of utilities. For example it is not applicable to organizations producing utilities, such as, NTPC, TATA power, NHPC etc.

As per Para 3.4 of CAS -8, the issues related to ascertainment and treatment of carbon credit are not covered under this standard.

Definitions

The following terms are used in this guidance note with the meaning specified:

Abnormal cost: ***An unusual or a typical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.***

Committed Cost: ***The cost of maintaining stand-by utilities shall be the committed cost.***

Cost Object: This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.

Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.***

Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***

Normal capacity: Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.

Standard Cost: A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.

Utilities: Significant inputs such as power, steam, water, compressed air and the like which are used for manufacturing process but do not form part of the final product.

Stand-by utilities: Any utility created to safeguard against the failure of the main source of inputs.

Principles of measurement

5.1 ***Each type of utility shall be treated as a distinct cost object.***

As each utility is a distinct cost object, cost of each utility is to be collected and measured separately. For example power, steam, water, compressed air, oxygen, nitrogen, coke oven gas and the like are distinct utilities, and the cost is collected and measured for each utility separately. The costs are booked to each utility through initial documents such as supplier 's bill, if directly identifiable with utility, payroll analysis sheet, stores requisition, etc. A separate cost statement is to be prepared for each utility.

5.2 ***Cost of utilities purchased shall be measured at cost of purchase including duties and taxes, transportation cost, insurance and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified with reasonable accuracy at the time of acquisition.***

There can be a mix source of supply for a given utility. For example, the entity may purchase electricity from electricity supplier and may also be receiving from its own stand-by facilities for generation of electricity.

For purchased power it will include all cost of purchase, maximum demand charges (which is payable irrespective of the actual power consumption), Load factor, local duties and other expenditure attributable to procurement. Credit is to be given for any discount, rebate, taxes and duties refundable.

The above treatment is also applicable to any other utility purchased, such as purchase of steam, coke oven gas from other unit, raw water from municipal sources and so on.

Cost of utility consists of direct employee cost, fuel, direct expenses, chemicals, stores and spares, repairs & maintenance, depreciation and inter utility transfer cost.

5.3.1 ***Cost of self generated utilities for own consumption shall comprise direct material cost, direct employee cost, direct expenses and factory overheads.***

The cost of generating a utility may comprise water, fuel, power, direct expenses (such as boiler inspection fee) consumable stores, direct employee cost, repair and maintenance, depreciation, inter–utility transfer and factory overhead.

For example:

Cost of power generation will include cost of fuel such as furnace oil, coal, salaries and wages, consumable stores, repair and maintenance, deprecation and factory overhead.

Unit cost is arrived at on the basis of the net aggregate consumption in different departments after adjusting transmission losses. In case of cogeneration (power and steam) where waste heat from TG (Turbine Generation) is recovered in waste heat recovery unit and used for production of steam, due credit should be given to the Power plant and corresponding charge to SGP(Steam Generation Plant).

Charging of power to the consuming cost object is generally done at the weighted average of the cost of power purchased , generated and distribution cost at the consuming point.

Steam: A separate statement of cost of steam is prepared indicating the quantity of steam generated, cost of fuel, soft water, power, employee cost for operating staff, sundry supplies, chemical additives, deprecation and other works overhead. Unit cost of steam is arrived at on the basis of units consumed in different departments after adjusting distribution loss.

Steam may be of high pressure, low pressure and medium pressure with multiple paths by which the steam pressure is reduced according to the purpose of use. Steam costs are highly dependent on the path that steam follows in the generation and distribution system.

Raw water: Raw water is either purchased or obtained from ground wells/canal. The cost of water mainly consists of share of cost of power allocated through inter-utility transfer. The total cost of water should include employee cost, fuel, power, repair and maintenance of tube wells, depreciation, overhead. The total monthly cost of operating this department is divided by the quantity of K Ltr of water pumped during the month to determine the unit cost of water pumped.

Cost of Soft Water: Water, if hard, requires treatment. The cost of soft water will include the cost of raw water, chemicals, cost of maintenance of settling tanks, employees cost, depreciation and the like.

The cost of demineralised water is also arrived at on the above basis.

Inter Utility transfer

There is inter–utility transfer cost for a utility. For example water utility may be used in generation of steam and power. Power may be required for pumping water from tubewell. Inter-utility cost is to be determined by the following method:

(a) repeated distribution method;

(b) matrix algebra through computer application

(a) When Repeated Distribution Method is adopted, the utility costs are repeatedly allocated in the specified percentage until the figures become too small to be significant. Steps to be followed under this method are:

   I. The proportion at which the cost of a utility is to be distributed to production cost centres and other utilities centre is determined based on usage.

   II. Cost of first utility is to be apportioned to production cost centres and other utilities in the proportion as determined in step (a) above.

   III. Similarly cost of other utilities is to be apportioned.

   IV. This process as stated above is to be continued till the figures remaining undistributed in the utility are too small to be significant. The small amount left with utilities may be distributed to the production cost centres.

(b) Matrix algebra through computer application: Spread sheet software such as Excel provides facility for inter-division cost ascertainment and reapportionment of inter utility. This application may be used for determining inter-utility transfer cost.

Quantitative records of production and distribution should be recorded for each utility to measure the unit cost of a utility.

An illustration of steam cost is at Annexure 2.

5.3.2 ***In case of Utilities generated for the purpose of inter unit transfers, the distribution cost incurred for such transfers shall be added to the cost of utilities determined as per paragraph 5.3.1.***

If utilities generated are transferred to inter units of an entity, the cost of distribution of such utilities will be included in the cost of utility as determined under para 5.3.1. It will comprise cost of generating utility and cost of distribution facility. Distribution may be through a pipe line/transmission line. The cost of maintenance of pipe line/ Transmission line for transfer of utility will be added to the cost of utility.

5.3.3 ***Cost of Utilities generated for the inter company transfers shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost and share of administrative overheads.***

In case of inter company transfer, cost of utility so transferred should comprise as para 5.3.2 viz. direct material(fuel and the like),direct labour, direct expenses, chemicals, share of factory overheads ,distribution cost and share of administrative overhead. Cost of a utility determined as above plus share of administrative overhead is to be charged for inter company transfer. Transmission loss should be treated as per agreement between the parties.

5.3.4 ***Cost of Utilities generated for the sale to outside parties shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost, share of administrative overheads and marketing overheads.***

The sale price of utilities sold to out side parties should include cost of utilities as computed under para 5.3.3. plus marketing overhead and margin, as illustrated in **Annexure 3.**

5.4 ***Finance costs incurred in connection with the utilities shall not form part of cost of utilities.***

Finance Costs are *incurred by an enterprise in connection with the borrowing of funds*. While determining the cost of utility as para 5.3.1 to 5.3.4. above, finance cost i.e. interest related cost will not be considered as an item of cost.

5.5 ***The cost of utilities shall include the cost of distribution of such utilities.*** The cost of distribution will consist of the cost of delivery of utilities up to the point of consumption.

The utility is supplied to the user from the place of generating the utility. The cost incurred from the place of generating to the end users (i.e.setting of pipe line and the like) will form part of the cost of utility supplied. It will include the cost of transportation through pipe/ transmission line, stepping up/stepping down of power voltage, maintenance of distribution channels, etc.

5.6 ***Cost of utilities shall not include imputed costs.***

Imputed cost does not involve any cash payment. It should not be included in the cost of utility.

5.7 ***Where cost of utilities is accounted at standard cost, the price variances related to utilities shall be treated as part of cost of utilities and the portion of usage variances due to normal reasons shall be treated as part of cost of utilities. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.***

The cost of utility may be accounted on standard cost method. The standards are fixed for various inputs, such as material, fuel, direct employee cost, budgeted overhead expenses. Under this method, price of inputs of material fuel and the like is predetermined for a stated period taking into account all the factors affecting price such as anticipated market trends, transportation charges and normal quantity of purchase. Standard prices are determined for each input and material requisitions are valued at standard price irrespective of the actual purchase price. Any difference between the standard and actual prices of purchase results in input/ material price variance. The material price variance is to be treated as part of input/material cost. There may be also input/material usage variance (the difference between the quantity required as per standard and actual consumption). Normal variance will form part of the cost of input. Abnormal usage variance will not form part of the utility cost. There can be other variances relating to employee cost, overhead between actual and budgeted and the like. Variances due to normal reasons should be treated as cost while the variances due to abnormal\ reasons should not form part of the cost of production.

For other expenses and overhead, expenses budgeted and actual are compared at different level of activity.

5.8 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to any cost of utilities shall be reduced for ascertainment of the cost to which such amounts are related.***

Subsidy, grant or incentives are provided for specific purpose. For example, generation of non-conventional energy. Any subsidy, grant received/receivable should be reduced from the utility cost.

5.9 ***The cost of production and distribution of utilities shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost. Cost of a Stand-by Utility shall include the committed costs of maintaining such a utility.***

Where utilities are created exclusively for captive consumption, utility plants are operated based on the production plan of end product. Normal capacity of end product is considered to be normal capacity for the utility.

Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance. There may be a situation when end product itself may be operated at below normal capacity in adverse market conditions and recession. In such a situation the normal capacity adopted for end product should be treated as normal capacity for the utility. The cost of production and distribution of utilities should be determined based on the normal capacity. The unabsorbed cost is to be treated as abnormal cost.

The committed cost of maintaining a stand-by utility should be included in the cost of stand by utility. All related cost of the standby utility is to be absorbed irrespective of its level of utilization.

There may be a different situation where a utility is purchased and generated also. For example in case of electricity, there is one subset called purchased electricity and another is a electricity generation through DG set.

Where utilities have capacity to cater to plant requirement and for sale to other parties, the cost of production and utilities is to be determined based on the normal capacity of the utility plant. If it is operating below normal capacity utilization, unabsorbed cost is to be treated as abnormal cost.

5.10 ***Any abnormal cost where it is material and quantifiable shall not form part of the cost of utilities.***

Abnormal cost may arise for example due to plant break down, flood fire and the like. Such cost will not form, part of the utility cost. Another example of abnormal cost is due to low capacity utilization.

5.11 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of utilities.***

Penalties /damages are levied for non compliance of regulatory requirements. For example not complying with boiler inspection, not safeguarding hazardous utility. Penalty so levied should not form part of the cost of utilities.

5.12 ***Credits/recoveries relating to the utilities including cost of utilities provided to outside parties, material and quantifiable, shall be deducted from the total cost of utility to arrive at the net cost of utility.***

The total cost of a utility is to be adjusted for the cost of utility supplied to outside parties if the its cost is material and quantifiable. Credit should also be given for the recovery made for the utility consumed by other units such as township and the like. The net cost arrived at, be then charged to the different units benefitted by the use of a utility.

Example:

(1) Where a unit has a township/colony, electricity and water charges recovered for its use may be credited to the cost of these utilities and net cost distributed to production centres.

(2) If utility is sold by Unit A to outside parties, credit is to be given to the cost of utility at price of utility sold to outside parties (i.e. cost of utility including distribution +administrative Overhead+ Marketing Overhead and Margin)

5.13 *Any change in the cost accounting principles applied for the measurement of the cost of utilities shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.*

Cost accounting principle applied for measurement of the cost of utilities should be followed consistently and uniformly among different utilities and period. Change in cost accounting principle should be made only if required by law or for compliance with requirement of law. If various inputs are valued on FIFO basis, it should be followed consistently.

Assignment of costs

6.1 *While assigning cost of utilities, traceability to a cost object in an economically feasible manner shall be the guiding principle.*

The cost of utilities is to be assigned to the end user/ cost objects on the basis of traceability to a cost object. Cost Object as defined under paragraph 4.3 includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which utility costs are to be ascertained. The meter installed for recording consumption of utility is the right source of traceability of cost of utility for a cost object**.** If no meters are provided, the cost of utilities is to be assigned on the basis of rated capacity, wattage, horse power of machines, area volume or on technical assessment. The basis adopted for assigning cost of utility should be economically feasible. Economic feasible means cost effectiveness in the sense that cost accounting is not too expensive in relation to expected benefits. Basis of assignment varies with each utility as detailed below:

Power: The power consumed by each cost object /activity/sub-activity is to be assigned on the basis of meter reading. Current period reading minus previous period reading indicates the units consumed by the cost object and multiplying with utility rate, total cost of the utility is assigned.

If no meters are provided, the cost is assigned on the basis of, kw or horse power of machines, as discussed earlier. This practice applies for other utilities

6.2 Where the cost of utilities is not directly traceable to cost object, it shall be assigned on the most appropriate basis.

The cost of utilities is to be assigned on the basis of meter reading which is more reliable. In case meters have not been installed, it should be assessed on technical estimate based on equipment rating, area, volume, and the like.

For example:

For Product A, in the absence of meter, utility required may be assigned based on product requirement as per technical estimate.

6.3 *The most appropriate basis of distribution of cost of a utility to the departments consuming services is to be derived from usage parameters.*

In the absence of meter, utility is to be distributed to the consuming departments based on usage parameters such as stated in the project report, technical estimates taking into account the equipment rating capacity, space, volume and the like .The project report of the plant lays down various usage requirement of utility, and the same should also be taken into account while assigning the utility consumption.

Presentation

7.1 *Utilities costs shall be presented as a separate cost head for each type of utility in the cost statement, if material.*

The cost statement should indicate the details of each utility separately, if material, as detailed blow:

Cost statement of A Product				
Particulars	Unit	Qty	Rate/Per unit	Amount(₹)
Material consumed	Xx	Xx		Xx
Utilities Water	KL	62500	1.50	93750
Dm Water	KL	3560	3.00	10680
Power	Kwh	615780	4.00	2463120
Steam	MT	2560	780.00	1996800

In the context of cost statement, Materiality is to be judged in terms of nature, quantity and cost of utility. A piece of information is material, if its omission/non-disclosure could influence the decision of the user. If a utility is not material, it may be shown under production overhead.

For utilities (such as steam, hot water, thermic fluid) produced with heat recovery system, separate cost statement shall be prepared giving details of cost elements.

7.2 *Where separate cost statements are prepared for utilities, cost of utilities shall be classified as purchased or generated. Such statement shall also include cost of utilities consumed along with quantitative information by individual consuming units, inter unit transfers, inter company transfers and sale to outside parties wherever applicable.*

If a utility is purchased and generated, purchase value of the units purchased and cost of units generated is to be indicated in the cost statement separately. Weighted average rate is to be used for assigning the cost of utility to the user departments. The cost statement should also furnish distribution of utility to users departments, inter unit transfers, inter company transfers and sale to outside parties. The information is to be furnished both in quantity and value. Cost of utility is to be assigned as provided under para 6 above.

Disclosures

8.1 *The cost statements shall disclose the following:*

8.1.1 The basis of distribution of Cost of Utility to the consuming centres.

The basis of distribution of cost of utility to the consuming centre adopted is to be disclosed in the cost statement. Normally it will be based on meter readings of period/technical estimates, area, etc as detailed in the table below

Power	**Basis**	**Units (KWH)**	**Amount**
Production Deptt A	Meter reading	5700	23370
Production Deptt B	Meter reading	3560	14596
Utility : Water	Meter reading	1000	4100
Air-conditioning	Meter reading	2300	9430
Others	Meter reading	1500	6150
	Total	14060	57646

Steam Power House Production Deptt A Production Deptt B	Basis Meter Reading Meter Reading Meter Reading	M.Tons	Amount
	Total		
Air Conditioning	Basis		
Production Design & Drawing Administration Sales Department	Volume Volume Volume Volume		

8.1.2 The cost of purchase, production, distribution, marketing and price with reference to sales to outside parties.

If a utility purchased as well as generated is sold to outside parties, the utility cost statement should disclose the following details

Particulars	Units	Rate	Amount
POWER Purchased Generated Total Less Distribution loss			
Net units			
Distribution Deptt A Deptt B Other Outside parties			
Total			
Sale to outside parties Cost of generation & Distribution Add: Administrative Overhead Add: Marketing & Distribution cost Total Sale Price			

For Example

Disclosure: During the period, unit has sold 5680 KWH units to outside parties @ ₹ 6.50 per KWH against cost of sales (including marketing and distribution cost) of ₹ 5.10 per KWH.

8.1.3 Where cost of utilities is disclosed at standard cost, the price and usage variances.

In case standard costing technique is used, cost statement of a utility should disclose price and usage variance separately relating to various inputs. Variances should be indicated in the cost statement. Abnormal variance are to be excluded and indicated in the cost statement as a foot note.

A cost statement indicating the variance is at **Annexure 3**.

8.1.4. The cost and price of Utility received from/supplied to related parties.

If any utility is procured from or supplied to related parties(as defined under the Companies (Accounting Standards) Rules, 2006) its relationship, nature of transaction viz quantity, rate, other terms/ conditions of procurement are to be disclosed. The objective of disclosure is to ascertain that the transaction is at arm's length and on purely commercial terms.

Example

Related party → XYZ Ltd

Nature of relationship → We and our subsidiaries own 51 percent of their Equity.

Nature of transactions: XYZ Ltd supplies power

Volume of transaction: During this year ….2500 KWH units of power were supplied @ ₹ 4.50 per KWH for ₹ 11250.

8.1.5 The cost and price of Utility received from/supplied as inter unit transfers and inter company transfers

Inter unit transfers/inter company transfers relating to utility received/supplied is to be disclosed in the cost statement or as a foot note. It should indicate cost of a utility supplied and price of a utility purchased. In case of inter-unit transfers, utility should be at cost. if inter utility transfer is at selling price, difference between cost and price to be indicated as a footnote in the cost statement of a product. In case of inter company transfers, if utility is charged at price in the cost statement, details of cost should be furnished by a footnote.

For Example:

(1) Main Steel plant has supplied coke oven gas to Tubes Plant at cost of ₹ xxx per cub meter.

(2) Company A has sold power 6500 KWH to Company B at a selling price of ₹ 5.00 per KWH against cost of sales of ₹ 3.75 per KWH.

Cost of Production per KWH ….. ₹ 3.50

Selling & Distribution per KWH ….. ₹ 0.25

Cost of Sales per KWH ….. ₹ 3.75

8.1.6 Cost of utilities incurred in foreign exchange.

Cost of inputs for a utility incurred in foreign exchange is to be disclosed by way of footnote in the cost statement of the utility.

For Example:

Unit has captive thermal power plant. It has imported 1500 MT coke valued in foreign exchange US $ xxxxx during the current year.

8.1.7 Any Subsidy/Grant/Incentive and any such payment reduced from Cost of utilities.

Any subsidy/grant/incentive received relating to utilities is to be reduced from the cost of utilities and disclosure made accordingly by way of a foot note.

Example

The State Government has been subsidizing setting up of non-conventional energy plant/its use. Such subsidies received and receivable are to be reduced from the cost of utility.

Example: Unit has set up wind plant and received subsidy of ₹ 10.0 lakhs. This has been reduced from the capital cost of the plant and resulting in lower depreciation of ₹ xxxx.

8.1.8 Credits/recoveries relating to the Cost of utilities.

If any credit or recovery considered while determining the cost of utility, the same should be disclosed in the body of the cost statement.

8.1.9 Any abnormal cost excluded from Cost of utilities.

Abnormal cost is to be excluded from the cost of utilities as the same has not contributed to the production of utilities. Disclosure is to be made by way of foot note in the cost statement.

For example: During the year there was theft of 300 Tons of coal valued at ₹ xxxx. The same has been excluded from the cost of the power generated. .

8.1.10 Penalties and damages paid etc. excluded from cost of utilities.

Penalties and damages paid are not an item of cost as these are levied for non compliance with regulatory /contractual requirements. These are to be excluded from cost and disclosure made as a footnote in the cost statement.

8.2 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the Cost of utilities during the period covered by the cost statement which has a material effect on the Cost of utilities. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

Cost Accounting principles, and methods applied for the measurement and assignment of cost of utilities are to be applied consistently between one period and uniformly applied for different utilities. If any change is made in these principles and methods results in material effect on the cost of utilities, the same should be disclosed in the cost statement or by a foot note. In case the impact of change in principles and methods of cost accounting is not ascertainable, the fact is to be disclosed by a note to the cost statements.

For Example:

(1) Heat recovery steam partly used for drying process was charged at of the normal steam rate. It has been changed to charging Heat recovery steam at equivalent calorific value of furnace oil used resulting in higher charges to dry process of ₹ xxx and higher credit to steam.

(2) Steam to various cost centres was being assigned on technical estimates. During the current period, meters have been installed and the cost of steam has been assigned on the basis of meter reading.

8.3 *Disclosures shall be made only where material, significant and quantifiable.*

Level of materiality and significance has not been stated in the standard. As stated in para 7.1 Material and significance of an information will be different from situation to situation. Materiality of cost information is to be judged from the perspective of the users of that information. If material, the same is to be disclosed.

8.4 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.*

Disclosure in the body of cost statement will depend on cost of each utility. If it forms material part of the cost of the utility, the same should be disclosed in the cost statement. Disclosures may also be by way of foot note.

Annexure 1

CLASSIFICATION OF UTILITY

Power	Purchased Power Generated Power (stand alone) Co Generation
Water	Raw Water Treated water Demineralized water Distilled water/softening water Chilled/cold water Hot water
Steam	Low Pressure steam High pressure steam
Climatic control	Air conditioning Humidification Air Handling units
Air	Compressed Air Instrument Air (Vacuum) Oxygen Gas Nitrogen gas, Hydrogenation

Annexure 2

Illustration of Steam Cost

RAW MATERIAL	UNIT	QTY	RATE	AMOUNT	COST PER MT
Coal	MT	9380.00	4386.25	411.43	742.85
Coal Handling Charges				3.5	6.32
Diesel oil expenses for loader				5.5	9.93
Coal consumption /Ash sale				-6.28	-11.34
Siding Expenses				1.67	3.01
Entry Tax				6.5	11.28
Raw Material Total				422.07	762.05
Chemicals					
Lime	MT	11.85	3460.21	0.41	0.74
Caustic Soda	MT	11.85	27,512.87	3.26	5.89
HCL	MT	67.94	3694.60	2.51	4.53
Resin-FFIP	LT	118.50	151.91	0.18	0.32
Sulphuric Acid	LT	2.37	8438.2	0.2	0.36
Chlorine	LT	1.58	7594.94	0.12	0.22
Sodium Sulphate	KG	19.75	151.91	0.03	0.05
Others		0.00	1.00	1.65	2.98
Chemical Total				8.36	15.09
Power	KW	871172.00	2.79	24.3	43.87
Water	KL	49003.00	2.72	1.33	2.40
Total Variable Cost				456.06	823.41
Fixed Cost					
Employees				8.04	14.52
Depreciation				4.5	8.12
Others				1.2	2.17
Total Fixed Cost				13.74	24.81
Total Cost (Variable + Fixed)				469.80	.24

Annexure 3

Examples of Steam cost – Transfer to Other units

Steam cost per tonne works out to ₹ 471.09 as illustrated under Annexure 2. If steam is transferred to other unit, distribution cost will be in addition to the above cost as illustrated below

1	Steam generation cost as 5.3.1 above	₹ 471.09 Per MT
	Distribution cost : Operation &Main tenance cost of distribution line Depreciation Other	Per MT ₹ 1.00 ₹ 0.75 ₹ 0.75
2	Total Distribution cost	₹ 2.50
3.	Inter Unit transfer cost	₹ 473.59

Cost of a utility determined as per para 5.3.2 plus share of administrative overhead to be charged.

Example:

Inter Company transfer price

1.	Cost of steam generation as para 5.3.1.	₹ 471.09 per MT
2.	Distribution cost	₹ 2.50 per MT
3.	Share of Administrative Overheads	₹ 0.50 per MT
4.	Inter company transfer, cost of utility	₹ 474.09 per MT

Example of Sale of Utility

1.	Cost of steam generation as para 5.3.1.	₹ 471.09 per MT
2	Distribution cost	₹ 2.50 per MT
3	Share of Administrative Overheads	₹ 0.50 per MT
4	Marketing overhead	₹ 0.75 per MT
5.	Cost of Sales	₹ 474.80 per MT
6	Margin	₹ 2.20 per MT
7	Sales to outside parties	₹ 477.00 per MT

Illustration : Determination of Abnormal Cost due to low capacity Utilisation	
Installed capacity Power Plant	400,000 kwh
Normal Capacity fixed after accounting for normal unavoidable interruptions	366,000 kwh
Generation of Power: 20XX-XX 20XX-XX	 370,000 340,000
Generation during 2008-09 was low due to strike for 30 days. Therefore it was decided by the management to remove cost portion of fixed overheads incurred during the strike period and the same was shown as a reconciliation item(Abnormal Overhead) in the Profit Reconciliation Statement for Profit as per Cost Accounts and Profit as per financial Account. Detailed working is as under:	
(A) Variable Cost	₹ 11,90,000

(B) Fixed Overheads for the year based on Normal Capacity of (C) Abnormal Fixed Overhead due to unutilised capacity (D) Share of Fixed Overhead for Actual Production (B-C)	₹ 7,32,000 ₹ 61,000 ₹ 671,000
Cost of generation after excluding low utilisation cost (a) Variable cost (b) Fixed Overhead for actual production (c) Total	₹ 11,90,000 ₹ 6,71,000 ₹ 1,861,000
Units produced Cost per unit (KWH) ₹ 1861000/340000	340000 kwh ₹ 5.53 kwh
Fixed Overhead unabsorbed (treated as an item of reconciliation between Costing P&L A/c & Financial A/c)	₹ 61,000

(CAS-8)

COST ACCOUNTING STANDARD ON COST OF UTILITIES

The following is the COST ACCOUNTING STANDARD – 8 (CAS-8) issued by the Council of The Institute of Cost and Works Accountants of India on "COST OF UTILITIES", for comments. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the cost of utilities.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of cost of utilities, for determination of the cost of product or service, and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the cost of utilities with reasonable accuracy.

3. Scope

3.1 ***This standard shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of cost of utilities including those requiring attestation.***

3.2 ***For determining the cost of production to arrive at an assessable value of excisable utilities used for captive consumption, Cost Accounting Standard 4 on Cost of Production for Captive Consumption (CAS 4) shall apply.***

3.3 ***This standard shall not be applicable to the organizations primarily engaged in generation and sale of utilities.***

3.4 This standard does not cover issues related to the ascertainment and treatment of carbon credits, which shall be dealt with in a separate standard.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.[1]

4.2 Committed Cost: ***The cost of maintaining stand-by utilities shall be the committed cost.***

4.3 Cost Object: This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.

4.4 Finance Costs: Costs incurred by an enterprise in connection with the borrowing of funds. This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[2]. The terms Finance costs and Borrowing costs are used interchangeably.

4.5 Imputed Costs: Hypothetical or notional costs, not involving cash outlay, computed for any purpose.[3]

4.6 Normal capacity: Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.[4]

In case of any standby utility the normal capacity will be the same as actual production of the utility.

The normal capacity of a utility meant for captive consumption would be based on the normal capacity for the production facility of the end product of the consuming unit.

4.7 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

4.8 Utilities: ***Significant inputs such as power, steam, water, compressed air and the like which are used for manufacturing process but do not form part of the final product.***

4.9 Stand-by utilities: ***Any utility created to safeguard against the failure of the main source of inputs.***

5. Principles of measurement

5.1 Each type of utility shall be treated as a distinct cost object.

5.2 Cost of utilities purchased shall be measured at cost of purchase including duties and taxes, transportation cost, insurance and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified with reasonable accuracy at the time of acquisition.

5.3.1 Cost of self generated utilities for own consumption shall comprise direct material cost, direct employee cost, direct expenses and factory overheads.

5.3.2 In case of Utilities generated for the purpose of inter unit transfers, the distribution cost incurred for such transfers shall be added to the cost of utilities determined as per paragraph 5.3.1.

5.3.3 ***Cost of Utilities generated for the inter company transfers shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost and share of administrative overheads.***

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1 Adapted from CAS 1 paragraph 6.5.19

2 Adapted from CIMA Terminology

3 Adapted from CAS 1 paragraph 6.5.13

4 Adapted from CAS 2 paragraph 4.4

5.3.4 ***Cost of Utilities generated for the sale to outside parties shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost, share of administrative overheads and marketing overheads.***

The sale value of such utilities will also include the margin.

5.4 ***Finance costs incurred in connection with the utilities shall not form part of cost of utilities.***

5.5 ***The cost of utilities shall include the cost of distribution of such utilities.***

The cost of distribution will consist of the cost of delivery of utilities up to the point of consumption.

5.6 ***Cost of utilities shall not include imputed costs.***

5.7 ***Where cost of utilities is accounted at standard cost, the price variances related to utilities shall be treated as part of cost of utilities and the portion of usage variances due to normal reasons shall be treated as part of cost of utilities. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.***

5.8 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to any cost of utilities shall be reduced for ascertainment of the cost to which such amounts are related.***

5.9 The cost of production and distribution of utilities shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost[5]. Cost of a Stand-by Utility shall include the committed costs of maintaining such a utility.

5.10 ***Any abnormal cost where it is material and quantifiable shall not form part of the cost of utilities.***

5.11 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of utilities.***

5.12 ***Credits/recoveries relating to the utilities including cost of utilities provided to outside parties, material and quantifiable, shall be deducted from the total cost of utility to arrive at the net cost of utility.***

5.13 ***Any change in the cost accounting principles applied for the measurement of the cost of utilities should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***While assigning cost of utilities, traceability to a cost object in an economically feasible manner shall be the guiding principle.***

6.2 ***Where the cost of utilities is not directly traceable to cost object, it shall be assigned on the most appropriate basis.***

6.3 ***The most appropriate basis of distribution of cost of a utility to the departments consuming services is to be derived from usage parameters.***

7. Presentation

7.1 ***Utilities costs shall be presented as a separate cost head for each type of utility in the cost statement, if material.***

7.2 Where separate cost statements are prepared for utilities, cost of utilities shall be classified as purchased or generated. Such statement shall also include cost of utilities consumed along with quantitative information by individual consuming units, inter unit transfers, inter company transfers and sale to outside parties wherever applicable.

5 Adapted from paragraph 5.7 of CAS 3

8. Disclosures

8.1 *The cost statements shall disclose the following:*

1. *The basis of distribution of Cost of Utility to the consuming centres.*
2. *The cost of purchase, production, distribution, marketing and price with reference to sales to outside parties.*
3. *Where cost of utilities is disclosed at standard cost, the price and usage variances.*
4. *The cost and price of Utility received from/supplied to related parties6.*
5. *The cost and price of Utility received from/supplied as inter unit transfers and inter company transfers*
6. *Cost of utilities incurred in foreign exchange.*
7. *Any Subsidy/Grant/Incentive and any such payment reduced from Cost of utilities.*
8. *Credits/recoveries relating to the Cost of utilities.*
9. *Any abnormal cost excluded from Cost of utilities.*
10. *Penalties and damages paid etc excluded from cost of utilities.*

8.2 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the Cost of utilities during the period covered by the cost statement which has a material effect on the Cost of utilities. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

8.3 *Disclosures shall be made only where material, significant and quantifiable.*

8.4 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.*

Disclaimer

There are some provisions though spelt under the Companies Act, 2013, but not yet notified/enforced "till date of publication of this Study Material". Hence, for such provisions, the relevant and corresponding Sections/Provisions of the Companies Act, 1956 is applicable. All concerned are requested to follow both – the MCA, GOI website as well as Clarification/Circular issued/to be issued by the Institute from time to time – on applicability of sections of Companies Act for CMA Examinations.

6 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

2.6 GUIDANCE NOTE ON COST ACCOUNTING STANDARD ON PACKING MATERIAL COST (CAS-9)

The Council of the Institute of Cost Accountants of India has issued the Cost Accounting Standard on Packing Material Cost (CAS - 9) which lays down a set of principles and methods of classification, measurement and assignment of packing material cost for determination of the cost of product and the presentation and disclosure in the cost statement.

The Guidance Note deals with principles and methods as provided in the CAS-9 and practical aspects in connection with the determination of packing material cost of a product.

In the preparation of cost statement and its attestation if any packing material cost is required, the same shall be determined with reference to CAS-9.

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 state that for the purposes of sub-section (1) of section 148 of the Act, the class of companies, including foreign companies defined in clause (42) of section 2 of the Act engaged in the production of the goods or providing services, specified in the Table below, having an overall turnover from all its products and services of rupees **thirty five crore or more** during the immediately preceding financial year, shall include cost records for such products or services in their books of account.

Rule 4(a) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (A) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **fifty crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **twenty five crore or more**.

Rule 4(b) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (B) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **one hundred crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **thirty five crore or more**.

The Cost Accounting Standards have been set in ***bold italic*** type. Numbering of standard has been retained as in CAS-9 for facility of reference.

Introduction

Packaging is enclosing or protecting products for distribution, storage, sale, and use. Material used for packaging is termed as Packing Material.

Packing material is required for containment, protection, handling, presentation, delivery, transporting, warehousing, logistics, sale, and end use of the product as detailed below:

- **Physical protection** - The products enclosed in the package require protection from, among other things, shock, vibration, compression, temperature, and the like.
- **Barrier protection** - A barrier from oxygen, water vapour, dust, and the like, is often required. Packing Keeps the contents clean, fresh, sterile and safe for the intended shelf life
- **Containment or agglomeration** - Small objects are typically grouped together in one package for reasons of efficiency. For example, a single box of 1000 pencils requires less physical handling than 1000 single pencils. Liquids, powders, and granular materials need containment.
- **Information transmission** - Packages and labels communicate how to use, transport, recycle or dispose of the package or product. With pharmaceuticals, food, medical and chemical products, some types of information are required by regulatory authorities. Some packages and labels are used for track and trace purposes.

- **Marketing** - The packaging and labels are used by marketers to encourage potential buyers to purchase the product.
- **Security** - Packaging can play an important role in reducing the security risks of shipment. Packages can be made with improved tamper resistance to deter tampering.
- **Convenience** - Packages can have features that add convenience in distribution, handling, stacking, display, sale, opening, reclosing, use, dispensing and reuse.
- **Portion control** - Single serving or single dosage packaging has a precise amount of contents to control usage. Bulk commodities (such as salt) can be divided into packages that are more suitable for individual households. It also aids the control of inventory, selling sealed one-litre-bottles of milk, rather than people bringing their own bottles.

Type of packing material required depends on the type of product to be packed. Packing materials are of various types. Type of packing material required for a product depend upon the nature of the product to be packed. Illustrative list of packing material used is at ***Annexure I***. It varies from industry to industry as items to be packed will be different as indicated in ***Annexure II***.

Packing Material is classified under a common designation on the basis of similarities of nature, attribute, source of supply and the like. For example Wooden crates, Aluminium foil, paper bag, gunny bags, HDPE bags, Glass, plastic bottles, closures (metal / plastic rubber) and the like.

On the basis of source of supply, packing materials are classified as indigenous materials / imported materials. Indigenous packing materials are manufactured within the country and imported packing materials are purchased from other countries.

For the purpose of this standard Packing Materials are classified into primary and secondary packing materials.

Primary Packing Material are for holding the product, keeping the contents clean, fresh, sterile and safe for the intended shelf life and sale. Primary packing material required for a product will depend upon the type of the product to be packed.

For example for pharmaceutical industry primary packing material will be insertion related to product, Blister strips for tablets / capsules, bottle, tubes and the like. For confectionary / food products, it may be butter paper, wrappers, box, tray, can, jar and so on.

Primary packing material may also be intended for shop display .But the function of primary packing material is essentially for holding a product. Depending upon use, the same material may be classified as secondary packing material. For example, a shrink wrap can be primary packaging when applied directly to the product, and secondary packaging when combining smaller packages.

Primary packing material cost is part of production cost of a cost object. In case two types of primary packing materials are used viz. plain and fancy, the difference in the plain and fancy packing material is to be treated as secondary packing. In such cases, differentiating between primary and secondary packaging will depend upon the specific facts and circumstances of a product to be packed and type of industry.

Secondary packing material is the term used to describe larger cases or boxes that are used to group quantities of primary packaged goods for distribution.

Secondary Packing material also include transit packaging such as wooden pallets, board and plastic wrapping and containers that are used to collate the groups into larger loads for transport, which facilitates loading and unloading of goods.

Some products such as sugar, fertilizers, cements, and the like are sold in bags and do not need any further packing. Such packing is to be treated as primary packing and will form part of cost of production.

Definitions

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and / or due to some abnormal situation of the production or operation.***

4.2 Administrative Overheads: ***Cost of all activities relating to general management and administration of an organisation.***

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.4 Direct Employee Cost: ***The cost of employees which can be attributed to a Cost Object in an economically feasible way.***

4.5 Direct Expenses: ***Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material or direct employee cost.***

4.6 Direct Materials: ***Materials the costs of which can be attributed to a cost object.***

4.7 Distribution Overheads: ***Distribution overheads, also known as Distribution Cost, are the costs incurred in handling a product from the time it is ready for despatch until it reaches the ultimate consumer.***

4.8 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.***

4.9 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***

4.10 Marketing overheads: ***Marketing Overheads comprises selling overheads and distribution overheads.***

4.11 ***Packing Materials: Materials used to hold, identify, describe, store, protect, display, transport, promote and make the product marketable and communicate with the consumer.***

4.11.1 Defectives: ***Packing materials that do not meet quality standards. This may include reworks or rejects.***

4.11.1.1 Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***

4.11.1.2 Rejects: ***Defectives which cannot meet the quality standards even after putting in additional resources.***

4.11.2 Packing Material Cost: The cost of material of any nature used for the purpose of packing of a product.

4.11.3 Primary Packing Material: Packing material which is essential to hold the product and bring it to a condition in which it can be used by or sold to a customer.

4.11.4 Reusable Packing Material: Packing materials that are used more than once to pack the product.

4.11.5 Scrap: Discarded packing material having some value in a few cases and which is usually either disposed of without further treatment or reintroduced into the production of packing material.

4.11.6 Secondary Packing Material: Packing material that enables to store, transport, inform the customer, promote and otherwise make the product marketable.

4.12 Packing Material Development Cost: ***Cost of evaluation of packing material such as pilot test, field test, consumer research, feedback, and final evaluation cost.***

4.13 Production overheads: ***Indirect costs involved in the production process or in rendering service.***

4.14 ***Selling Overheads: Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***

4.15 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Principles of Measurement

5.1. Principle of valuation of receipt of packing material:

5.1.1 ***The packing material receipts should be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified at the time of acquisition.***

The valuation of receipt of packing materials is to be based on the terms and conditions stated in the purchase /supply order. It indicates the source of supply i.e. indigenous or imported and the like.

Purchase of indigenous Packing material:

The purchase / supply order inter alia states:

(1) Specification of packing material being purchased

(2) Purchase price

(3) Quantity of supply

(4) Time of supply

(5) Place of supply

(6) Payment terms

(7) Other commercial conditions regarding inspection, rejection, cash / trade discount etc.

In addition to basic purchase price, duties and taxes, freight inwards, insurance and other expenditure directly attributable to procurement are to be taken into account while valuing the receipt of packing material if these can be quantified with reasonable accuracy at the time of receipt. If any of these items of expenditure cannot be quantified with reasonable accuracy, these are treated as material handling cost, an item of overhead.

Trade / cash discount, rebates, taxes and duties refundable (or to be credited by the taxing authorities) are to be set off. Examples of taxes and duties to be deducted from cost are CENVAT credits, credit for countervailing customs duty, sales tax set off / vat credits and other similar items of credit recovered / recoverable.

Imported Packing Material:

Packing Materials are imported from other countries depending upon the availability in the country / economics of import. Import license may be required in certain cases. Terms of Purchase inter alia may be FOB, CIF port/airport. FOB (Free on Board) means that goods are loaded on the ship and there is no additional charge relating to loading and the like. Purchaser has to pay transit insurance and freight from place of loading to its destination. In case of CIF (Cost, Insurance & Freight) price, price includes besides basic price, transit insurance and freight. On receipt of packing material, bill of entry is prepared and other custom formalities are complied with for clearance of the goods.

Following points are to be considered while valuing imported packing material:

a. Actual customs duty paid on the basis of classification by the customs authorities will be assigned, net of any credits. Higher duty paid under protest will not be included in cost if there is reasonable expectation that the entity will satisfy the conditions for the excess duty to be refunded.

b. Packing Material imported free of duty or at concessional rate of duty under export incentive scheme will be accounted for at the actual rate of duty applicable so long as there is reasonable expectation that the entity will satisfy the conditions for the duty exemption or concession. In case the packing material is used other than the intended purpose, provision for import duty / penalty leviable, if any, shall be provided. This entry may be offset when the material is available for export purposes at the imported parity rate of material.

c. Harbour dues, stevedoring charges, congestion charges, and the like on the basis of actual, if imported singly. If the packing material is imported as part of a basket, then a suitable basis such as proportionate weight, volume or value will become the basis for assigning the above charges

d. If Intermediate storage is called by the nature of transport, the actual charges by the storage provider will be included in the cost.

   For example transporting the material by different mode of transport due to certain transport constraint.

e. Commission Agent's Charges will be added to cost of materials. Where other services are also provided by the commission agent besides procurement of orders, e.g. arranging for LC, the charges for such services will also be assigned to the materials covered on a suitable basis.

f. Adjustment of CENVAT / VAT as per applicable regulation

g. Duty drawback and other similar duties subsequently recoverable shall also be deducted from the cost of material

h. Bank Charges are in the nature of borrowing cost or in the nature of administrative overheads will not form part of packing material cost.

Cost incurred for acquisition, inspection, storage, movement of materials and insurance is also to be assigned to packing material cost on rational basis.

Handling costs upto works / factory gate

If handling cost is specific and handled singly, it is to be assigned to the packing material handled. If employees are used for handling the packing material, it is to be treated as procurement overheads and not included in Packing Material Cost. In other cases where handling charges are included in the carrier's responsibility, there will be no assignable cost due to handling.

Incoming Inspection

If the packing material calls for inspection by a third party, specific cost will be assigned to the packing material inspected. If the inspection is carried out internally with own employees, it is to be treated as procurement overheads and not included in Packing Material Cost. If the inspection is part of the vendor's responsibility, no separate inspection cost will be assigned.

Other cost incurred for packing material acquisition is insuring of packing material. If insurance premium is specific and insured singly, it is to be assigned to the specific packing material insured. In case it is part of a comprehensive policy then the assignment of the insurance premium will be on the basis of the proportionate value insured. If insurance becomes part of the carrier's responsibility no separate cost will be assigned in this regard.

5.1.2 ***Finance costs directly incurred in connection with the acquisition of Packing Material shall not form part of Packing Material Cost.***

Finance costs are interest and the like on borrowed funds. Finance costs are excluded from packing material cost. The letters of credit charges are for credit risk or a transaction risk (demand bill) and / or part of bank charges, which form part of administrative overheads. Such charges are not finance charges except where they are in the nature of borrowing costs.

Sometimes goods are kept in bonded warehouse and clearance of goods is delayed. This may happen due to any financial stringency delaying the payment to the bank. Such payments of storage are to be excluded from packing material cost and are dealt with in the financial accounts.

5.1.3 ***Self manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads including share of administrative overheads comprising factory management and administration and share of research and development cost incurred for development and improvement of existing process or product.***

The packing material may be manufactured by an entity. It is to be valued taking into account all the relevant cost incurred in manufacturing the packing material. For example it shall take into account the direct material cost, direct employee cost, direct expenses, share of factory overhead and share of administrative overheads relating to production.

In case any packing material development cost such as pilot test, field test consumer research, feedback and final evaluation cost is incurred, it will form part of the cost of self manufactured packing material.

Direct Material is the cost of material which can be attributed to a cost object. It is consumed for production of a product or service which is identifiable in the product and forms direct material cost.

Direct material consumed in the manufacture of packing material is to be valued at purchase price including duties and taxes, freight inwards, insurance and other expenditure (net of trade discounts, rebate, taxes and duties refundable or to be credited) as detailed under paragraph 5.1.1.

Direct employee cost is that portion of wages and salaries which can be identified with and charged to a cost object. Direct Employees engaged in the manufacturing of packing material are to be identified. Remuneration paid to them and share of other employee related cost are to be determined as per Standard CAS-7 on Employee cost.

Direct Expenses specifically identifiable with the production of packing material (for example job charges, hire charges for use of specific equipment, cost of special designing of packing material or drawings etc.) shall form part of the cost of self manufactured packing material.

Factory 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. these are the indirect costs incurred in the production process or in rendering service.

The Factory overheads includes administration cost relating to production, factory or manufacturing.

5.1.4 ***The valuation of captive consumption of packing materials shall be in accordance with paragraph 5 of Cost Accounting Standard 4.***

Para 5 of the Cost Accounting Standard on Cost of Production for Captive Consumption (CAS-4) deals with the determination of cost production for captive consumption. While valuing the cost for captive consumption of packing material, the following elements of costs are to be considered:

I. Material consumed (indigenous, imported, bought out items, self manufactured items, process material etc.)

II. Direct employee cost (as per CAS-7)

III. Direct expenses (for example cost of utilities, royalty, technical know-how charges for design)

IV. Quality control Cost

V. Research and Development

VI. Share of factory overhead (including factory administration and management expenses)

VII. Inputs received free

VIII. Adjustment for misc income, if any.

5.1.5 ***Normal loss or spoilage of packing material prior to receipt in the factory shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.***

Sometimes packing materials are lost in transit or spoiled. Treatment of loss will depend upon the terms and conditions of purchase order. If the purchase order does not specify any level of loss, and supplier is responsible to supply good quantity, the loss is to be recovered from suppliers or insurers as the case may be.

The normal loss is to be absorbed by the good units. Abnormal loss of packing material is taken to reconciliation and does not form part of the packing material cost.

5.1.6 ***The forex component of imported packing material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the packing material cost.***

Forex conversion has to be on the date of transaction. The cost and financial accounts will have the same basis for alignment. The date on which the transaction first qualifies for recognition in accounts is adopted as the date of transaction. The difference between the actual payment and the amount taken as packing material cost is taken to a separate financial account as exchange rate variations not being part of the packing material cost. Foreign Exchange difference shall be a reconciliation item.

5.1.7 ***Any demurrage, detention charges or penalty levied by the transport agency or any authority shall not form part of the cost of packing materials.***

Demurrage and penalties are levied by the transport agency or any other authority such as custom authorities for delay in clearance of wagon/vessel and the like.

Illustrations are:

- Demurrages levied by transporter for not removing goods,
- Penalties for keeping hazardous goods in unauthorized places in transit without proper safeguards.
- Penalties or interest levied by custom authorities for delayed clearance.

Demurrage and penalties are abnormal cost and are not part of the packing material cost. It is taken to reconciliation.

5.1.8 ***Any Subsidy / Grant / Incentive or any such payment received / receivable with respect to packing material shall be reduced for ascertainment of the cost to which such amounts are related.***

Subsidy and grant received should be recognized on a systematic basis. These should be matched with the related cost for which these are intended to compensate. Subsidy received for any packing material is to be reduced from the packing material cost.

Subsidy receivable for using specific packing materials produced on account of environmental reasons shall be adjusted against the packing material cost.

5.2. Principle of valuation of issue of packing material: ***Issues shall be valued using appropriate assumptions on cost flow.***

The CAS-9 provides for adopting any one of the following three methods for valuation of issues of material:

a) FIFO (First in First out)

b) LIFO (Last in First out)

c) Weighted Average Rate

Method of valuation of issue of packing material once adopted shall be followed consistently. If method of valuation is changed, its impact on costs of packing material shall be disclosed.

The FIFO formula assumes a cost flow that the items of packing materials that were purchased or produced first are issued first while LIFO assumes the exactly opposite cost flow charging the current price to cost. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each fresh shipment is received, depending upon the circumstances of the entity.

Accounting Standard AS-2 provides for cost formulae, viz. Specific identification, FIFO (First in First out) and Weighted Average cost method. Any of the above assumptions on cost flow can be used under

CAS 6. In addition, LIFO assumption can also be used. CAS 6 does not preclude the use of specific identification of cost.

LIFO method can be gainfully applied while estimating or projection of cost as it it reflects current price cost.

Any accepted method of pricing of issue may be used. However, whatever method of pricing is adopted under CAS 6, the same should be specified and followed consistently.

5.3 ***Wherever, packing material costs include transportation costs, determination of costs of transportation shall be governed by CAS – 5 Cost Accounting Standard on determination of average (equalized) cost of transportation.***

Inward freight shall form the part of the packing materials cost. In case inward freight charges are indicated in the invoice which is for more than one material, inward freight shall be assigned to different materials indicated in the invoice on appropriate basis such as weight, volume, nos. and the like.

If the packing material is carried by special carrier, it will be assigned to the specific packing material transported.

5.4 ***Packing Material Costs shall not include imputed costs. However in case of Cost of Production of Excisable Goods for Captive Consumption the computation of cost shall be as per CAS 4.***

Imputed cost does not involve any cash outlay and is relevant for decision making purpose viz whether to use reusable packing material or not. This will not form part of the packing material cost. But if any excisable goods produced is used for captive consumption, its cost is to be determined as per CAS-4. Under CAS-4 in case 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.

5.5 ***Where packing materials are accounted at standard cost, the price variances related to such materials shall be treated as part of packing material cost and the portion of usage variances due to normal reasons shall be treated as part of packing material cost. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.***

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 for variance is placed. Standard costs are used to compare the actual costs with the standard cost with a view to determine the variances, if any, analyse the causes of variances and take proper measure to control them.

Standard Cost method can also be applied for valuation of receipt and issue of packing material. In this method price of issues is predetermined for a stated period taking into account all the factors affecting price such as anticipated market trends, transportation charges and normal quantity of purchase. Standard price is determined for each packing material and material requisitions are valued at standard price irrespective of the actual purchase price. Any difference between the standard and actual prices of purchase results in packing material price variance. The packing material price variance is to be treated as part of packing material cost.

When standard costing system is in vogue, there can be other variances relating to usage during the course of packing the cost object which may be due to normal or abnormal reasons. Variances due to normal reasons shall be treated as cost while the variances due to abnormal reasons are treated outside the cost of production.

5.6 ***The normal loss arising from the issue or consumption of packing materials shall be included in the packing materials cost.***

Certain losses are inherent in the use of packing material and cannot be eliminated. For example losses occur in cutting wood, cardboard to make box and crate. These losses occur even under efficient operating condition and are referred to as normal loss.

Normal loss arising from issue or consumption of packing materials shall be treated as a part of packing material cost.

5.7 ***Any abnormal cost where it is material and quantifiable shall be excluded from the packing material cost.***

Abnormal cost arises due to some abnormal causes viz. heavy break-down in plant, theft, fire, material not according to required specification and the like. They are not considered in the cost of production and charged to profit & loss account. In case of packing material which is rejected after issue due to abnormal causes such as misprinting, material of wrong specification, size and the like is to be treated as abnormal cost. It is to be excluded from cost of packing material cost of the product. Any realization from disposal of such rejected packing material is to be credited to the abnormal cost.

The rationale of exclusion of abnormal cost is that such items in the cost will make the cost not comparable with a normal situation. Such an aberration is avoided to understand the cost in a better perspective for any purpose. For instance, loss of packing material due to major fire accident is to be treated as Abnormal Cost. It shall not form part of cost of the packing material consumed as not to distort the cost due to abnormal reasons. It is dealt with in the reconciliation with financial accounts.

5.8 ***The credits / recoveries in the nature of normal scrap arising from packing materials if any, should be deducted from the total cost of packing materials to arrive at the net cost of packing materials.***

Normal Loss occurs in use of different packing material such as in cutting wood and cardboard to make box and crate. Adjustment shall be made to the cost of packing material for credits / recoveries from sale of such scrap.

Assignment of Cost

6.1 Assignment of packing material costs to cost objects: ***Packing material costs shall be directly traced to a cost object to the extent it is economically feasible.***

Assignment of packing material cost involves establishing a suitable procedure to identify and record the packing material consumed by the cost object. Cost object includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained. It is the logical sub-unit for collection of cost.

Material requisition is the source document indicating details of packing material issued for a product. It records the job number, quantity, type of packing material, and items listed are priced at their acquisition cost. Thus material requisition represents the source of information for assigning the cost of packing material to cost object. Based on actual issues, the cost of packing material is traced to cost object to the extent economically feasible.

Packing material cost may also be assigned on the basis of standard bill of packing material in place of actual issues. Under this method packing material is issued as Standard Bill of material. The standard cost for each item of packing material is defined at the beginning of the year. The variances from standard on account of price and consumption are adjusted to consumption at suitable interval. Any variation between the actual issues (both quantity and value) and the standard as accumulated over the period is charged off to consumption.

In many situations packing materials cannot be issued for the exact quantity required for packing the products produced. This may happen because the material is bulky e.g. wood used for making crates and they cannot be cut to the exact size in the stores. It may also happen that packing materials of small value like nails, glue etc. are issued in bulk as it is cumbersome to issue them for the exact quantity. In such cases, the quantity of packing materials issued cannot be taken as consumption.

In such cases, the material issued to the packing department is treated as departmental stock and the quantity of packing material required to pack the quantity of the product produced as per norms is relieved from the stock, on production being reported. The normative consumption so arrived at will be adjusted for excess or short consumption based on physical stock taking of packing materials in stock in the packing department at periodic intervals. Quantity of packing material consumed so arrived at can be valued either at standard rate or actual rate depending on the cost system in vogue in the Company.

The norms regarding the quantity of packing materials required for each product is stored either as part of the standard bill of materials relating to the product or in a separate bill of packing materials.

Packing material cost may also be assigned on the basis of standard bill of packing material in place of actual issues. Under this method packing material is issued as Standard Bill of material. The standard cost for each item of packing material is defined at the beginning of the year. The variances from standard on account of price and consumption are adjusted to consumption at suitable interval. Any variation between the actual issues (both quantity and value) and the standard as accumulated over the period is charged off to consumption.

For tracing of packing material cost direct to a cost object, concept of “to the extent economic feasible” is also to be taken into account. This requires an exercise to analyse the cost involved, benefit to accrue and over-riding requirement to identify packing material with the object.

6.2 ***Where the packing material costs are not directly traceable to the cost object, these may be assigned on the basis of quantity consumed or similar measures like technical estimates.***

Packing Material Costs which are not directly traceable to cost object, are to be assigned on some rational basis consistently. The basis could be on some factor linking to the utilization. Technical estimates help in arriving at such rational basis.

Illustration: Nails, adhesive, tapes, gums etc are consumed while packing the cost object. Such packing materials are used in small quantities and are not significant in value. In such cases it may not be economical to issue individual requisition to charge to cost object each time. It is desirable to take the total consumption of such packing material per month and divide the cost between costs objects packed based on a technical estimate or on a sample survey of usage during a selected period. Such studies may be reviewed periodically to correct for changes taking place affecting the consumption.

6.3 ***The packing material cost of reusable packing shall be assigned to the cost object taking into account the number of times or the period over which it is expected to be reused.***

Certain packing materials are reusable. Assigning the cost of reusable packing material will depend on the number of times or period over which it is expected to be reused.

For example if the packing material costs ₹120 and it is expected to be reissued six times, the cost of reusable packing material to be assigned to the product will be taken to be ₹20.

Assuming further that, the returnable packing material (say container) is charged in the invoice and refunded for a part value of charged amount, when returned. If charged value for container is ₹75 and return credit is ₹40, ₹35 will be treated as recovery towards packing material cost. The Charge of ₹35 per returnable container is to be determined considering the number of times / period over which it is expected to be reused and the total recovery targeted over the entire period.

Another example is gas cylinder. These are returnable. Filled cylinders are supplied against a security deposit and user is charged rent. Cylinders are depreciated over its useful life and any repair and depreciation will form packing material cost.

While arriving at the cost of reusable packing material, the cost of freight and other costs attributable to activities associated to make the packing material reusable like minor repair cost, storage cost of these material, manpower dedicated for this activity shall identified and forms part of the packing material cost .

6.4 *Cost of primary packing materials shall form part of the cost of production.*

Primary packing material has been defined under paragraph 4.11 of the CAS-9. These materials are essential to hold the product and bring it to a condition in which it can be used by or sold to a customer. Primary packing materials are of various types and their use varies with industry to industry.

For example:

- Pharmaceutical industry: Insertions related to product, Foils for strips of tablets / capsules, vials.
- Industrial gases: Cylinders / bottles used for filling the gaseous products.

The cost of primary packing material used for a product shall form part of the cost of production.

6.5 *Cost of secondary packing materials shall form part of distribution overheads.*

Secondary Packing material has been defined under paragraph 4.11.6. These are:

(a) The packing material used for storing and transport from factory to customer / warehouse for further distribution to marketing agents.

For example

I. Cartons holding strips of tablets and card board boxes used for holding cartons;

II. cartons containing packs of biscuits

III. card board boxes for holding packed cloth

IV. Strips are primary packing material and will form cost of production and whereas carton and card board boxes used for strips of tablets shall form part of the distribution overheads as these are used for storing transporting. Similarly cartons for pack of biscuits, card boxes for packed cloth will form part of secondary packing material.

(b) fancy packing material to attract customers;

(c) Product literature to inform the customers etc.

As per the Companies (Cost Records and Audit) Rules, 2014 (Annexure 2 of the Part B to Form CRA-3) the cost of secondary packing materials is to be exhibited as a separate line item 26 in the Abridged Cost Statement.

The cost of secondary packing materials is generally to be treated as distribution overhead as these are used to make the product marketable.

Presentation

7.1 *Packing Materials shall be classified as primary and secondary and within this classification as purchased – indigenous, imported and self manufactured.*

This paragraph specifies categories under which Packing Material Cost is to be exhibited in the Cost statement viz. by type of packing material – Primary packing material and Secondary packing material. It further specifies classification of packing material cost on the basis of source of supply viz. indigenous, imported and self manufactured. These items are to be exhibited separately as illustrated in ***Annexure III***.

7.2 *Where separate cost statements are prepared for packing costs, the cost of packing materials consumed shall be presented in terms of type of packing in which the materials are used (For example; Bale, Bag, Carton, Pallet). Such statements shall also include cost and quantitative information, wherever it is found material and quantifiable.*

Separate cost statement for packing cost, if prepared, shall indicate the following details in regard to packing material:

S. No.	Item	Quantity (Nos.)	Rate	Amount	Cost Per unit
1	Packing material Cost				
1.A	Primary Packing Cost				
(i)	Primary packing material				
	Wrapper				
	Boxes				
(ii)	Others	500	1.00	500	
	(Such as gum, tape, string etc)......	50	5.00	250	
1.B	Secondary Packing cost				
	Secondary Packing Material				
	Card Box	5	20	100	
	Others				

It is advisable to provide previous year's figures against cost per unit. Type of packing used, i.e. strips, bottle, container, Bags, bale, Box, carton and the like is to be indicated.

Disclosures

8.1 The cost statements shall disclose the following:

8.1.1 ***The basis of valuation of Packing Materials.***

The standard provides various methods of valuation of issues of Packing material such as FIFO, LIFO and weighted average. Method adopted for valuation of packing material cost shall be disclosed in the cost statement.

For example:

Basis of valuation of packing material cost**:**

Periodic quarterly weighted average is used for pricing the issues of packing material.

8.1.2 ***Where Packing Materials Cost is disclosed at standard cost, the price and usage variances.***

In case issue of packing material is valued at standard cost, the cost statement shall disclose the standard cost and variance thereof.

8.1.3 ***The cost and price of Packing Materials received from / supplied to related parties.***

If any packing material is procured from or supplied to related parties, (as defined under the Companies Act 2013) name & address of the party, name of the packing material, nature of transaction, quantity, transfer price, amount, normal price and basis adopted for determining normal price are to be disclosed. The objective of disclosure is to ascertain that the transaction is at arm's length and on purely commercial terms.

For example:

Name and address of Related Party	XYZ Ltd (address)
Nature of transactions:	XYZ Ltd supplies packing bags
Volume of transaction:	During the year 500 HDPE bags were supplied @ ₹5 per bag for ₹2500
Normal Price:	₹5 per bag

Basis adopted for determining normal price: The above price is based on competitive quotes.

8.1.4 ***Packing Materials cost incurred in foreign exchange.***

Payment made in foreign exchange for importing packing material shall be indicated in the cost statement.

8.1.5 *Any Subsidy / Grant / Incentive and any such payment reduced from Packing Materials Costs.*

Any subsidy / grant / incentive received relating to packing material is to be reduced from the cost of packing material and disclosure made accordingly by way of a foot note.

The State Government has been subsidizing using of jute / paper bags in place of pvc bags for environmental reasons. Subsidy received and receivable are reduced from the cost of packing material.

8.1.6 *Credits/recoveries relating to the Packing Materials Costs.*

If any credit or recovery is considered while determining the cost of packing material, the same shall be disclosed in the cost statement e.g. sale of empties returned by customers.

8.1.7 *Any abnormal cost excluded from Packing Materials Costs.*

Abnormal cost is to be excluded from the cost of packing material as the same has not contributed to the packing cost of the cost object. Disclosure is to be made.

For example: During the year there was fire resulting in loss of packing material valued at ₹2.5 lakhs. The same has been excluded from the cost of packing material.

8.1.8 *Penalties and damages paid etc. excluded from Packing Materials Costs.*

Penalties and damages paid are not an item of cost as these are levied for non compliance with regulatory /contractual requirements. These are to be excluded from cost and disclosure made.

8.2 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the Packing Materials Costs during the period covered by the cost statement which has a material effect on the Packing Materials Cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

Cost Accounting principles, and methods applied for the measurement and assignment of cost of packing material are to be applied consistently between one period to subsequent period and uniformly applied for different packing material. If any change is made in these principles and methods which results in material effect on the cost of packing material, the same shall be disclosed in the cost statement or by a foot note. In case the impact of change in principles and methods of cost accounting is not ascertainable, the fact is to be disclosed by a foot note to the cost statements.

8.3 *Disclosures shall be made only where material, significant and quantifiable.*

Level of materiality and significance has not been stated in the standard. Material and significance of any information will be different from situation to situation. If material, the same is to be disclosed. The following criteria can be applied for determining the materiality. No one criterion is determinative in and of itself.

- The absolute amount – the larger the amount , the more likely that it is material
- The amount of cost of a cost object compared to the amount of packing material cost under consideration – the greater the proportion of the considered amount of packing material cost versus the cost of object, the more likely it is material.
- The relationship of repairs and maintenance cost with cost object.
- The cumulative impact of individually immaterial items - do they offset one another or do they accumulate in one direction (increase or decrease)
- The cost of determining the repairs and maintenance cost

8.4 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.*

Disclosure may be made in the body of cost statement or as a footnote. If there are many items of disclosure, the same may be included in schedule of notes to the cost statement.

ANNEXURE I
TYPE OF PACKING MATERIALS USED

Wood Boxes/crates	Cheapest and commonly available material. Exports are generally preferred in white or silver coloured wood. softwood can be used instead of hardwood, which is heavier,
Cardboard/corrugated boxes	These are usually made out of corrugated fiberboard. If more protection is needed, double-walled boxes can be used. Cardboard / corrugated boxes are cheaper to manufacture and easier to handle than the traditional wooden crates.
Different types of material used for packaging:	Aerosols, Bottles. Cans, Foils, Lids, Bottle Caps, Closures Packaging Bags, Packaging Boxes, Packing & Sealing Tapes , Plastic Packaging Materials, Tear Tapes Thermocol, Tin can, tin Containers, Jumbo Bags, Gunny Bags, polythene bags. Bulk Bags and Sacks, Packaging Bags, Laminated Bags and Zip Bags Lids, Bottle Caps, Closures, Corks & Packaging Seals Other Miscellaneous Packaging and Lamination Material Packaging & Lamination Films, Foils, Sheets, Rolls & Wrappers, Packaging Boxes, Crates, Cartons, Pallets & Trays, Packaging Pouches, Sachets, Envelopes and Zipper Pouches, Packaging Tubes, Cans, Bottles, Jars & Containers, Box, Case, Tray and Carton, Box boards, Linerboards, Corrugated & Bleached Boards.
Plastic	Plastic is the most frequently used type of packaging material because of its low cost and light weight. It can be manufactured in a variety of sizes and shapes, allowing users to make convenient packages for the user of a particular item.
Plastic films- Wrapping with stretch film.	These wraps are water proof, moisture proof, dust proof and transparent.
Wrapping with shrink film	Shrink wrap is commonly used on commercial products where tamper-protection is a high priority, such as CDs or DVDs. After the item is wrapped, heat is applied to make the wrap shrink to fit. Because it creates such a tight seal and keeps moisture out, shrink wrap can also be used to package perishable food items.
Bubble Wrap	Bubble wrap is common due to its effectiveness at protecting fragile items without adding significant weight or cost. For small items or those that require additional protection, the bubble wrap can simply be overlapped to provide several layers of cushioning.
Tissue Paper	Tissue paper is used inside a container to fill empty space so that the packed items do not shift in transit. Fragile contents like glass or porcelain are often wrapped in tissue paper before being placed inside another type of protective container for shipping.
Poly Bags, Tubes & Sheets	Poly Wrappers in custom Sizes & Thickness plastic wrappers, films and sheet
PVC- Polyvinyl chloride	Food trays, cling film, bottles for squash, mineral water and shampoo.

HDPE - High-density polyethylene	Bottles for milk and washing-up liquids.
Polyethylene terephthalate	Fizzy drink bottles and oven-ready meal trays.
LDPE - Low density polyethylene	Carrier bags and bin liners, plastic goods and toys.
PP - Polypropylene	Margarine tubs, microwaveable meal trays.
PS – Polystyrene	pots, trays, food boxes and egg cartons, vending cups, plastic cutlery, protective packaging
Adhesives, Glue, Barcodes, Stickers & Lable Sealants	Adhesive, Non-Adhesive & Pressure Sensitive Vacuum, Skin, Blister & Thermoform Packaging Banding & Bundling Material
Sticker	Labelling, Marking
Insertions	

Packing material may be classified as primary packing material or secondary packing material depending upon its use. But certain packing materials having a characteristics of primary packing material are classified as raw material based on industry practice .For example

Primary enclosure of:

- Sterile Injection
- Home carry pack of ice cream/shri kand
- Ink/colours for drawing

Repellent liquid for mosquitoes and the like.

ANNEXURE II

Details of packing materials used in different industries

Food Packaging	Bakery items, dairy products, confectionary, snacks, frozen items, ice creams- food packaging foils, food packaging laminates, flexible packaging foils, cookies packaging, cracker packaging, bread packaging material, chips packaging, chocolate packaging, wafer packaging, namkeen packaging, pastry packaging, toffee wrappers, lollipop wrappers, chewing gum wrappers, chocolate wrappers and many more.
Beverage Packaging	Beer, drinks, water bottle, juice, soft drinks bottles / can
Personal care cosmetic Packaging	Cosmetic, oral care, Toiletries, soap, shampoo, glass like clear polymer bottle / tubes / pouch etc
Pharmaceutical	Blister, Aluminium / cellophane / glassine paper foil for strip or blister packing of tablets / capsules, bottle (glass / plastic), closures, (metal / plastic / Rubber closures for vials) jars , tubes, aerosol etc
Heavy machinery packing	Wooden crates / boxes / pallets
Fertilizers, cement, sugar,	HDPE Bags
Paper/stationery	Wrapper, liner, strings, gum tape, wooden , bottle (for ink / gum), tubes, box for holding pens/pencils
Textiles	Yarn in hanks packed in burlap and bales; Yarn in cones packed in boxes/ bags; Cloth packed in bales; fancy cloth in wooden/cardboard cases/ boxes; Other packing material used are hessian ,cloth, paper board, polythene paper, lining paper, iron/plastic hooks, nails, sewing thread etc.

Annexure III
Illustration of Presentation of Packing Material

Item	Quantity (Unit)	Rate/Unit	Amount	Cost Per unit
Material Cost Employee cost Primary packing Cost a) Primary packing material • imported • indigenous b) Other expenses • Production Overhead				
Production cost (after adjustment of WIP)				
Secondary Packing Cost: Cartoons (indigenous) Card Boxes (imported)				
Selling Expenses				

ANNEXURE IV

(CAS 9)

COST ACCOUNTING STANDARD ON PACKING MATERIAL COST

The following is the COST ACCOUNTING STANDARD - (CAS - 9) issued by the Council of The Institute of Cost and Works Accountants of India on "PACKING MATERIAL COST", for comments. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the Packing Material Cost.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of Packing Material Cost, for determination of the cost of product, and the presentation and disclosure in cost statements.***

1.3 ***Packing Materials for the purpose of this standard are classified into primary and secondary packing materials.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the packing material cost with reasonable accuracy.

3. Scope

This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of Packing Material Cost including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.***[1]

1 Adapted from CAS 1 paragraph 6.5.19

For example: the cost of packing material which is rejected after issue due to abnormal causes such as misprinting, use of material of wrong specification etc. (net of realisable value) may be treated as abnormal cost.

4.2 Administrative Overheads: ***Cost of all activities relating to general management and administration of an organisation.*** Administrative overheads shall exclude any overhead relating to production, operations and marketing.

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.4 Direct Employee Cost: ***The cost of employees which can be attributed to a Cost Object in an economically feasible way.***[2]

4.5 Direct Expenses: ***Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material or direct employee cost***[3]***.*** Examples of Direct Expenses are royalties charged on production, job charges, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling Expenses for a specific job.

4.6 Direct Materials: ***Materials the costs of which can be attributed to a cost object.***[4]

4.7 Distribution Overheads: ***Distribution overheads, also known as Distribution Cost, are the costs incurred in handling a product from the time it is ready for despatch until it reaches the ultimate consumer.***[5]

For example:

- Secondary packing
- Transportation cost
- Warehousing cost
- Cost of delivering the products to customers etc.
- Clearing and forwarding charges
- Cost of mending or replacing packing materials at distribution point.

4.8 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[6]. The terms Finance costs and Borrowing costs are used interchangeably.

4.9 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[7]

For example: packing material supplied by the customer**.**

4.10 Marketing overheads: ***Marketing Overheads comprises selling overheads and distribution overheads.***

2 Adapted from CAS 7 paragraph 4.6
3 Adapted from CAS 1 paragraph 6.2.6 and also proposed in the CAS on Direct Expenses
4 Adapted from CAS 6 paragraph 4.6.1
5 Adapted from CAS 1 paragraph 6.3.9
6 Adapted from CIMA Terminology
7 Adapted from CAS 1 paragraph 6.5.13

4.11 Packing Materials: Materials used to hold, identify, describe, store, protect, display, transport, promote and make the product marketable and communicate with the consumer.

4.11.1 Defectives: ***Packing materials that do not meet quality standards. This may include reworks or rejects.***[8]

4.11.1.1 Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***[9]

Rework includes repairs, reconditioning and refurbishing.

4.11.1.2 Rejects: ***Defectives which can not meet the quality standards even after putting in additional resources.***[10]

Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

4.11.2 Packing Material Cost: The cost of material of any nature used for the purpose of packing of a product.

4.11.3 Primary Packing Material: Packing material which is essential to hold the product and bring it to a condition in which it can be used by or sold to a customer.

For example:

- Pharmaceutical industry: Insertions related to product, Foils for strips of tablets/capsules, vials.
- Industrial gases: Cylinders / bottles used for filling the gaseous products
- Confectionary Industry: Butter paper and wrappers.

4.11.4 Reusable Packing Material: ***Packing materials that are used more than once to pack the product.***

4.11.5 Scrap: ***Discarded packing material having some value in a few cases and which is usually either disposed of without further treatment or reintroduced into the production of packing material.***[11]

4.11.6 Secondary Packing Material: ***Packing material that enables to store, transport, inform the customer, promote and otherwise make the product marketable.***

For example:

- Pharmaceutical industry: Cartons used for holding strips of tablets and card board boxes used for holding cartons.
- Textile industry: Card board boxes used for holding cones on which yarn is woven.
- Confectionary Industry: Jars for holding wrapped chocolates, Cartons containing packs of biscuits.

4.12 Packing Material Development Cost: ***Cost of evaluation of packing material such as pilot test, field test, consumer research, feed back, and final evaluation cost.***

4.13 Production overheads: ***Indirect costs involved in the production process or in rendering service***[12]**.**

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably. Production overheads shall include administration cost relating to production, factory, works or manufacturing.

4.14 Selling Overheads: ***Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***[13]

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8 Adapted from CAS 6 paragraph 4.4
9 Adapted from CAS 6 paragraph 4.4.1
10 Adapted from CAS 6 paragraph 4.4.2
11 Adapted from paragraph 4.9 of CAS 6
12 Adapted from CAS-1 paragraph 6.3.3 and 6.3.4
13 Adapted from CAS 1 paragraph 6.3.7

4.15 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***[14]

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

5. Principles of Measurement

5.1 Principle of valuation of receipts of packing material:

5.1.1 ***The packing material receipts should be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified at the time of acquisition.***

Examples of taxes and duties to be deducted from cost are CENVAT credits, credit for countervailing customs duty, sales tax set off/ vat credits and other similar items of credit recovered/ recoverable.

5.1.2 ***Finance costs directly incurred in connection with the acquisition of Packing Material shall not form part of Packing Material Cost.***

5.1.3 ***Self manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads including share of administrative overheads comprising factory management and administration and share of research and development cost incurred for development and improvement of existing process or product.***

5.1.4 ***The valuation of captive consumption of packing materials shall be in accordance with paragraph 5 of Cost Accounting Standard 4.***

5.1.5 ***Normal loss or spoilage of packing material prior to receipt in the factory shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.***

5.1.6 ***The forex component of imported packing material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the packing material cost.***

Explanation: The date on which a transaction (whether for goods or services) is recognised in accounting in conformity with generally accepted accounting principles.

5.1.7 ***Any demurrage, detention charges or penalty levied by the transport agency or any authority shall not form part of the cost of packing materials.***

5.1.8 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to packing material shall be reduced for ascertainment of the cost to which such amounts are related.***

5.2. Principle of valuation of issue of packing material

Issues shall be valued using appropriate assumptions on cost flow.

For example: First In First Out, Last In First Out, Weighted Average Rate.

The method of valuation shall be followed on a consistent basis.

5.3 ***Wherever, packing material costs include transportation costs, determination of costs of transportation shall be governed by CAS 5 – Cost Accounting Standard on determination of average (equalized) cost of transportation.***

5.4 ***Packing Material Costs shall not include imputed costs. However in case of Cost of Production of Excisable Goods for Captive Consumption the computation of cost shall be as per CAS 4.***

5.5 ***Where packing materials are accounted at standard cost, the price variances related to such materials shall be treated as part of packing material cost and the portion of usage variances due to normal reasons shall be treated as part of packing material cost. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.***

14 Adapted from CAS 6 paragraph 4.15

5.6 *The normal loss arising from the issue or consumption of packing materials shall be included in the packing materials cost.*

5.7 *Any abnormal cost where it is material and quantifiable shall be excluded from the packing material cost.*

5.8 *The credits/recoveries in the nature of normal scrap arising from packing materials if any, should be deducted from the total cost of packing materials to arrive at the net cost of packing materials.*

6. Assignment of Cost

6.1 Assignment of packing material costs to cost objects: *Packing material costs shall be directly traced to a cost object to the extent it is economically feasible.*

6.2 *Where the packing material costs are not directly traceable to the cost object, these may be assigned on the basis of quantity consumed or similar measures like technical estimates.*

6.3 *The packing material cost of reusable packing shall be assigned to the cost object taking into account the number of times or the period over which it is expected to be reused.*

6.4 *Cost of primary packing materials shall form part of the cost of production.*

6.5 *Cost of secondary packing materials shall form part of distribution overheads.*

7. Presentation

7.1 *Packing Materials shall be classified as primary and secondary and within this classification as purchased – indigenous, imported and self manufactured.*

7.2 *Where separate cost statements are prepared for packing costs, the cost of packing materials consumed shall be presented in terms of type of packing in which the materials are used (For example; Bale, Bag, Carton, Pallet). Such statements shall also include cost and quantitative information, wherever it is found material and quantifiable.*

8. Disclosures

8.1 *The cost statements shall disclose the following:*

1. *The basis of valuation of Packing Materials.*
2. *Where Packing Materials Cost is disclosed at standard cost, the price and usage variances.*
3. *The cost and price of Packing Materials received from/supplied to related parties*[15].
4. *Packing Materials cost incurred in foreign exchange.*
5. *Any Subsidy/Grant/Incentive and any such payment reduced from Packing Materials Costs.*
6. *Credits/recoveries relating to the Packing Materials Costs.*
7. *Any abnormal cost excluded from Packing Materials Costs.*
8. *Penalties and damages paid etc. excluded from Packing Materials Costs.*

8.2 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the Packing Materials Costs during the period covered by the cost statement which has a material effect on the Packing Materials Cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

8.3 *Disclosures shall be made only where material, significant and quantifiable.*

8.4 *Disclosures shall be made in the body of the Cost Statement or as, a foot note or as a separate schedule.*

Disclaimer

There are some provisions though spelt under the Companies Act, 2013, but not yet notified/enforced "till date of publication of this Study Material". Hence, for such provisions, the relevant and corresponding Sections/Provisions of the Companies Act, 1956 is applicable. All concerned are requested to follow both – the MCA, GOI website as well as Clarification/Circular issued/to be issued by the Institute from time to time – on applicability of sections of Companies Act for CMA Examinations.

15 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

2.7 GUIDANCE NOTE ON COST ACCOUNTING STANDARD ON ADMINISTRATIVE OVERHEADS (CAS-11)

The Council of the Institute of Cost Accountants of India has issued the Cost Accounting Standard - 11 (CAS-11) on Administrative Overheads which lays down a set of principles and methods of classification, measurement and assignment of Administrative Overheads for determination of the cost of product or service and the presentation and disclosure in the cost statements.

The Guidance Note deals with principles and methods as provided in the CAS-11 and practical aspects in connection with the determination of Administrative Overheads for a product or service.

In the preparation of cost statement including those requiring attestation, Administrative Overheads should be determined as per CAS-11. The Cost Accounting Standards have been set in **bold Italic** type and reference number of the standard has been retained.

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 state that for the purposes of sub-section (1) of section 148 of the Act, the class of companies, including foreign companies defined in clause (42) of section 2 of the Act engaged in the production of the goods or providing services, specified in the Table below, having an overall turnover from all its products and services of rupees **thirty five crore or more** during the immediately preceding financial year, shall include cost records for such products or services in their books of account.

Rule 4(a) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (A) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **fifty crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **twenty five crore or more**.

Rule 4(b) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (B) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **one hundred crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **thirty five crore or more**.

Introduction

Administrative Overheads have been defined by the CAS-11 as the cost of all activities relating to general management and administration of an entity. These costs generally represent amounts incurred at Head office / Corporate office relating to administration and policy matters of the company. Administrative Overheads are the cost of all activities relating to general management and administration of an entity**.** These are the total costs of formulating the policy, directing the organisation and controlling the operations of an entity.

Administrative Overheads exclude production overheads, marketing overheads and finance cost. Production overheads include administration cost relating to production, factory, works or manufacturing. Such costs are in the nature of administrative support to functions connected with the production e.g. Purchase, factory accounts, factory administration etc.

Administrative cost on the other hand represent costs incurred in connection with the management of affairs of the entity such as Policy making, Finance, Human resources and the like.

For example:

Indirect materials - printing and stationery; office supplies;

Indirect employee costs - Salaries of administrative directors, secretaries, accounts department and so on;

Indirect expenses – rent, rates and taxes, insurance, legal charges, audit fee and the like. These include the costs of the concerned departments as well as the Head Office and other administration costs as detailed below:

A. Administrative Overheads generally include the expenses of following departments:

- General Administration
- Human Resources
- Finance and Accounts
- Cost Accounts
- Internal Audit
- Secretarial
- Law and Taxation
- Information Technology
- Security

Administrative costs include all executive, organizational, and clerical costs associated with general management of an organization rather than with manufacturing, marketing, or selling. For examples administrative costs include executive compensation, secretarial salaries, general accounting, public relations, and similar costs involved in the overall, general administration of the organization as a whole.

Other Administrative Expenses:

Printing and stationery

Travelling & Local Conveyance

Membership fee

Computer maintenance expenses for administration

Vehicle maintenance expenses and the like for administration.

A detailed list of other administrative expenses is at **Annexure 1**

B. Corporate Office Expenses:

Board of Directors:

- Directors' sitting fees, remuneration and commission;
- Directors' travelling expenses;
- Meeting and other board expenses.

Other Management Expenses:

1. Administration - Salaries and fringe benefits of general and administrative personnel. For example salaries of managers, and other employees in the administrative functions of the company. Rent, rates and taxes, travelling and other administrative expenses;
2. Cost information should be collected and analyzed systematically and consistently, whether for a routine information system, or for a specific application and / or purpose. In the preparation of cost statement and its attestation, if required, Administrative Overheads relating to a product / service should be determined with reference to CAS-11.

Definitions

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and / or due to some abnormal situation of the production or operation.***

4.2 Absorption of overheads: ***Absorption of overheads is charging of overheads to Cost Objects by means of appropriate absorption rate.***

4.3 Administrative Overheads: ***Cost of all activities relating to general management and administration of an organisation.***

4.4 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.5 ***Finance Costs: Costs incurred by an enterprise in connection with the borrowing of funds.***

4.6 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***

4.7 Normal capacity: ***Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.***

4.8 Overheads: ***Overheads comprise of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object.***

Principles of Measurement

5.1 ***Administrative*** **overheads** ***shall be the aggregate of cost of resources consumed in activities relating to general management and administration of an organisation.***

Administrative Overheads is the cost of all activities relating to general management and administration of an organisation. It is represented by cost of shared services, infrastructure cost and general management cost. Resources consumed are in terms of employee costs, utilities, office supplies, legal expenses and outside services. The measurement of these resources consumed is to be determined in terms of relevant cost accounting standards.

CAS-6 lays down the principles with regard to the valuation of receipts of material. Therefore receipt of indirect materials should be valued at purchase price including duties and taxes, freight inwards, insurance and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities) that can be quantified with reasonable accuracy at the time of acquisition.

The consumption of indirect material is to be valued at issue rate adopted i.e. First in First out, Last in First out, Weighted Average. Such basis should be followed consistently.

Indirect employee cost is to be measured in terms of CAS-7 (Employee cost). Employee cost relating to administrative staff should be the gross pay and allowances payable. It should take into account the employee's salary including all allowances and other benefits, such as Employer's contribution to EPF, FPS, ESIS, Holiday Pay, Gratuity Payable, Bonus and so on. Remuneration paid to Officers, Managers and Executive Directors of an entity - engaged in administrative function should cover fixed salary, PF contribution, leave, superannuation and severance payment, other benefits, and the like. It should also include any amount paid as commission based on percentage of profit. Other benefits include free furnished accommodation, house rent allowance, leave travel concession, reimbursement of medical expenses for self and family. Personal accident insurance, fully maintained company's car with driver, gardener, watchmen and the like. These should form part of employee cost. Remuneration paid to non-executive directors should be treated as Administrative Overheads.

Utilities consumed by administrative cost centres are to be collected and measured in accordance with principles laid down by CAS-8. Repair and maintenance cost should be measured in accordance with principles laid down by CAS -12.

5.2 ***In case of leased assets, if the lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a financial lease, the finance cost portion shall be segregated and treated as part of finance costs.***

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. Leases are of two types viz Finance lease and Operating lease. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Whereas an operating lease is a lease other than a finance lease. The basic concept of lease accounting is that operating lease is merely rental, whereas financial is a disguised purchase.

Lease Rentals in respect of assets taken on 'Operating Lease' for administrative activities should be included under Administrative Overheads. Payments under an operating lease will be recognised by the lessee as an expense over the lease term. Lease rentals for assets acquired under Financial Lease should be segregated between the cost component of asset and interest component by applying an implicit rate of return. Interest component should form part of the Finance Cost and should not be included under Administrative Overheads.

5.3 ***The cost of software (developed in house, purchased, licensed or customised), including up-gradation cost shall be amortised over its estimated useful life.***

Software may be either developed in house, purchased**,** licensed or customised. Where software is included in the purchase price of hardware (For example operating system software) and the cost of the software cannot be easily calculated, the software should be capitalized and amortized as part of hardware. In case of licensed software, if one-off licensing fee is paid during the period in order to use the software which has acquired service potential or future economic benefits relating to that software, such cost of license fee should be capitalized as part of the software and amortised over its useful life. In case licensing fee is not a one-off (For example a yearly licensing fee which covers maintenance and upgrades automatically provided by the vendor) service potential or future economic benefits obtained will normally expire when the next payment is due and should not be capitalized and charged during the period. In house developed software, as soon as it is put to use, should be capitalized and amortized over its useful life.

5.4 ***The cost of administrative services procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited.***

Various types of services related to administration may be procured from outside, such as legal consultancy, management consultancy, internal audit, and so on. In such cases determination of cost of administrative services procured from outside should be as per agreed price / invoice. It should include duties and taxes and other expenditure. These are to be net of any discount, rebate, taxes and duties refundable, if any.

5.5 ***Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable with respect to any Administrative overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.***

Subsidy and grant received / receivable should be recognized on a systematic basis. These should be matched with the related cost for which these are intended to compensate over the period.

For example:

Subsidy may be receivable for any social service, such as crèche, schooling, community centre and the like. Subsidy receivable for this purpose may be reduced from the cost of such services, while ascertaining the cost of the administrative overheads.

5.6 Administrative overheads shall not include any abnormal administrative cost.

Abnormal cost has been defined under paragraph 4.1 of CAS - 11. The rationale of exclusion is that inclusion of such items in the cost will make the cost not comparable with a normal situation. Such an aberration is avoided to understand the cost in a better perspective for any purpose. For determining the abnormal cost following two conditions should be satisfied:

(a) Costs were never envisaged; and

(b) They are not likely to recur during an accounting period.

For example:

- Abnormal administrative cost resulting from natural calamity (flood, earthquake, and the like).
- Sudden breakdown/ loss due to major fire accident.

It should not form part of the administrative overheads and should be dealt with in the costing profit and loss account.

5.7 Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the administrative overheads.

Fines, Penalties, damages and the like are levied by the statutory authorities for non-compliance with statutory requirements or delays. These are abnormal cost and should not form part of Administrative Overheads.

For example:

- Penalty for delay in depositing Provident Fund contribution with the Provident Fund Authorities.
- Penalties for non-payment of statutory dues / noncompliance with legal requirement for example not filing certain statutory returns in time.

5.8 ***Credits / recoveries relating to the administrative overheads including those rendered without any consideration, material and quantifiable, shall be deducted to arrive at the net administrative overheads.***

If any administrative services are provided to other activity / unit without any consideration, the cost of the same, if material and quantifiable, should be determined and adjusted against the Administrative Overhead.

For example management consultancy services provided to other unit, the cost of the same should be adjusted against the administrative overheads

5.9***Any change in the cost accounting principles applied for the measurement of the administrative overheads should be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

Resources consumed in the administrative overheads are indirect material, indirect employees cost, utilities and other similar items. These are represented in the form of shared services, infrastructure cost and general management cost. Principles applied for measurement of these resources are to be as per relevant cost accounting standard and are to be followed consistently. However, change in principle of measurement of Administrative Overheads should be applied if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an entity.

For example profit sharing bonus paid to employees was not earlier treated as employee cost. But as per the CAS - 7, profit sharing bonus now forms part of employee cost. It is to be measured as per requirement of Bonus Act and CAS - 7. If there is any change in computation of bonus, its measurement has to comply with required changes.

Assignment of Cost

6.1 ***While assigning administrative overheads, traceability to a cost object in an economically feasible manner shall be the guiding principle.***

Once administrative overheads have been accumulated and measured, these are to be assigned to a cost object. Cost Object is a logical sub-unit for collection of cost. Cost Object may be classified in different ways like function-wise and nature-wise. Thus cost object may be any customer, product service, contract, project, activity or other work unit for which a separate cost measurement is desired.

For assigning the administrative overheads, traceability is a key element. Tracing administrative overheads to cost objects can occur by way of:

1. Direct tracing;
2. Driver tracing; and
3. Allocation.

Direct tracing is the process of identifying and assigning cost that is specifically or physically associated with cost object. For example, tracing cost of stationery consumed in the accounts department to a cost object i.e. accounts department. Drivers tracing may be through cost activities viz. units manufactured, hours worked, number of batches in production, number of orders processed, number of departments, and so on.

The method of direct cost tracing usually relies on the observation, counting, and/or recording of the consumption of resource units, such as staff hours or days that are spent on or assignment, or gallons of fuel consumed in a transport trip. Direct tracing also applies to specific resources that are dedicated to particular outputs.

Direct cost tracing often minimizes distortion and ensures accuracy in cost assignments. It shall be applied only to items that account for a substantial portion of the cost of an output and only when it is economically feasible. For example, it is usually unnecessary to trace the cost of office supplies (pens, papers, computer disks, etc.) to various activities or outputs.

The tracing of such costs directly usually outweighs the benefit of the increased accuracy in assigning the resources.

It is often not possible to physically observe the exact amount of resources consumed by a cost object, especially in case of administrative overhead, being an indirect cost. In case of indirect cost there is no relationship between the cost and cost object and tracing is not economically feasible.

The following steps are to be followed when tracing the administrative cost:

1. Identify the activities that cause the administrative costs,
2. Measure the cost of those activities; and
3. Assign the cost of the activities to those products and customers.

Various items of administration overheads are first collected according to nature of expenditure. These are arranged according to department or function. This is the method of primary distribution. The expenses which are capable of being identified with a specific department are directly assigned. The expenses which cannot be assigned directly to specific departments are assigned on suitable basis. Examples of direct identifying with department or functions are:

General Office	
Secretariat	
Finance and Accounts	
Human Resources	
Legal	
Following are the bases used for assignment of administrative expenses:	
Expenses	***Bases***
Office rent, rates and taxes	Floor area
Depreciation of office building	Floor area
Legal expenses	Number of cases handled / time basis for consultancy
Salaries and allowances	Number of employees

In brief, administrative costs shall be assigned on a reasonable and consistent basis. Directly tracing costs might be a preferred approach when economically feasible. Assigning costs on a cause-and-effect basis shall be considered for costs that cannot be directly traced to outputs. This issue therefore requires a judgment taking into account facts and circumstances of each case.

6.2 ***Assignment of administrative overheads to the cost objects shall be based on either of the following two principles;***

1) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost.

2) Benefits received – overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

A cost is assignable or chargeable to one or more cost objects on the basis of relative benefits received or other equitable relationship. Assigning of costs shall be done on a reasonable and consistent basis. Testing reasonableness shall take into account the purpose of the cost information and the economic feasibility of collecting and assigning it. Following criterion shall be considered:

Assigning costs on a cause-and-effect basis shall be considered for costs that cannot be directly traced to outputs.

For example: A computer technology department provides technical support to other departments of an organization. The costs of the department may be assigned to other departments on a cause-and effect basis through two steps. In the first step, the costs are assigned to the activities of the department, such as hardware installation and maintenance, software development and installation, or programming adjustments. In the second step, the costs of these activities are further assigned to other departments based on their usage of the technical services.

Assigning Cost - Benefit received:

Standard provides for assigning of Administrative Overheads to the various cost objects in proportion to the benefits received by them. Benefits received when measurable and traceable, provide guidance for assignment. The beneficiaries of the output of the cost pool shall be identified and costs allocated in proportion to the benefits received. Benefits received shall be interpreted as meaning the receiving of services or goods by the activity represented by the cost objects to which the costs are being assigned.

For example: A corporate wide advertising programme promotes the general image of corporation rather than an individual product. The costs of such programme may be allocated on the basis of division sales in the belief that divisions with higher sales levels are more likely to benefit than divisions with lower sales levels.

Presentation

7.1 ***Administrative overheads shall be presented as a separate cost head in the cost statement.***

7.2 Element wise details of the administrative overheads based on materiality shall be presented.

Administrative overheads are required to be presented as a separate head in the cost statement. Element wise details of administrative overheads are to be indicated in the cost statement if these are material. What is considered material or immaterial depends on the facts of each case. The materiality of a particular cost is important in classifying costs. The less significant a cost, the less likely will it need to be traced to a cost object. An example as to how administrative overheads can be reflected in a cost statement is given in **Annexure II**.

Disclosures

8.1 The cost statements shall disclose the following:

- ***The basis of assignment of administrative overheads to the cost objects.***

  Disclosure is to ensure the consistency and compliance of requirement of Cost Accounting standards. Disclosure is to be made relating to the basis of assignment of administrative overheads adopted for cost objects / units in the cost statement or by way of foot note.

- ***Any imputed cost included as a part of administrative overheads.***

  Imputed cost does not form part of the cost as it does not involve any cash outlay. However, if any imputed cost has been included in the administrative overheads, the same shall be disclosed.

For example: Rent of ₹ Two Lakh for owned office building may have been included in Administrative Overhead.

- ***Administrative overheads incurred in foreign exchange.***

  Payment made in foreign exchange for Administrative Overhead relating to import of any office equipment / consultancy / foreign travelling shall be disclosed in the cost statement.

- ***Cost of administrative activities received from or supplied to related parties.***

  If any administrative service has been procured from or supplied to related parties (as defined under The Companies Act, 2013), its relationship, nature of transaction viz. quantity, rate, other terms / conditions are to be disclosed. The objective of disclosure is to ascertain that the transaction is at arm's length and on purely commercial terms. *For example:*

  Related party → A B C Ltd

  Nature of relationship → We and our subsidiaries own 51 percent of their Equity.

  Nature of transactions: Hiring of office premises.

  Office premises measuring 15000 sq ft has been hired from ABC Ltd @ ₹ 1500 per sq ft. The rate is a market prevailing rate for such premises and transaction is at arm's length. Related party disclosure is to be made.

- ***Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable reduced from administrative overheads.***

  Any subsidy / grant / incentive or any amount of similar nature received or receivable relating to Administrative Overheads is to be reduced from the Administrative overheads.

  For example for setting up school in township / adopting any social activity, subsidy/grant received is to be disclosed.

- ***Credits / recoveries relating to the administrative overheads.***

  If any credit or recovery is considered while determining the administrative overheads the same shall be disclosed.

  For Example: certain administrative services were provided during the year to an Associate/Group entity unit, a sum of ₹ 15 lakh received has been credited to the Administrative Overheads.

- ***Any abnormal portion of the administrative overheads.***

  Abnormal portion of administrative overhead in the cost of cost object is to be excluded as the same has not contributed to the cost object. Disclosure is to be made.

  For example: During the year there was fire resulting in loss of office equipment, furniture and fixtures of ₹ 9 lakh. The same has been excluded from the administrative overheads.

- ***Penalties and damages excluded from the administrative overheads.***

  Penalties and damages paid are not an item of cost as these are levied for non compliance with regulatory / contractual requirements. These are to be excluded from cost and disclosure made.

8.2 *Disclosures shall be made only where material, significant and quantifiable.*

Level of materiality and significance has not been stated in the standard. Materiality is to be judged in terms of quantity and nature of cost element and in particular context of its omission. A piece of information is material, if its non disclosure could influence the decision of a user.

Materiality and significance of any information will be different from situation to situation. If material, the same is to be disclosed.

8.3 Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.

Disclosure in the body of cost statement will depend on nature and materiality of Administrative Overheads. If it forms material part of the Administrative Overheads and can be identified with a cost object the same shall be disclosed in the cost statement otherwise, disclosures may be made either in the body of the Cost Statement or by way of foot note.

8.4 Any change in the cost accounting principles and methods applied for the measurement and assignment of the administrative overheads during the period covered by the cost statement which has a material effect on the administrative overheads shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.

Cost Accounting principles, and methods applied for the measurement and assignment of Administrative Overheads are to be applied consistently between one period and another and uniformly applied for different elements of Administrative Overheads. If any change is made in these principles and methods which results in material effect on the cost of product, the same shall be disclosed in the cost statement. In case the impact of change in principles and methods of cost accounting is not ascertainable, the fact is to be disclosed by a note to the cost statements.

For example Head Office (General Management) expenses were being assigned to various units on the basis of turnover. During the current year the general management expenses have been assigned on a composite ratio which takes into account turnover, capital employed, gross profit, employee cost of units. Previous year’s figure is not on comparable basis.

Annexure I

List of other administrative expenses:

i. General Charges;

ii. Casual labour;

iii. Licence fees;

iv. Insurance expenses;

v. Training expenses;

vi. Printing of the Annual Report;

vii. Telephone;

viii. Bank charges;

ix. Printing and stationery;

x. Vehicle maintenance expenses;

xi. Travelling and local conveyance for staff;

xii. Water charges;

xiii. Electricity charges;

xiv. Subscription and membership fee;

xv. Books and periodicals;

xvi. Inspection fees;

xvii. Computer maintenance expenses;

xviii. Gas charges;

xix. Cleaning and plant watering;

xx. Advertisement (related to recruitment);

xxi. Stipend and trainee expenses;

xxii. Gifts and presents;

xxiii. Depreciation and repair & maintenance of administrative fixed assets(machines and furniture located in HO; and

xxiv. Other miscellaneous expenses, such as Reception; Company party to celebrate functions.

Annexure II

COST STATEMENT OF PRODUCT

ELEMENTS OF ADMINISTRATIVE OVERHEADS

(as at serial no.9 of the Cost Statement)

For the period/year ending ---------

S.No.	Item	Unit	Quantity	Rate	Amount	Cost per unit
1.	Material cost					
1(a)	Indigenous – I. Purchases II. Self manufactured					
1(b)	Imported					
2.	Other materials					
3.	Total Material cost					
4.	Utilities – Power Steam Water etc.					
5.	Employee cost					
6.	Direct expenses: Royalty Others(specify)					
7	Production Overhead					
8	Adjustment for opening/closing WIP					
9	Cost of Production					
10	Increase/decrease in Finished Goods					
11	Cost of production of goods sold					
12	ADMINISTRATIVE OVERHEADS Employees cost Repairs and Maintenance Depreciation Others Total					
13	Selling and Distribution					
14	Interest and Financing charges					
15	Cost of sales					
16	Net sales realization					
17	Margin (Profit /loss)					

Annexure III

CAS - 11

COST ACCOUNTING STANDARD ON ADMINISTRATIVE OVERHEADS

The following is the COST ACCOUNTING STANDARD – (CAS-11) issued by the Council of The Institute of Cost and Works Accountants of India on "ADMINISTRATIVE OVERHEADS". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1. This standard deals with the principles and methods of determining the administrative overheads.

1.2 This standard deals with the principles and methods of classification, measurement and assignment of administrative overheads, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the administrative overheads with reasonable accuracy.

3. Scope

This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of administrative overheads including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.[1]

4.2 Absorption of overheads: ***Absorption of overheads is charging of overheads to Cost Objects by means of appropriate absorption rate.***[2]

Overhead Absorption Rate = Overheads of the Cost object / Quantum of base.

4.3 Administrative Overheads: ***Cost of all activities relating to general management and administration of an organisation.***

Administrative overheads shall exclude production overheads[3], marketing overheads[4] and finance cost. Production overheads includes administration cost relating to production, factory, works or manufacturing.

4.4 Cost Object: This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.

4.5 Finance Costs: Costs incurred by an enterprise in connection with the borrowing of funds. This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[5]. The terms Finance costs and Borrowing costs are used interchangeably.

1 Adapted from CAS 1 Para 6.5.19
2 Adapted from CAS 3 Para 4.6
3 Paragraph reference 4.13 CAS -9
4 Paragraph reference 4.11 CAS -7
5 Adapted from CIMA Terminology

4.6 Imputed Costs: Hypothetical or notional costs, not involving cash outlay, computed for any purpose.[6]

4.7 Normal capacity: Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.[7]

4.8 Overheads: Overheads comprise of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object.[8]

5. Principles of Measurement

5.1 Administrative overheads shall be the aggregate of cost of resources consumed in activities relating to general management and administration of an organisation.

It usually represents the cost of shared services, cost of infrastructure and general management costs. Administrative overheads comprise items such as employee costs, utilities, office supplies, legal expenses and outside services. The principles of measurement of Material Cost, Employee Costs, Utilities, Repairs and Maintenance and Depreciation found in the respective standards will apply to these elements included in administrative overheads.

5.2 In case of leased assets, if the lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a financial lease, the finance cost portion shall be segregated and treated as part of finance costs.

5.3 The cost of software (developed in house, purchased, licensed or customised), including up-gradation cost shall be amortised over its estimated useful life.

When hardware requires up-gradation along with software up-gradation, it is recommended that compatible estimated lives be used for the two sets of cost.

5.4 The cost of administrative services procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited.

5.5 Any Subsidy/Grant/Incentive or any amount of similar nature received/receivable with respect to any Administrative overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

5.6 *Administrative overheads shall not include any abnormal administrative cost.*

Example: Expense incurred in a situation of natural calamity.

5.7 Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the administrative overheads.

5.8 Credits/ recoveries relating to the administrative overheads including those rendered without any consideration, material and quantifiable, shall be deducted to arrive at the net administrative overheads.

5.9 Any change in the cost accounting principles applied for the measurement of the administrative overheads should be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.

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6 Adapted from CAS 1 Para 6.5.13

7 Adapted from CAS 2 Para 4.4

8 Adapted from CAS 3 Para 4.1

6. Assignment of Cost

6.1 While assigning administrative overheads, traceability to a cost object in an economically feasible manner shall be the guiding principle.

6.2 Assignment of administrative overheads to the cost objects shall be based on either of the following two principles;

(i) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost.

(ii) Benefits received – overheads are to be apportioned to the various cost objects in proportion to the benefits received by them[9].

The costs of shared services should be assigned to user activities on the basis of actual usage.

Where the resources by way of infrastructure are shared the cost should be assigned on a readiness to serve basis.

General management costs should be assigned on rational basis.

For example: Number of employees, turnover, investment size etc.

7. Presentation

7.1 Administrative overheads shall be presented as a separate cost head in the cost statement.

7.2 Element wise details of the administrative overheads based on materiality shall be presented.

8. Disclosures

8.1 The cost statements shall disclose the following:

- ***The basis of assignment of administrative overheads to the cost objects.***
- ***Any imputed cost included as a part of administrative overheads.***
- ***Administrative overheads incurred in foreign exchange.***
- ***Cost of administrative activities received from or supplied to related parties[10].***
- ***Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable reduced from administrative overheads.***
- ***Credits / recoveries relating to the administrative overheads.***
- ***Any abnormal portion of the administrative overheads.***
- ***Penalties and damages excluded from the administrative overheads.***

8.2 Disclosures shall be made only where material, significant and quantifiable.

8.3 Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.

8.4 Any change in the cost accounting principles and methods applied for the measurement and assignment of the administrative overheads during the period covered by the cost statement which has a material effect on the administrative overheads shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.

9 Adapted from of CAS 3 Para 5.1

10 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

Study Note - 3
GACAP & COST ACCOUNTING STANDARDS

This Study Note includes

3.1 Generally Accepted Cost Accounting Principles (GACAP)
3.2 Cost Accounting Standards
3.3 Glossary of Terms used in Cost Accounting Standards

3.1 GENERALLY ACCEPTED COST ACCTOUNTING PRINCIPLES (GACAP)

1. Introduction

The compilation of Generally Accepted Cost Accounting Principles (GACAP) by the Institute of Cost and Accountants of India is a unique effort to record principles and practices in the discipline of Cost Accountancy in India, which takes into consideration the global practices as well. There have been compilations of financial accounting principles such as Paul Grady's work. ("Inventory of generally accepted accounting principles", American Institute of Certified Public Accountants, New York, 1961). While cost data is being used by various stakeholders, the focus has been more on management use. The absence of institutionalization of external cost reporting might explain this lacuna in theory. The Cost Accounting Standards issued by the Cost Accounting Standards Board in the United States is the nearest to such compilation though this is in the context of Defence Contract Costing.

The formalization of Cost Accounting Principles in use in India started acquiring a more cohesive form in the regime of administered prices ushered in the 1950 through the work of Tariff Commission mandated to fix tariffs and prices in a variety of industries. The movement acquired further fillip through the work of other statutory price-fixing authorities including the Bureau of Industrial Costs and Prices, Cost Accounts Branch of Ministry of Finance. Since the price enquiries by these bodies covered a wide range of industries, industry specific practices started unifying into a common body of cost accounting principles.

The introduction of the regulated and non-regulated sector wise Companies (Cost Records and Audit) Rules, 2014 further strengthened the evolution of a uniform body of cost accounting principles. Even though intended to prescribe the Cost Accounting records to be maintained by various industries, the Rules carried nuggets of Cost Accounting principles in the body of the Rules and in footnotes to format of prescribed cost statements. When some of these got repeated in the Rules prescribed for different industries, it helped towards the evolution of a generally accepted set of cost accounting principles. Thus the Rules contained directions on valuation of purchased materials (all direct costs upto the works), the treatment of major repairs (to be prorated over the period of benefit derived by such repairs), the costing of transfers of raw materials from own farms (sugar cane at government controlled price) and the like. It, however, cannot be denied that the Rules framed from time to time did have certain contradictions – for example, the valuation of sugarcane from own farm to be valued at market price and valuation of wood from own forest to be valued at cost – but the Companies (Cost Records and Audit) Rules, 2014 did play a major role in unifying cost accounting principles as applied to various industries.

Similarly the regulatory agencies in charge of individual industries, particularly Fertilizer Industry Co-ordination Committee, Drug Price Control Authority, Central Electricity Regulatory Commission and Telecom Regulatory Authority of India, all played a role in evolving a more consistent set of cost accounting principles.

The Companies (Cost Records and Audit) Rules, 2014 did not lay down any cost accounting principles as such but by requiring disclosure of principles and methods used, it focused attention on them.

The requirement for determination of cost of production of manufactured goods used for captive consumption further focussed attention on the subject of GACAP. According to the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000, the assessable value of goods used for captive consumption is 110% of cost of production of such goods and as may be prescribed by the Government from time to time. The cost accounting principles for determination of cost of production were also well established. Their codification and standardization in a single document viz. Cost Accounting Standard 4 (CAS 4) issued on January 3, 2003 became a landmark event. The standard contains a format for reporting the cost of production of products manufactured for captive consumption. The Certificate for the cost statement carried a reference to the basis being *"Generally Accepted Cost Accounting Principles and Practices"*. Thus was born the phrase forming the title of this document.

The Expert Group constituted by the Ministry of Corporate Affairs under the Chairmanship of **Mr. B.B. Goyal, Advisor(Cost), Ministry of Corporate Affairs, Government of India** acknowledged the existence of an un-codified set of generally accepted cost accounting principles in use in Indian industries and by the practicing cost accountants for attestation of Cost Statements. The Expert Group suggested that the principles be codified to provide a formal basis for the practice of Cost Accounting. The Expert Group also recommended review of alternate treatment of items in cost accounting thus eliminating needless diversities in practice leading to the development of cost accounting standards.

The Ministry of Corporate Affairs decided to implement the recommendations of the Expert Group and notified the Companies (Cost Records and Audit) Rules, 2014 on 30th June, 2014. These Rules introduced a common set of record rules for industries other than regulated industries specified in the Rules, in place of industry specific rules in vogue earlier. The Rules require every company to which the rules apply, including all units and branches thereof, to keep cost records in respect of each of its products and activities on regular basis. The cost records are to be maintained in accordance with the ***generally accepted cost accounting principles*** and ***cost accounting standards*** issued by the Institute of Cost Accountants of India to the extent these are found to be relevant and applicable. The variations, if any, are to be clearly indicated and explained.

The present effort of codifying the GACAP and presenting them in a single volume is the culmination of all the above developments in the practice of cost accounting in India.

Whereas Cost Accounting Standard 4 (CAS 4) issued in 2003 focused attention on GACAP, the Companies (Cost Records and Audit) Rules, 2014 which require maintenance of cost records according to GACAP and Cost Accounting Standards gave the mandate for a compilation of GACAP. Moreover, the supersession of the erstwhile industry-wise detailed Rules providing guidance on cost accounting principles and practices to be followed by the companies further necessitated the issuance of this document.

2. Objectives

The objectives of this document are:

1. to codify the GACAP as applied in the Indian industry;
2. to narrow down diversities in cost accounting practices facilitating the process of development of cost accounting standards;
3. to provide a reference source to industry and practitioners in preparation and attestation of Cost Statements, where specific cost accounting standards are yet to be issued;
4. to provide a reference source to all the stakeholders in the understanding and interpreting the cost statement; and,
5. to provide a base for monitoring the evolution of new concepts and practices in cost accounting and to codify them as and when they become generally accepted.

3. Scope

The scope is to codify the cost accounting principles to be followed by business and other entities in India in preparing and presenting cost information – more particularly the General Purpose Cost Statements covered by Cost Audit. This document also encompasses the generally accepted cost accounting practices presently being followed by such entities.

4. Nature of Content and Format

1. This document titled Generally Accepted Cost Accounting Principles (GACAP) contains a summary of the Cost accounting principles currently followed by business entities in India in preparing and presenting cost information in the context of general purpose cost statements for statutory reporting and covered by Cost Audit.
2. It explicitly incorporates the principles already contained in the Cost Accounting Standards 1-22 issued by the Cost Accounting Standards Board (CASB) in India without necessarily repeating them.
3. In areas not covered by the standards, it reflects the cost accounting principles found in the Companies (Cost Records and Audit) Rules, 2014.
4. Where somewhat conflicting principles have been laid down by the Companies (Cost Records and Audit) Rules, 2014 in different industries, attempt has been made to harmonize the principles so as to evolve a generally acceptable framework. Where use of alternate principles are sanctioned by the Rules or where alternate principles are applied in practice in the absence of explicit guidance in Rules, the alternates have been mentioned with an indication of the preferred practice.
5. Because the Rules were framed at different points of time spread over many years, it is likely that the principles contained in the Rules and the practice based on them do not reflect current concepts. In such cases, the document reflects the current concepts.
6. It also reflects the Cost Accounting Principles contained in the Guidance Notes and other publications issued by ICAI from time to time.
7. Cost Accounting principles which are gathering wide spread acceptance in Indian Companies for management reporting, even though not adopted for statutory cost reporting (for example, Activity Based Costing),are mentioned with suitable caveats regarding their lack of applicability for general purpose cost statements for statutory reporting, where applicable.
8. The document stipulates the main principles in **bold letters** followed by explanation in normal type.

5. Conceptual Frame Work

There is a need for a conceptual frame work that underlies the GACAP detailed in the succeeding sections. The conceptual frame work, as the name suggests, is a frame work and not a superset of cost accounting principles. It does not attempt to lay down a principle for any particular costing issue or to amplify the GACAP. The frame work helps to understand the GACAP that follow, in the appropriate perspective and guides in modifying them or developing new principles;

- **Focus on drivers of value**

  Costing is necessary for an informed understanding of the organizational drivers of cost, revenue, profits and value. Costing has to fulfil this role both in a historical and in a forward looking context.

- **Cost for a purpose**

  Over a long time it has been recognized that there is a cost concept relevant for a purpose. Thus external reporting requires historical and full absorption costing while performance evaluation requires attention directing and diagnostic information; planning and decision making requires analytical and predictive information. It is, therefore, not possible for the same set of cost data to fit all purposes, thereby resulting in a wide range of cost concepts from which preparers and users of cost information choose a concept relevant to the purpose.

- **Reality driven**

  Cost models must reflect the entity's business model, its operational processes, its strategy, its organizational structure and its competitive environment. Organizational processes and activities drive the costs and these are in turn influenced by other factors mentioned above.

- **Materiality and cost effectiveness**

  The selection of the methods of implementing the costing principles should have regard to the issues of materiality and cost effectiveness. Materiality of cost information is to be judged from the perspective of the user of that information. The degree of detail and accuracy required are governed by the perspective of materiality. From the preparers' viewpoint there is the need to balance the cost of maintaining a cost accounting system with corresponding benefits. This is the reason why in a number of places, while dealing with methods of implementing cost accounting principles, the expression "economically feasible way" has been used in this document.

  Hence, for preparation and disclosure of cost information, one is required to judge the materiality aspect in conjunction with economic feasibility of maintaining such data and information. For example, maintenance of product/activity-wise cost details for each of the ancillary product or activity of an entity would neither be material nor economically feasible.

  Any product or activity of an entity which is incidental to its main operations and does not constitute its main line of business and whose total turnover from the sale/supply of such product or activity does not exceed 2% of the total turnover of the entity or ₹20 crores, whichever is lower, should be treated as an ancillary product or activity.

- **Comparability and consistency**

  Cost information should be prepared and presented in a way which provides for comparability over time and consistency. The methods used for preparing and presenting cost information should be changed only where for valid reasons such as those required by law, compliance with new cost accounting standards or on the ground that it would result in a more appropriate presentation of cost information.

- **Transparency and auditability**

  Since cost information is used generally by various stakeholders like management, regulators and Government with a business outlook, there is a need for transparency regarding the definitions used and sources of data. It should be possible for those who wish to review such cost information to follow an audit trail. Auditability of cost information is a prerequisite to the effective use of such information.

6. Definitions

Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and / or due to some abnormal situation of the production or operation.***

Abnormal idle Capacity: ***Abnormal idle capacity is the difference between normal capacity and actual capacity utilization where the actual capacity is lower than the normal capacity.***

Abnormal Idle time*: An unusual or atypical idle time occurrence of which is irregular and unexpected or due to some abnormal situations.*

E.g. Idle time due to a strike, lockout or an accident

Absorption of overheads: ***Assigning of overheads to cost objects by means of appropriate absorption rate.***

Overhead Absorption Rate = Overheads of the Cost object / Quantum of base.

Actual Capacity Utilization: ***Actual Capacity Utilization is the volume of production achieved or service provided in a specified period, expressed as a percentage of installed capacity.***

Administrative Overheads: ***Cost of all activities relating to general management and administration of an entity.***

Administrative overheads shall exclude production overheads, marketing overheads and finance cost. Production overheads includes administration cost relating to production, factory, works or manufacturing.

Allocation of overheads***: Allocation of overheads is assigning total amount of an item of cost directly to a cost object.***

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.

Apportionment of overhead: ***Assigning of overhead is distribution of overheads to more than one cost objects 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.

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 entity or related undertaking for manufacturing another product(s).***

Cartage: ***The expenses incurred for movement of goods covering short distance for further transportation for delivery to customer or storage.***

Collection of Overheads: ***Collection of overheads means the pooling of items of indirect 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.

Committed Cost: ***The cost of maintaining stand-by utilities shall be the committed cost.***

Cost: ***Cost is a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services.***

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.

Cost Centre***: Any unit of an entity selected with a view to accumulating all cost under that unit. The unit can be division, department, section, group of plant and machinery, group of employees or combination of several units.***

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 centres. Personal cost centre consists of a person or a group of persons.

Cost centres which are not personal cost centres are impersonal cost centres. Again Cost centres 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 centres are for rendering service to production cost centre like Power house, Maintenance, Stores, Purchase office etc.

Cost Object: ***An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

Cost of Production: ***Cost of production of a product or a service consists of cost of materials consumed, direct employee costs, direct expenses, production overheads, quality control costs, packing costs, research and development costs and 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.

Cost of Transportation: ***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.***

Cost of transportation is classified as inward transportation cost and outward transportation Cost.

Cost unit: ***Cost unit is a form of measurement of volume of production of a product or a service. Cost unit is generally adopted on the basis of convenience and practice in the industry concerned.***

Current Asset: An entity shall classify an asset as current when:

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle; (b) it holds the asset primarily for the purpose of trading;

(c) it expects to realise the asset within twelve months after the reporting period; or

(d) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability.

Current liabilities: A entity shall classify a liability as current when:

(a) It is expected to settle the liability in its normal operating cycle

(b) It is holds the liability primarily for the purpose of trading

(c) the liability it is due to be settled within twelve months after the reporting period ; or

(d) the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

Defectives: ***Materials, products or intermediate products that do not meet quality standards. This may include reworks or rejects.***

Depot: ***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, stock yards etc.

Direct Expenses: ***Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material cost and direct employee cost.***

Examples of Direct Expenses are royalties charged on production, job charges, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling Expenses for a specific job.

Direct Employee Cost: ***Employee cost, which can be attributed to a cost object in an economically feasible way.***

Direct Material Cost: ***The cost of material which can be attributed to a cost object in an economically feasible way.***

Distribution Overheads: ***Distribution overheads, also known as distribution costs, are the costs incurred in handling a product or service from the time it is ready for despatch or delivery until it reaches the ultimate consumer including the units receiving the product or service in an inter-unit transfer.***

For example:

- Secondary packing
- Transportation cost
- Warehousing cost
- Cost of delivering the products to customers etc.
- Clearing and forwarding charges
- Cost of mending or replacing packing materials at distribution point.

Employee Cost: ***Benefits paid or payable for the services rendered by employees (including temporary, part time and contract employees)of an entity.***

Explanation:

1. Contract employees include employees directly engaged by the employer on contract basis but does not include employees of any contractor engaged in the organisation.
2. Compensation paid to employees for the past period on account of any dispute / court orders shall not form part of Employee Cost.
3. Short provisions of prior period made up in current period shall not form part of the employee cost in the current period.

Employee cost includes payment made in cash or kind.

For example:

- **Employee cost**
  - Salaries, wages, allowances and bonus / incentives.
  - Contribution to provident and other funds.
  - Employee welfare
  - Other benefits
- **Employee cost – Future benefits**
  - Gratuity.
  - Leave encashment.
  - Other retirement/separation benefits.
  - VRS/ other deferred Employee cost.
  - Other future benefits
- **Benefits generally include actual cost of**
  - Paid holidays.
  - Leave with pay.

- Statutory provisions for insurance against accident or health scheme.
- Statutory provisions for workman's compensation.
- Medical benefits to the Employees and dependents.
- Free or subsidised food.
- Free or subsidised housing.
- Free or subsidised education to children.
- Free or subsidised canteen, crèches and recreational facilities.
- Free or subsidised conveyance.
- Leave travel concession.
- Any other free or subsidised facility.
- Cost of Employees' stock option.

Equalized Freight: ***Equalized Freight means average freight.***

Equalized Transportation Cost: ***Equalized Transportation Cost means average transportation cost incurred during a specified period.***

Excess Capacity Utilization: ***Excess Capacity Utilization is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is more than installed capacity.***

Fixed Cost: ***Fixed costs are costs which do not vary with the change in the volume of activity. Fixed indirect costs are termed fixed overheads.***

Freight: ***Freight is the charges paid or payable for transporting materials/ goods from one location to another.***

Idle Capacity: ***Idle Capacity is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is less than installed capacity.***

Idle time: ***The difference between the time for which employees are paid /payable to employees and the employees' time booked against cost objects.***

The time for which the employees are paid includes holidays, paid leave and other allowable time offs such as lunch, tea breaks.

Imputed Costs: ***Notional cost, not involving cash outlay, computed for any purpose.***

Indirect Employee Cost: ***Employee cost, which cannot be directly attributed to a particular cost object.***

Indirect Materials: ***Materials, the costs of which cannot be directly attributed to a particular cost object.***

Installed Capacity: ***Installed capacity is the maximum capacity of producing goods or providing services, according to the manufacturer's specifications or determined through an expert study.***

Intangible Asset: An intangible asset is an identifiable non-monetary asset without physical substance

Interest and Finance charges: Interest, including any payment in the nature of interest for use of non equity funds and incidental cost that an entity incurs in arranging those funds.

This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs. The terms Finance costs and Borrowing costs are used interchangeably.

Inward 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.***

Licensed Capacity: ***Licensed Capacity is the production capacity of the plant for which license has been issued by an appropriate authority.***

Marketing overheads: ***Marketing overheads comprise of selling overheads and distribution overheads.***

Material Cost: ***The cost of material used for the purpose of production of a product or rendering a service.***

Normal capacity: ***Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.***

Outward Transportation Cost: ***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.***

Overheads: ***Overheads comprise costs of indirect materials, indirect employees and indirect expenses.***

Overtime Premium: ***The extra amount payable beyond the normal wages and salaries for beyond the normal working hours.***

Packing Materials: ***Materials used to hold, identify, describe, store, protect, display, transport, promote and make the product marketable.***

Packing Material Cost: The cost of material of any nature used for the purpose of packing of a product.

Packing Material Development Cost: ***Cost of evaluation of packing material such as pilot test, field test, consumer research, feedback, and final evaluation cost.***

Practical or Achievable Capacity: ***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.

Primary Packing Material: Packing material which is essential to hold and preserve the product for its used by the customer..

For example:

- Pharmaceutical industry: Insertions related to product, Foils for strips of tablets/capsules, vials.
- Industrial gases: Cylinders / bottles used for filling the gaseous products
- Confectionary Industry: Butter paper and wrappers.

Production Overheads: ***Indirect costs involved in the production of a product or in rendering service.***

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

Rejects: ***Defectives which cannot meet the quality standards even after putting in additional resource***

Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

Repairs and Maintenance Cost: ***Cost of all activities which have the objective of maintaining or restoring an asset in or to a state in which it can perform its required function at intended capacity and efficiency.***

Repairs and Maintenance activities for the purpose of this standard include routine or preventive maintenance, planned (predictive or corrective) maintenance and breakdown maintenance. The repair or overhaul of an asset which results in restoration of the asset to intended condition would also be a part of Repairs and Maintenance activity. Major overhaul is a periodic (generally more than one year) repair work carried out to substantially restore the asset to intended working condition.

Research & Development Cost:

Development cost: Development cost is the cost for application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Research cost: Research cost is the cost of original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding

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.

Reusable Packing Material: ***Packing materials that are used more than once to pack the product.***

Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***

Rework includes repairs, reconditioning and refurbishing.

Scrap: ***Discarded material having no or insignificant value and which is usually either disposed off without further treatment (other than reclamation and handling) or reintroduced into the process in place of raw material.***

Secondary Packing Material: ***Packing material that enables to store, transport, inform the customer, promote and otherwise make the product marketable.***

For example:

- Pharmaceutical industry: Cartons used for holding strips of tablets and card board boxes used for holding cartons.
- Textile industry: Card board boxes used for holding cones on which yarn is woven.
- Confectionary Industry: Jars for holding wrapped chocolates, Cartons containing packs of biscuits.

Selling Overheads: ***Selling overheads are the expenses related to sale of products or services and include all indirect expenses incurred in selling the products or services.***

Semi Variable Costs: ***Semi variable costs are the costs that contain both fixed and variable elements. They partly change with the change in the level of activity.***

Spoilage: ***Production that does not meet the quality requirements or specifications and cannot be rectified economically.***

Standard Cost: ***A predetermined cost of a product or service based on technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

Stand-by Service: ***Any facility created as backup against any failure of the main source of service.***

Stand-by Utilities: Any utility created as backup against any failure of the main source of utilities.

Support- Service Cost Centre: ***The cost centre which primarily provides auxiliary services across the entity.***

The cost centre which provides services to Production, Operation or other Service Cost Centre but not directly engaged in manufacturing process or operation is a service cost centre. A service cost centre renders services to other cost centres / other units and in some cases to outside parties.

Examples of service cost centres are engineering, workshop, research & development, quality control, quality assurance, designing, laboratory, welfare services, safety, transport, Component, Tool stores, Pollution Control, Computer Cell, dispensary, school, crèche, township, Security etc.

Administrative Overheads include cost of administrative Service Cost Centre.

Transit Insurance Cost: ***Transit Insurance Cost is the amount of premium to be paid to cover the risk of loss /damage to the goods in transit.***

Utilities: ***Significant inputs such as power, steam, water, compressed air and the like which are used for manufacturing process but do not form part of the final product.***

Variable Cost: ***Variable Costs are the cost which tend to directly vary with the volume of activity.***

Waste: ***Material lost during production or storage and discarded material which may or may not have any value.***

7. Principles applicable to Elements of Cost

The following section deal with GACAP applicable to individual elements of cost.

Before proceeding with element-wise principles, it is useful to summarise the principles applicable to all elements of cost.

1. **When an element of cost is accounted at standard cost, variances due to normal reasons are treated as a part of the element-wise cost. Variances due to abnormal reasons will not form part of the cost.**
2. **Any Subsidy/Grant/Incentive and any such payment received/receivable with respect to the input cost is reduced from cost for ascertainment of the cost of the cost object to which such amount pertains.**
3. **Any abnormal cost where it is material and quantifiable will not form part of the cost.**
4. **Penalties, damages paid to statutory authorities or other third parties will not form part of the cost.**
5. **Costs reported under various elements of cost will not include imputed costs.**
6. **Finance costs incurred in connection with acquisition of resources such as materials, utilities and the like will not form part of the cost of such resources.**
7. **Any credits or recoveries from employees or suppliers or other parties towards costs incurred by the entity for a resource will be netted against such costs.**
8. **Except otherwise stated, the measurement of costs for cost accounting purposes will follow the same principles as set out in Generally Accepted Accounting Principles, applicable to the concerned entity.**

MATERIAL COST

1. **Material Cost usually includes all costs required to bring the materials to the present condition and location.**

   In case of manufacturing units, the location means the factory gate / works. In case of service organisation, the location means the place from which the services are rendered or activities are carried out.

2. **Material receipt is valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities) that can be quantified with reasonable accuracy at the time of acquisition**[1]**.**

   The test that the expenditure must be capable of being quantified with reasonable accuracy at the time of acquisition is significant. For large volume small value purchases, it is usual to take freight or other costs at a predetermined percentage of purchase prices and recognise any difference as expense for the period when actual costs are booked as expenses of the period. For small value items of purchase, it is usual even to treat all freight on such purchases as overheads.

3. **Procurement costs are not generally included in material cost. However, those costs which can be directly identified with a material are included in the material cost.**

   Purchase Department Overheads are not generally included in material cost. But the procurement expenses incurred at Collection Centres in the Paper Industry such as Salaries & Wages, Stores, Repairs & Maintenance, Other Expenses, Share of Forest Development Expenses, if any, are included as part of the cost of wood. Similarly expenses incurred at Cane Collection Centres are included in the cost of sugar cane procured by a Sugar Mill.

4. **Development expenses incurred in respect of materials procured is included in the cost of material to the extent that the material procured is the result of such developments.**

   For example, the Forest Development Expenses incurred by a paper mill is included in the cost of wood on an equitable basis. It is usual to relate the development expenses to the area under development and charge a share to the quantity of wood received during the period as a proportion of expected yield. It is less preferable to charge the Forest Development Expenses as period cost and charge the whole of it to the quantity of wood procured during the period.

5. **Where a material is acquired in exchange for other materials or services supplied, the cost of material acquired is taken as the cost of material supplied or services provided plus other applicable costs such as freight.**

   In the Paper industry where bagasse from the Sugar mills is obtained by the paper mill by supplying coal to the sugar mills, in the cost statement, the cost of coal supplied is considered as the cost of bagasse procured.

6. **Normal loss or spoilage of material prior to reaching the factory or at places where the services are provided is absorbed in the cost of balance of materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal**[2].

7. **Losses due to shrinkage or evaporation and gain due to elongation or absorption of moisture etc., before the material is received is absorbed in material cost to the extent they are normal, with corresponding adjustment in the quantity**[3].

8. **Where the material procured represents an agricultural produce from own sources, the same is valued at market price or cost where it can be determined with reasonable accuracy.**

   The cane supplied from own farm to a Sugar Mill is charged at state advisory price/ control rate and profit/loss on farm taken to profit & loss account directly. This is permitted by the Companies (Cost Records and Audit) Rules, 2014 for Sugar Industry. Such a treatment is advised where the correct determination of cost of the production of items procured from own farm, is fraught with difficulty. Costing of agricultural produce in many cases has not reached a level of maturity that the cost of an item produced by an agricultural process can be used in a General Purpose Cost Statement subject to attest function. The use of a fair market value is indicated in such cases.

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1 CAS 6 Paragraph 5.1.1

2 CAS 6 Paragraph 5.1.5

3 CAS 6 Paragraph 5.1.6

However in the Paper industry, where bamboo/wood is grown in forests owned or taken on lease by the company and collection is made by departmental operations or by contract, detailed records are generally maintained in a suitable form so as to enable computation of the cost of such bamboo or wood. In such cases, cost is taken as the basis of valuation of material. Similar is the case of cost of green leaf produced in tea plantations where cost of green leaf produced can be determined based on detailed plantation records maintained for the purpose.

9. **The forex component of imported material cost is converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise will not form part of the material cost**[4].

10. **Self Manufactured Materials (and Self manufactured components and sub assemblies) are valued at cost including Direct Material Cost, Direct Employee Cost, Direct Expenses, Factory Overheads and share of Administrative Overheads relating to production. Share of other Administrative Overheads, Finance Cost and Marketing Overheads are excluded**[5].

11. **The material cost of normal scrap/defectives, which are rejects, is included in the material cost of goods manufactured. This cost not exceeding the normal is adjusted in the material cost of good production. Material cost of abnormal scrap/defectives should not be included in the material cost, but treated as loss after giving credit to the realizable value of such scrap/defectives**[6].

12. **Issues of materials are valued using appropriate assumptions on cost flow**[7].

    Examples are FIFO, LIFO, and Weighted Average rate.

13. **Material Costs are assigned to cost objects on the basis of material quantity consumed where traceable and where not traceable on technical norms or estimates**[8]**.**

14. **When material is processed or part manufactured by a third party according to specifications provided by the buyer, the processing/ manufacturing charges payable to the third party is treated as part of the material cost**[9]**.**

15. **When the part of the manufacturing operations/activity is subcontracted, the subcontract charges related to materials is treated as direct expenses and assigned directly to the cost object**[10].

16. **Cost of materials like catalysts, dies, tools, patterns etc., which are relatable to production over a period of time, is amortized over the production units benefited by such cost. Cost of materials with life exceeding one year is included in the cost over the useful life of the material**[11].

17. **Where the cost of materials is written off or written down in the financial books as per the accounting policy followed by the entity, such write off or write down amount is not treated as cost.**

    It is usual for the companies to write off or write down the cost of non-moving / slow-moving items, say items which have not moved for three years or more.

18. **When the material referred to in paragraph 17 above, is subsequently issued, the issue is valued at the original cost in cost accounting records and the difference between the original cost and the carrying amount is presented in the reconciliation statement, wherever, economically feasible.**

    When it is not economically feasible to apply the above principle, the issue is valued at the carrying amount in the cost accounting records.

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4 CAS 6 Paragraph 5.1.7

5 CAS 6 Paragraph 5.1.3, 5.3

6 CAS 6 Paragraph 5.4

7 CAS 6 Paragraph 5.2.1

8 CAS 6 Paragraph 6.3.1

9 CAS 6 Paragraph 6.2.1

10 CAS 6 Paragraph 6.2.2

11 CAS 6 Paragraph 6.3.2

EMPLOYEE COST

1. **Employee cost or Labour cost is ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all benefits**[12].

2. **Bonus, whether payable as a statutory minimum or on a sharing of surplus and Ex gratia payable in lieu of or in addition to Bonus is treated as part of the employee cost**[13].

3. **Remuneration payable to Managerial Personnel including Executive Directors on the Board and other officers of a corporate body under a statute is considered as part of the Employee Cost of the year under reference whether the whole or part of the remuneration is computed as a percentage of profits**[14].

   Remuneration of Non Executive Directors will not be considered as part of Employee cost but treated as part of administrative overheads.

4. **Performance Incentives must be accumulated over the entire production and not recognised after the threshold limit for earning the incentive is reached.**

5. **Separation costs related to voluntary retirement, retrenchment, termination etc. should be amortized over the period benefiting from such costs**[15].

6. **Amount payable to employees during the lay off period or for the strike period or during suspension, is not included in cost.**

7. **Cost of employee share options is treated part of employee cost provided the same is not a notional cost and involves an actual cash outlay.**

8. **Gratuity, pension and other superannuation benefits, measured using actuarial valuation method or any other methods, are part of Employee Cost.**

9. **Amortized separation costs related to voluntary retirement, retrenchment, and termination etc. for the period is treated as indirect cost and assigned to the cost objects. Unamortized amount relating to discontinued operations should not be treated as employee cost**[16]**.**

10. **Recruitment costs, Training costs and other such costs is treated as overheads and dealt with accordingly**[17]**.**

11. **Overtime premium and idle time cost should be assigned directly to a cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime or idle time**[18].

12. **Where the employee service is directly traceable to a Cost object, such cost is assigned on the basis of time consumed**[19]**.**

13. **When employee costs are not directly traceable to a Cost object, they are assigned on a suitable basis like estimates of time based on time study**[20].

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12 CAS 7 Paragraph 5.1
13 CAS 7 Paragraph 5.2
14 CAS 7 Paragraph 5.3
15 CAS 7 Paragraph 5.4
16 CAS 7 Paragraph 6.4
17 CAS 7 Paragraph 6.5
18 CAS 7 Paragraph 6.6, 6.7
19 CAS 7 Paragraph 6.1
20 CAS 7 Paragraph 6.3

DIRECT EXPENSES

1. **The identification of Direct Expenses is based on traceability in an economically feasible manner**[21].

   Many expenses in real life may be capable of identified as Direct Expenses but often they are grouped as overheads because it is not economically feasible to trace them to cost objects.

2. **Similarly if an item of the expense does not meet the test of materiality, it can be treated as part of overheads**[22]**.**

3. **Expenses incurred for the use of bought out resources are determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of trade discounts, rebates, taxes and duties refundable or to be credited**[23]**.**

4. **Other Direct Expenses other than those referred above are determined on the basis of amount incurred in connection therewith**[24]**.**

5. **Expenses paid or incurred in lump sum or which is in the nature of 'one-time' payment, is amortized on the basis of the estimated output or benefit to be derived from such expenses**[25]**.**

6. **Direct Expenses are by definition directly traceable to cost objects and hence no special principles are involved for them to be assigned to cost object**[26].

UTILITIES

1. **The cost of utilities purchased is measured at cost of purchase including duties and taxes, transportation cost, insurance and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited**[27].

   This is subject to the usual condition that it can be quantified with reasonable accuracy at the time of acquisition.

2. **The cost of generated utilities includes direct materials, direct labour, direct expenses and factory overheads**[28].

   Example of Direct materials for utilities is fuel used in generation of power and for Direct Expenses, electricity tax for generation.

3. **Cost of Utilities generated for the purpose of inter unit transfers is arrived as Cost of self generated utilities with Distribution cost added**[29].

4. **Cost of Utilities generated for Intercompany transfer is arrived as Cost of self generated utilities plus Distribution cost plus share of administrative overheads**[30]**.**

5. **Cost of Utilities generated for sale to outside parties is arrived as Cost of self generated utilities plus Distribution cost plus share of administrative overheads plus marketing overheads**[31]**.**

6. **The Cost of Utilities includes Cost of distribution of such utilities**[32].

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21 CAS 10 Paragraph 5.1
22 CAS 10 Paragraph 5.2.3
23 CAS 10 Paragraph 5.2.1
24 CAS 10 Paragraph 5.2.2
25 CAS 10 Paragraph 5.3
26 CAS 10 Paragraph 6.1
27 CAS 8 Paragraph 5.2
28 CAS 8 Paragraph 5.3.1
29 CAS 8 Paragraph 5.3.2
30 CAS 8 Paragraph 5.3.3
31 CAS 8 Paragraph 5.3.4
32 CAS 8 Paragraph 5.3.4

7. **Cost of production and distribution of utilities is determined based on the normal or actual capacity whichever is higher and unabsorbed cost, if any, is treated as abnormal cost[33].**

8. **Cost of stand by utility includes the committed costs of maintaining such utility[34].**

9. **While assigning cost of utilities, traceability to a cost object in an economically feasible manner is the guiding principle[35].**

   Accurate recording of utilities consumed by various users' calls for significant investment in measuring instruments and manpower for recording and analysis of such metered data. The benefit from such expenditure needs to be justified.

10. **The most appropriate basis for distribution of cost of a utility to the departments consuming services is to be derived from usage parameters[36].**

REPAIRS AND MAINTENANCE COST

1. **The cost of Repairs and Maintenance is the aggregate of direct and indirect cost relating to repairs and maintenance activity[37].**

2. **Cost of in-house Repairs and Maintenance activity will include cost of materials, consumable stores, spares, manpower, equipment usage, utilities and other resources used in the activity[38].**

3. **Cost of Repairs and Maintenance activity carried out by outside contractors inside the entity will include the charges payable to the contractor apart from the above in-house cost[39].**

4. **Cost of Repairs and Maintenance activity carried out by contractors at his premises is determined at invoice or agreed price including duties and taxes and other expenditure directly attributable net of discounts (other than cash discount), taxes and duties refundable or to be credited. It will also include the cost of other resources provided to the contractors[40].**

5. **Each type of Repairs and Maintenance is treated as a distinct activity, if material and identifiable[41].**

6. **The cost is measured for each major asset category separately[42].**

7. **Cost of spares replaced which do not enhance the future economic benefits of the existing asset beyond its previously assessed standard of performance is included under Repairs and Maintenance cost[43], when Repairs and Maintenance is considered as a separate cost centre, the cost of which is apportioned to user centres.**

8. **Where a high value spare is replaced, and the replaced spare is reconditioned and such spare is expected to result in future economic benefits, it is taken into stock. Such a spare is valued at an amount that measures its service potential in relation to a new spare, the amount of which will not exceed the cost of reconditioning the spare. The difference between the total of the cost of the new spare and the reconditioning cost and the value of the reconditioned spare should be treated as Repairs and Maintenance cost[44].**

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33 CAS 8 Paragraph 5.9
34 CAS 8 Paragraph 5.9
35 CAS 8 Paragraph 6.1
36 CAS 8 Paragraph 6.3
37 CAS 12 Paragraph 5.1
38 CAS 12 Paragraph 5.2
39 CAS 12 Paragraph 5.3
40 CAS 12 Paragraph 5.4
41 CAS 12 Paragraph 5.6.1
42 CAS 12 Paragraph 5.6.2
43 CAS 12 Paragraph 5.7
44 CAS 12 Paragraph 5.8

9. **Cost of major overhaul is amortized on a rational basis**[45].

   Major overhaul is the periodic (generally more than one year) repair work carried out to substantially restore the asset to the intended working condition.

10. **Repairs and Maintenance cost is traced to a cost object to the extent economically feasible**[46].

11. **Where the Repairs and Maintenance cost is not directly traceable, it is assigned based on either of the principles of Cause and Effect or Benefits Received**[47].

PRODUCTION OVERHEADS

1. Overheads comprise of indirect material cost, indirect employee cost and indirect expenses. They are termed indirect because they are not directly identifiable or allocable to the ultimate cost object – usually a product or service – in an economically feasible way.

2. **Production Overheads are indirect costs involved in the production process or in rendering services.** Production Overheads include **administration cost relating to production, factory, works or manufacturing.** Production related expenses incurred at corporate office, e.g. design office expenses, materials management and industrial relations will also be covered by the term[48].

3. The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably[49].

4. Since overheads cannot be economically traced to products and services, they are assigned to them on some equitable basis.

5. **While assigning overheads, traceability to a cost object in an economically feasible manner shall be the guiding principle. The cost which can be traced directly to a cost object shall be directly assigned**[50]**.**

6. **Assignment of overheads to the cost objects shall be based on either of the following two principles;**

   (i) Cause and Effect – Cause is the process or operation or activity and effect is the incurrence of cost.

   (ii) Benefits Received –Overheads are to be apportioned to the various cost objects in proportion to the benefits received by them[51]**.**

7. **Secondary assignment 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(s)**[52]**.**

8. **It is not a good practice to allocate overheads to Cost Centres/ Cost Objects on the basis of "what the traffic will bear" – that is by size of the user.**

9. **There is a distinct preference for allocating overheads on the basis of "cause and effect" analysis. What or who causes the costs to be incurred is a more rational criterion to assign costs rather than size or benefits received.**

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45 CAS 12 Paragraph 5.9
46 CAS 12 Paragraph 6.1
47 CAS 12 Paragraph 6.2
48 CAS 13 Paragraph 4.9
49 CAS 13 Paragraph 4.2
50 CAS 3 (R-1) Paragraph 6.1
51 CAS 3 (R-1) Paragraph 6.2
52 CAS 3 (R-1)Paragraph 6.3.2

10. **In case of facilities created on a standby or ready to serve basis, the cost shall be assigned on the basis of expected benefits instead of actual.**

11. Production Overheads are usually accumulated under production cost centres to facilitate absorption by products or services.

12. **These costs are absorbed by the products on the basis of resources used by the product at the production centre.**

13. **The overheads assigned to the production cost centres are charged to products/ services through an overhead absorption rate for each cost centre.**

    Common bases for assignment of Production overheads to Cost Objects are:

Bases of denominator	***Applicability***
Unit of Production	***When single product is produced or various products are similar in specifications.***
Material Cost	***Where the overheads are mostly related to material.***
Direct employee cost	***When conversion process is labour intensive and wage rates are substantially uniform***
Direct employee 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***

    A preferred approach for assignment of overheads to cost objects is to use multiple drivers instead of a single driver such as machine hour, where feasible[53].

14. **A preferred approach to assignment of overheads is the assigning of cost of resources to activities and assigning the cost of activities to Cost Objects through use of cost drivers, wherever feasible[54].**

15. Also there are service cost centres through which the product does not pass through but which provide a support function to the production cost centres.

16. **Where the cost of services rendered by a service cost centre is not directly traceable to a cost object, it shall be assigned on the most appropriate basis[55].**

17. **The most appropriate basis of distribution of cost of a service cost centre to the cost centres consuming services is to be derived from logical parameters which could be related to the usage of the service rendered. The parameter shall be equitable, reasonable and consistent[56].**

18. **Charging overheads on the basis of "benefits received" by the various users is preferred. This requires some measure of "receipt of benefit" to be developed.**

19. **Sometimes capacity in a service department is created in anticipation of demand for services. It is appropriate to allocate such capacity costs on the basis of "capacity to serve" rather than actual usage of services.**

    Ultimately all overheads must be charged to products of services. Hence the total production overheads of Production Cost Centres are applied to products passing through them using a suitable absorption base.

20. **Before the final step of absorption, production overheads of production cost centres have to be segregated between fixed overheads and variable overheads. The fixed overheads are absorbed by products based on normal capacity or actual capacity utilization whichever is higher. Variable overheads are absorbed by products based on actual capacity utilization. This treatment is in line with Accounting Standard 2 as well.**

53 CAS 3 (R-1)Paragraph 6.4

54 CAS 3 (R-1)Paragraph 6.5

55 CAS 3 (R-1)Paragraph 6.2

56 CAS 3 (R-1)Paragraph 6.3

21. **Normal capacity is defined in Cost Accounting Standard 2 as 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. It is practical capacity minus the loss of productive capacity due to external factors**[57].
22. **Under-absorbed fixed overheads are charged off to Costing Profit & Loss Account and shown as an item of Reconciliation with financial accounts.**

DEPRECIATION

1. Depreciation, though part of overheads, generally appears as a separate line item in the cost statements instead of being grouped under overheads. This is because of its size in the technology driven business of today and its unique characteristic of being non-cash cost.
2. Amortization of intangible assets tends to be grouped with depreciation because intangible assets themselves are grouped with Fixed Assets in the presentation under Schedule III of the Companies Act 2013.
3. The measurement of depreciation in Cost accounts tends to mirror the practices in financial accounts.
4. However the treatment of depreciation in Cost Accounts must address the following issues:
   - Depreciation not calculated on period of use basis.
   - Depreciation an idle assets
   - 100% of depreciation on certain class of assets
   - Write-off of small value assets
   - Depreciation on fully depreciated assets
   - Depreciation on revalued assets
5. Sometimes depreciation in books is not calculated on period of use, for example 50% of annual depreciation is taken for an asset put into use for a day in financial accounts keeping in mind Income Tax provisions. **Cost accounts will always use the depreciation computed on period of use basis and take the balance to Costing P & L or reconciliation with financial accounts.**
6. Even where 100% of the depreciation is allowed in the first year for income tax purposes, companies are required to use regular rates of depreciation for cost accounting purposes. Even where an entity uses 100% depreciation rates in financial books of accounts, **depreciation based on estimated life is used for costing purposes with the difference taken to costing Profit & Loss or Reconciliation with Financial Accounts.**
7. **Where small value items are written off fully at the time of purchase in financial accounts, the same is generally adopted for cost accounts.**
8. **In the case of old plants, there is the special case for fully depreciated assets which however continue in regular service. Some entities continue to provide a notional depreciation on such assets for decision making purposes.**
9. Depreciation on the amount by which the asset is written up on Revaluation is charged to Revaluation Reserve in financial books. **Some entities compute the depreciation on the revalued figure for costing purposes to reflect the true cost of depreciation.**

57 CAS 2 Paragraph 4.4

10. **It goes without saying that the cumulative depreciation charged in the Cost Accounts against any individual item of fixed asset will not exceed the original cost of the asset.**

11. The assignment of depreciation to various cost centres should not pose a problem so long as detailed Fixed Asset records are maintained by the Company. However there are some common items of fixed assets between cost centres e.g. yard piping carrying products from one process to another, common storage tanks and the like. **Depreciation on common assets are apportioned to individual cost centre on some suitable basis e.g. yard piping is assigned to the cost centre receiving the material.**

ADMINISTRATIVE OVERHEADS

1. Administrative overheads are the aggregate cost of resources consumed in activities relating to general management and administration of an organisation[58].

The principles of measurement of Material Cost, Employee Cost, Utilities, Repairs &Maintenance and Depreciation found in the respective standards will apply if included in administrative overheads.

2. In case of leased assets, if it is an operating lease – the entire rentals will be treated as a part of administrative overheads, while in case of a financial lease – the finance cost portion will be segregated and treated as a part of finance cost[59].

3. The cost of software (developed in house, purchased, licensed or customized), including up-gradation should be amortized over its useful life[60].

When hardware requires up-gradation along with the software, it is recommended to use compatible estimated lives for the two sets of cost.

4. The cost of the administrative services procured from outside is determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable net of discounts (other than cash discount), taxes and duties refundable or to be credited[61]. The assignment of administrative overheads to cost objects is based on either of the principles of Cause and Effect or Benefits received, if it is not directly traceable[62].

The cost of shared services is best assigned to user activities on the basis of actual usage, infrastructure costs on the basis of readiness to serve and general management costs on a rational basis. For e.g.: Number of employees, turnover, investment size etc.

5. Since most administrative costs are fixed in nature, it is preferable to change them to users on "readiness to serve" basis such as installed capacity, budgeted sales etc. rather than actual production or actual sales. Even the drivers mentioned in (9) above can be on the basis of expected driver qualities rather than actual.

SELLING AND DISTRIBUTION OVERHEADS

1. Selling costs can be recorded in a manner which will facilitate customer / product profitability analysis, as appropriate. Thus selling costs can be identified to markets, distribution channels, territories, salesman etc., before being assigned to customer / product as applicable.

2. **The acceptable bases for apportionment of common selling costs to customers / products are:**
   - **a. Weight**
   - **b. Units / equivalent units**

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58 CAS 11 Paragraph 5.1

59 CAS 11 Paragraph 5.2

60 CAS 11 Paragraph 5.3

61 CAS 11 Paragraph 5.4

62 CAS 11 Paragraph 6.2

c. **Value of goods**

d. **Any other appropriate and equitable basis**

3. **The acceptable bases for assigning common transport costs to products are:**

   a. **Weight**

   b. **Volume of goods**

   c. **Tonne km**

   d. **Units / equivalent units**

   e. **Value of goods**

4. **The transportation costs assigned to products are charged to units based on some measure which factors in the distance e.g. tonne km.**

INTEREST AND FINANCE CHARGES

1. **Interest and Finance Charges have come to be included in cost of sales though not in cost of production. Such costs are also assigned to products before arriving at margins by product.**

2. **For the purpose of assignment, Interest charges are grouped under**

   - **interest on long term funds**

   - **interest on working capital funds**

3. **The former is assigned to product lines based on fixed capital investment (including fixed assets and mould and dies) in such product lines. A portion of the interest is also charged to outside investments, if they exist, and excluded from cost of sales. For this purpose, it is usual to develop an average cost of long term funds and apply it to fixed capital investment in each product line.**

4. **It is not the accepted practice to charge imputed interest on owners' funds in cost accounting.**

SALES

1. Cost of sales statements lead right up to margin and hence sales also have to be handled in Cost Accounting.

2. **Since costing is always by product, cost accounting requires product wise analysis of sales.** This is usually produced by other modules of the enterprise system.

3. What is critical is the value of sales produced by such analysis. Often sales analysis produce invoiced value of sales. **What is required for cost accounting is net value of sales net of trade discounts, returns, allowances, volume discounts, special discounts based on market conditions etc.**

4. Many of these deductions from sales are transacted through credit notes which also must be processed through the sales analysis to arrive at product wise break up.

5. **Some of these deductions from sales may be available only in total and hence may have to be allocated to products on a suitable basis, say, sales value.**

6. It is not unusual for businesses to focus on net realization from sales ex-factory gate. This means that freight (both primary and secondary), transit insurance, loading and unloading charges, handling charges and the like are deducted from net sales as arrived at in 3 above to arrive at net sales realization ex-factory gate. This also entails freight and other transport costs not being shown under the head Distribution costs. So long as these costs are shown separately as deductions from net sales value, the practice is acceptable.

7. Companies (Cost Records and Audit) Rules, 2014 require gross sales to be shown in addition to net sales in cost statement. This requires that excise duty, sales tax (VAT) etc is added to net sales to arrive at gross sales by product.

JOINT COSTS

1. Joint Costs are the costs of a production process that yields multiple products simultaneously, for example, in the refining of Petroleum which yields Petrol, Kerosene, Diesel, Naphta, Grease, Tar and several other products or the distillation of coal, which yields coke, natural gas, and other products.
2. The costs of the common process are the joint costs.
3. **Joint costs are allocated**

   (a) Based on a measure of the number of units, weight, or volume of the joint products, or

   (b) Based on the values attributed to the joint products.
4. By-product is a special case of Joint Product where one or more of the joint product has minor value compared to others.
5. **Such by-products are generally valued at their value at the split-off point with such value being credited to the costs of the main product. The split-off point value is arrived at on the basis of the ultimate realizable value of the by-product less the post split-off costs.**

COMMON COSTS

1. A common cost is the cost of operating a common facility, activity or service or that is shared by two or more cost objects.
2. The common cost is generally lower than the stand-alone individual cost to each cost object was the facility not shared.
3. **Common costs are therefore allocated to each cost object based on the individual costs of the cost object.**

8. Presentation and Disclosure

Generally the presentation requirements of cost information for statutory purposes are laid down in the respective rules. Similarly the requirements of reporting for regulatory purposes are laid down by the regulatory agencies. Managements stipulate the presentation formats for managerial purposes. It is therefore not considered necessary to lay down any model statements or formats in this document.

However it is considered appropriate to stress certain disclosure practices which are generally applicable.

1. Cost Statements must contain, besides total cost, unit cost per unit of output.
2. Output quantities with unit of measure must appear in the Cost Statements.
3. Input costs are best broken up as quantity and rate.
4. The basis of valuation of inputs must be stated.
5. The basis of distribution of costs to cost objects or cost centres must be disclosed.
6. Costs incurred in foreign currency must be stated separately.
7. Any costs excluded must be disclosed.
8. Any credits or recoveries netted against cost must be disclosed separately.
9. Transactions with related parties must be highlighted or disclosed separately.
10. Cost elements, which are material for a product or activity, must be disclosed separately.
11. Cost details of all ancillary products or activities may be maintained under a miscellaneous group and disclosed appropriately.
12. Changes in the costing principles and methods applied must be disclosed with the effect.

9. Conclusion

This document contains a discussion of the generally accepted cost accounting principles in the context of today and the times gone by. It must be understood that cost accounting principles and methods of applying them are in a constant flux influenced by fresh thinking by experts, regulatory influences, parallel developments in financial accounting standards and the like. Professional accountants will be well advised to use this document as a guide and not as a set of rules.

Appendix I

APPLICATION GUIDANCE

Material Cost

1. Under the erstwhile Companies (Cost Records and Audit) Rules, 2014 the Cost of purchased materials is reckoned inclusive of all "direct charges up to works". The term "works" can be taken to mean any place of operations.
2. The direct charges include in the case of indigenous materials, the invoice cost, freight, transit insurance, loading and unloading charges. In the case of imported materials, they include FOB value, overseas freight, insurance, customs duty, clearing charges, inland freight etc.
3. Demurrage or detention charges at port or by carrier or penalty levied by them are not treated as cost, being abnormal cost.
4. Penalties levied by tax authorities such as customs, excise sales tax authorities on consignments of goods are not treated as cost.
5. Taxes for which the buyer gets credit like Vat, cenvat, countervailing import duty are excluded from Cost.
6. Purchase Tax is sometimes levied by State Governments on inputs with or without relief against tax payable on sale. Such tax is to be taken as part of cost except to the extent it is allowed to be offset against tax on sale.
7. Octroi levied by local authorities on inputs entering the local limits must be added to cost. If subsequently the goods are taken out of local limits, the amounts can be retrenched from cost.
8. The levy of additional tax for non compliance with filing declaration forms e.g. 'C' or 'D' forms under central sales tax is treated differently with the additional tax being treated as part of cost if known at the time of recording the transaction.
9. Cost is net of trade discount. Cash discount is generally treated as a financial income and not netted against cost. But there may be circumstances in a transaction which suggest that the cash discount is not a prompt payment discount but a price discount offered in the garb of a cash discount.
10. Cost is to be taken net of Volume discounts to the extent these can be anticipated. Where there is uncertainty regarding the eligibility or the quantum, these may be netted against consumption as when they become confirmed.
11. Bank charges for negotiation of documents in connection with a purchase transaction are generally treated as finance costs and not included in material cost. This is based on the premise that sale documents are negotiated through bank to avoid credit risks or to avail bank finance. Hence Bank Charges on bills negotiated through bank on collection or acceptance basis are often added to material cost but are best excluded from material cost. Interest, when charged by the supplier for the whole of part of the credit period extended, is generally treated as a finance charge. This is so even if the interest appears on the face of the invoice.

12. Imports of materials from certain countries are often available with extended periods of credit with zero or concessional rate of interest. Whether the concession in the matter of interest should be treated as cost is unsettled.

13. Exchange losses or gains incurred after the purchase transaction is completed is not treated as material cost but is to be treated as finance cost.

14. In some industries, the material purchased is the output of mining or quarrying operations form owned mines or quarries. For example, limestone which is a key raw material is obtained by a cement mill from its own mines. The cost of material mines is determined by taking into account royalty to government, cost of explosives used, and mining costs. The question of principle that arises is the treatment of mines development costs which occur regularly over the years. The cost of mines development is treated as cost of mining the output of the current year but there is much in favour of spreading the development costs over the period over based on a development to run-of-the mines ratio.

15. The cost of materials obtained in returnable containers where there is a credit on return is taken net of the credit. Where rent is payable for the period for which the container is retained, such rent is treated as overheads.

16. The rate to be adopted for a material in cost accounting is generally taken after adjusting material losses- in transit, in storage or other losses. This is however permissible only if the losses are normal. Transit losses can be reflected in the rate by deducting such losses from the billed quantity provided such losses are incidental to transport. The percentage of such normal losses can be quite high for some materials e.g. coal.

17. Apart from physical loss, there can be losses due to evaporation or shrinkage. They are also treated in the same way.

18. An abnormal loss in transit e.g. loss due to accident cannot be reflected in the rate. It will be treated as a loss and taken to Profit or Loss net of recoveries from insurance, or carrier.

19. Storage loses are also treated similarly provided they are incidental to storage and the period of storage is normal in the given case.

20. On a slightly different footing are moisture losses in transit or storage. Since most technical calculations are based on dry weight, it is advisable to account for materials which absorb moisture on a dry weight basis grossing up the rate. Dry weight can be air-dry or bone dry. In the case of wood used in paper industry, given that wood contains some moisture, the rate for wood is accounted on the basis of Air Dry weight which may be obtained after deducting standard or average moisture contents of such wood. Alternatively it can be accounted on bone-dry weight after deducting the entire moisture on actual basis.

21. Similar adjustments are called for when consumption quantities of materials in cost accounting are to be aligned with technical calculations which adjust physical quantities for strength, purity or other factors. In these cases also, the rates are grossed up to reflect quantity restatements.

22. Exchange losses or gains incurred after the purchase transaction is completed is not treated as material cost but is to be treated as finance cost.

23. Sometimes, materials are sent outside for pre-processing before it is used in the production process, e.g. cotton for ginning / cleaning, steel rods for blanking etc.Charges paid to outsiders for pre-processing are added to material cost.

24. If the same operations are performed in-house, it is usual to treat them as production cost and not as part of material cost.

25. Material is often held for long periods for seasoning, maturing etc. The storage and interest cost for such storage is treated as part of material cost.

26. Some materials may require special storage facilities e.g. prawns in freezers. A cost of such special storage is often treated as part of material costs.

27. Materials may undergo discolouration, deterioration in quality or outline the shelf-life. Losses for such reasons are not treated as part of material cost.

28. Amount of recovery from disposable containers in which material is received is best treated as miscellaneous income and not reduced from material cost.

29. The treatment in the case of returnable containers where credit is obtained from the supplier on a regular basis can be different. Such credit is generally reduced from material cost. Where the container cost is not included in the price charged but a charge is made for non-return or late return, such charge is treated as abnormal cost and excluded from cost.

30. When material is supplied in returnable containers and a rent is charged for such container based on the period of use, the cost is treated as overheads.

31. Material is often held in storage under special conditions e.g. LSHS at higher than ambient temperature to prevent solidifying, the associated costs are not treated as part of material costs but as part of production costs.

32. The costs of operating and maintaining pipe lines for moving materials from storage to production are not treated as part of material costs but as part of production costs. So also the pumping charges for liquids. The feeding charge for materials to equipment at an elevated level is also treated as production costs.

33. Any Subsidy / Grant / Incentive and any such payment received / receivable with respect to the input cost is reduced from the cost of the cost object to which such amount pertains. In case of any subsidy / grant received / receivable with respect to price of the product is to be treated as income and not reduced from the cost of the cost object.

EMPLOYEE COSTS

1. Employee Cost or Labour cost includes all remuneration paid to employees of the company including allowances, benefits or any payment made in behalf of employees.

2. Employee cost includes remuneration paid or payable and provisions made for future payments.

3. For cost accounting purposes, employee cost includes amounts paid to temporary, part time and casual or contract employees including benefits extended to them.

4. Bonus has been described by courts as "deferred wage" and customary payments by way of bonus have come to acquire the characteristic of mandatory payment. There is little reason to deny such payments the status of cost.

5. Ex-gratia payments are after often paid along with statutory bonus. These may take the form of;

   a. Amount paid as a rate higher than the rate arrived at as per Payment of Bonus Act calculations.

   b. Extending full rate of bonus to those to whom the maximum bonus under the Payment of Bonus Act will apply- presently limited to ₹ 8500/- per month by way of Basic + DA.

   c. Extending the bonus to employees not covered under the Payment of Bonus Act – presently ₹10000/- per month or more by way of Basic + DA.

   d. These payments which are in the nature of goodwill payment by managements and are in no way related to the amount of allocable surplus are generally treated as part of employee cost.

6. Bonus under the Payment of Bonus Act must be distinguished from performance incentives which are generally related to output and not profits. These may take the form of incentives at;

- Individual employee level – based on his or her performance.
- Group of employees level – based on performance of a group of employees or team
- Unit level – where the incentives are paid on the basis of performance of the factory or other unit.

Incentives at all three levels may be based on performance covering the production of more than one product; then an assignment issue arises. It is generally accepted that the incentives have to be prorated over all the products on the production of which the incentive is earned, not merely to the products produced after the threshold limit for earning the incentive is reached.

7. There has been generally a reluctance to treat incentives based on sales as cost of production, even though it is paid to production employees. The basis for calculating the incentive or the timing of payment should not determine the treatment of such incentive. The fact that such payment is computed on sales value of production or is payable only on sales of the product cannot change the character of an incentive – if it was originally conceived as an incentive for higher production.

8. Some will argue that managerial personnel are owners of the business and hence the payment to them must be regarded as return to owners. Others will argue that the remuneration to managerial personnel is as executive directors, manager etc and hence must be regarded as cost. The latter view gets higher credence with greater professionalization of management and whole-time Directors with no or little shareholding in the company drawing managerial remuneration which includes a commission as a % of profits.

9. In the case of sole proprietorships, salary paid to owner and in the case of a partnership fixed salary paid to a working partner must qualify as cost.

10. It is customary for senior management to be extended perquisites in the form of free housing, free car, services of waterman / gardener, free telephone, leave travel concession for self and family.

11. The Income-Tax rules provide for the valuation of these perquisites. But these cannot in anyway enter into cost calculations. Employee cost includes the cost to company of extending these benefits. The cost to company (CTC) calculations made at the time of appointment or later is a good guide on what should enter into employee cost. The fact that some portion of the perquisites is disallowed in the assessment of the employee as being personal in nature can not influence the treatment in cost accounts.

12. There are group benefits extended to employees such as Group Personal Accident Insurance, Group Medical Insurance Scheme etc. It is difficult to relate such costs to individual employees and therefore to cost centres or objects. These can only be allocated to cost centres or cost objects on the basis of number of employees or employee cost of each cost centre or cost object.

13. Employee welfare expenses similarly represent motley of benefits including canteen facilities, recreation facilities, gifts to individual employees on birthdays / marriage, dispensary facilities etc. These are legitimately treated as part of employee cost and allocated to cost centres or cost objects on the basis of no. of employees or employee cost of each centre or cost object.

14. Post-employment benefit schemes can take any two forms;

    a. Fixed contribution to a fund by the employer with varying benefits to employees.

    b. Variable contribution to a fund by the employer to assure given benefit to the employees.

    c. The fixed contribution plans involves a defined cost per employee and can be readily assigned to cost centres or objects. The contribution under variable contribution plans are generally determined on an actuarial valuation The treatment of such benefits in Cost Accounts will be on the same basis as in financial accounts which is governed by AS-15 in India.

    d. The allocation of the cost of such employee benefits to cost centres / Cost objects will be on the basis of no. of employees or employee cost.

15. Voluntary retirement plan costs have been treated in varying ways in India. The treatment of the same will be as per Cost Accounting Standard 7.

16. It is usual for employee cost, particularly direct employee cost, to be converted to hourly rates for ease of assignment to jobs or products. Such hourly rate may reflect only payroll costs i.e., only basic + dearness allowance + allowances or be comprehensive and include all benefits. The ultimate is for the rate to reflect the Cost to Company (CTC). Where the rate excludes some elements of employee cost, these will be treated as overheads and absorbed in cost.

17. Hourly rates are arrived at using the available hours as the divisor. Normal health breaks or rest allowances are excluded from available hours. It is important to note that any time like rest time which gets included in job times cannot be excluded from available hours.

18. It is not unusual for regular costing to proceed on the basis of standard hourly rates based on budgeted employee cost and budgeted hours and for the variances in labour rates to be treated as overheads or taken to costing P&L or reconciliation.

19. Labour cost falls into two categories;

    - Direct Employee cost
    - Indirect Employee cost

20. Early stages of technology witnessed a major role for the workmen in the manufacturing process with output being controlled mainly by the workmen's efforts. Hence elaborate systems were built to log workmen's time an individual jobs or products and operations and employee cost was assigned on the basis of seven time booking.

21. As technology grew, the importance of machines in production grew with decreasing nexus between workmen's efforts and production. Work men were assigned to more than one machine producing more than one product with his role being reduced to attending to controls.

22. Where technology is at an early stage, it is still common for direct employee cost to be assigned to products and operations on the basis of time booked. This is typical of engineering shops with conventional machines such as lathes, drilling machines, milling machines etc., and simple processing shops.

23. Where sophisticated technology is deployed such as computer numerically controlled machines are employed, it is usual for employee cost to be absorbed in products as part of a comprehensive machine hour rate.

24. Where a gang of workmen or a team of employees are assigned to a job, it is usual to assign direct employee cost on the basis of gang hours or time logged by the team.

25. The wheel turns a full circle when assembly operations are controlled in the main by robots and one or two work men control the whole assembly line only to attend to disruptions. Direct employee cost even the entire cost including equipment cost – in such cases is assigned on the time honoured direct labour hour basis.

26. In a balanced production line in a lean manufacturing set-up where workmen stand in fixed location, the belt carrying the work moves at fixed speed and work men are expected to complete their operations within the allotted time. In such cases, it is usual to charge employee cost as well as equipment cost on the basis of "Cycle Time" rather than labour hours.

27. Overtime which is based on single rate posses no special issues in costing. But where overtime is compensated at double or triple rate, the overtime premium is handled in one of the following ways;

    - Where the overtime working is caused by a "rush order" of the customer or other special requirement of a job, the premium is assigned to the job or product.

- In all other cases, it is usual to treat the premium as overheads and absorb the same as part of overheads.

28. Idle time of direct workmen is generally logged separately. Normal idle time is absorbed in product cost as part of overheads and abnormal idle time is taken to costing profit and loss or reconciliation.
29. Where direct workmen are expected to carry out maintenance on the machines attended by them, it is usual to log such time separately against maintenance work orders and treat the same as Repairs and Maintenance Cost.
30. Booking of time spent on jobs or products is relevant in job or batch operations but loses its relevance in continuous process industries where direct employee cost is treated as part of processing cost.
31. Changing direct employee cost on the basis of standard time is prevalent. In such cases, the efficiency variance is isolated and absorbed in product cost except where it is abnormal, where it is taken to costing P&L or reconciliation.

DIRECT EXPENSES

1. Direct expenses are those relating to manufacture of a product or rendering a service, which can be readily identified or linked with cost objects other than Direct Material and Direct Employee cost.
2. Examples are:
   a. Royalties charged on production,
   b. Job charges,
   c. Hire charges for use of specific equipment for a specific job,
   d. Cost of special designs or drawings for a job,
   e. Software services specifically required for a job,
   f. Travelling Expenses for a specific job.
3. The need for direct expenses to be amortised arises when for example Royalty or Technical know-how fees, or drawing designing fees, are paid for which the benefit accrues in the future period. In such case, the production / service volumes are estimated for the effective period and based on volume achieved during the current period, the charge for amortisation is determined.

COST OF UTILITIES

1. Utilities are a special class of service cost centres which generally produce a measurable output which are used as inputs in the process of manufacture of products and services but do not form of the products. Examples are power, steam, water (treated, demineralised etc.) compressed air and the like.
2. Utilities are generally meant for captive consumption even though it is not unusual for part of the output to be sold to a nearby plant of the same entity or another entity.
3. Utilities are also purchased by an entity from an outside source usually a public utility (e.g. power from an electricity authority) or steam from neighbouring plant.
4. It is also not usual for utilities produced to have more than one use – steam generated being used both to drive turbines to generate electricity (high pressure steam) and also for heating purposes in the process (low pressure steam) giving rise to interesting issues in costing.
5. Sometimes a utility is held to safeguard against the failure of the main source of input of the utility e.g., stand-by generators held against failure of power supply from the grid.

6. Administrative overheads are generally not allocated to captively used utilities. Where the utilities are largely meant for transfer to other units or sale to outside parties such as sale of generated power to the official grid, administrative overheads may also be allocated to the utilities.

7. Since the cost of utilities is significant in many entities and there is a measurable output, it is usual to do the costing of utilities with the same rigour as in the case of products and services. The Companies (Cost Records and Audit) Rules, 2014 require the preparation of separate cost statements for each major utility such as power, steam and the like. The Cost Accounting Standard 8 on Cost of Utilities requires each type of utility to be treated as a separate cost object.

8. Costs of distributing the utilities e.g. power through distribution lines including transformers, motor control centres and the like are treated differently based on end use. Costs of distribution of utilities for captive use are often captured in a separate service cost centre and treated as a service cost centre. Cost of utilities used for inter unit transfer often include the proportionate cost of distribution.

9. Costs of utilities meant for sale to outside parties will include marketing costs if the generated utility is mainly meant for sale but this takes the context out of captive generation and consumption of utilities in the manufacture of products and rendering of services.

10. Where part of the utility generated is used within the utility e.g. electricity used within the power house, cost of such consumption is generally absorbed by the cost of output meant for other users. This has got the effect of grossing up the unit cost of the utility for the costs of internal consumption of the respective utilities.

11. Output of utilities is generally distinguished in terms of quality. In the case of water, raising of water from bore wells or pumped from a nearby river is identified as raw water, whereas the output of a Water Treatment Plant is identified as treated water; the output from a cooling tower as cooling water; and the output from a chilling plant as chilled water. Similarly steam produced is classified as low pressure, medium pressure or high pressure or into bands of pressure rating.

12. Costs of generation of various types of water involve progressively additional costs while costs of steam generation have to be allocated to steam at different pressures based on some measure of work for e.g. British Thermal Units (BTUs)

13. The use of by-products from the manufacturing process as fuel in utilities e.g. bagasse as fuel in the boiler calls for special treatment. These by- products are evaluated on the basis of their calorific value in relation to the principal fuel used by the entity e.g. coal. If the by-product is the only fuel used by the entity, it is evaluated on the basis of its calorific value in relation to alternate fuels that can be used by the entity. In other cases, the market value of such by-product, e.g. price of bagasse in open market sales, can be used for valuing the by-product.

14. Sometimes, waste material recovered from input materials may be used as fuels in the utilities, e.g. pith from bagasse or bark from wood used as raw material in a paper mill.

15. The methods of assignment of costs of generated utilities to the consuming centres vary considerably depending on the system of measurement of usage, e.g. metering, instrumentation system and the like used in the entity. It may be safely said that it may be uneconomical to meter the consumption of utilities to the last unit. Some technical estimates may have to be used. The problem is complicated because distribution lines are not always laid out in such a way that measuring instruments can be installed at each distribution point. It is not uncommon to tap power from a nearby line carrying power to another consuming centre or to divert steam from a nearby pipe carrying steam to another consuming centre. These problems get accentuated as the plant advances in years when new requirements of utilities are met in an adhoc manner such that the original drawings of distribution lines are no longer representative.

16. Wherever meters are installed, utility costs are assigned on the basis of actual usage as metered.

17. Alternatively, utility costs are assigned on the basis of ratings of consuming equipment weighted by a usage factor, e.g. in the case of power, based on HP rating of equipment multiplied by

number of hours in use. As a last resort, technical estimates based on process specifications of power or steam consumed are used to develop the bases for allocation.

18. Distribution losses or unaccounted consumption of utilities are netted against the generated quantity before assignment to consuming cost centres so as to reflect such cost in grossed- up unit rates.
19. Any abnormal losses like venting of large quantities of high pressure steam to avoid an accident will of course be evaluated separately and treated as loss in the costing Profit & Loss or the Reconciliation with financial accounts.

REPAIRS AND MAINTENANCE COST

1. Repairs and Maintenance cost is the cost of all activities required to restore the asset to a condition to perform its function at intended capacity and efficiency.
2. Repairs and Maintenance cost includes cost of;
   a. Repair materials
   b. Spares
   c. Consumable stores
   d. Manpower
   e. Utilities
   f. Repair equipment costs
   g. Allocated costs from other service cost centres.
3. Repairs and Maintenance can be classified into
   a. Preventive Maintenance
   b. Planned Maintenance
   c. Breakdown Maintenance
4. Preventive Maintenance costs are generally booked through standing orders which are in essence continuing work orders, all issues of material time of maintenance crew and other resources used are booked against the standing orders.
5. Alternatively Preventive Maintenance schedules carry a standard bill of materials and standard usage of maintenance crew time and other resources and these are blown up based on no. of jobs completed. Actual usage of materials, time and other resources are recorded in detail and allocated to various preventive maintenance jobs based on standard usage.
6. Planned Maintenance jobs are jobs like Annual shutdowns, periodic overhaul etc. These carry a standard bill of materials to be used for the maintenance jobs, parts to be replaced during the planned maintenance, number and skill category of maintenance crew required, heavy maintenance equipment like cranes to be used and other resources. Actual of these resources is booked against the planned maintenance jobs.
7. Break down maintenance jobs are triggered by a Fault Report which generates a work order with a number. All issues of materials, time of crew and other resources are booked against these work orders to provide cost of individual maintenance jobs.
8. In a computerized environment, robust systems are in place to open and close work orders for all types of maintenance jobs with authorizations and sign offs, standard bills of materials type and number of persons and other resources required with automatic generation of issue requisitions and requests for personnel and equipment. Costs of closed work orders are transferred to relevant accounts in the books of accounts.

9. In a non-computerized environment, there is often a tendency to keep the paperwork to a minimum while ensuring accurate costing. In such an environment, work orders are opened only for large maintenance jobs. The threshold limit is fixed in terms of time taken for the maintenance job to be completed (or shut down time) the cost of materials requisitioned, the number of crew involved, special equipment required or a combination of these. Costs are booked by work orders for the major repairs and for others, costs are booked by cost centres or equipment number.

10. It is also usual to treat the maintenance crew as fixed resources and not attempt to book their time against maintenance jobs. The allocations to cost centres are based on the principle of "readiness to serve" with the estimate of demand from various cost centres prepared at the time of manpower planning acting as the base for allocation of manpower costs.

11. Maintenance jobs often require the use of heavy equipment such as cranes, hoists etc. The costs of this maintenance equipment are accumulated by equipment number. These are charged to maintenance jobs based on recorded usage in hours or to cost centres based on estimated usage prepared at the time of planning the capital expenditure on these items of equipment.

12. Many large production facilities have a captive workshop where parts are turned, machined or otherwise repaired. These workshops also produce some spare parts. Often, the workshop is treated similar to production cost centres with job orders being opened for production jobs and work orders for repair jobs. The costs of the workshop which comprises costs of materials, labour, equipment and other resources are assigned to jobs and work orders based on some suitable basis such as labour hours.

13. It is true that maintenance jobs are increasingly being outsourced. Maintenance Labour is almost completely outsourced with only a small crew of specialized craftsman retained on the company's rolls.

14. The outsourcing may be of the entire job or may take the form of a contract for supply of labour. In the former case, bill for completed jobs are generally available and lead to accurate costing of labour for such jobs. When outsourcing takes the form of a contract for supply of labour, no time recording by jobs is generally available and only deployment by department or cost centre is available.

15. With increasing sophistication of technology, maintenance of specialized equipment is entrusted on a turnkey basis to the vendor of the equipment or other specialized maintenance outfits. This may involve costs of travel of technicians besides bill for services from the agency rendering the services. It is usual to accumulate all costs of such maintenance jobs and treat them appropriately as outlined later.

16. It is usual to have Annual Maintenance Contracts (AMC) for specialized equipment particularly electronic equipment subject to sudden failures. These take the form of only servicing or servicing with parts (comprehensive). The AMCs specify the number of routine servicing calls that will be made in a year. Where a single machine is covered by an AMC, costing becomes simple. But where a fleet of machines are covered by a single AMC, allocation of costs to cost centres can be made on the basis of number of machines in each cost centre. Where the machine in various cost centres require different levels of service or vary in cost, a suitable allocation base has to be evolved based on such differences.

17. It has been customary in the past to treat major repair jobs differently with their cost being spread over the periods benefiting from such expenditure. Increasingly such expenditure is charged to the Profit and Loss Account of the period in financial accounts, which is driven largely by tax deductibility considerations. Further, with Accounting Standard 26 on Intangible Assets coming into force, creation of Deferred Revenue Expenditure is not allowed. However in Cost Accounts, these major repair job costs may be prorated over the year(s) of benefits with appropriate disclosure in Reconciliation statements of the respective years. The treatment in cost accounts would depend on the nature and benefit accruing from such expenditure.

PRODUCTION OVERHEADS

1. Overheads comprise of indirect material, indirect labour and indirect expenses. They are termed indirect because they are not directly identifiable or allocable to the ultimate cost object, usually a product or service, in an economically feasible way. Instead of using the term 'overheads', it is more appropriate to refer to them as Indirect Costs.
2. Increasingly with the spread of information technology, more and more costs can be identified with the final cost object. Even small materials which could not be previously identified with the products in an economically feasible way can now have the issues recorded by product.
3. On the contrary, the sophistication of manufacturing technology renders workman as observers of machines working or instrument watchers or console operators instead of tending to the machine or product directly. Thus a greater part of the labour cost is becoming indirect to the product.
4. Since overheads cannot be economically traced to products, they are traced to production centres through which the product passes to be absorbed by the product generally on the basis of time spent by the product at the production centre.
5. Also there are service cost centres through which the product does not pass through but which provide a support function to the production cost centres. The service department costs are assigned to production cost centres before being traced to products and services.
6. In traditional cost systems, a cost distribution sheet is prepared to capture the expenses in the nature of overheads booked in the books of accounts and supporting records like stores records. These are then analysed by cost centres.
7. Some overheads are booked in the system by cost centres. For this purpose, many General Ledger systems have extensions to account codes to book transactions by cost centres.
8. In other cases, the overheads individually or after being grouped into homogenous groups are apportioned to cost centres on some suitable basis. The following table reproduced from Cost Accounting Standard 3 lists the commonly used bases.

Item of Cost		**Basis of Apportionment**
Power	-	HP 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 material handled
Supervisor's 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

9. For a long time the method of apportionment used was based on "charging what the traffic will bear", i.e. the bigger the cost centre the greater the charge to it. This is actively discouraged now.
10. Changing overheads on the basis of benefits received by the various cost centres is preferred. This requires some measure of benefit to be developed.
11. After the spread of modern cost accounting concepts, particularly activity-based costing (ABC), there is a distinct preference for apportioning overheads on the basis of cause and effect analysis.

What or who causes the costs to be incurred is a more rational criterion to change costs rather than size or benefits received.

12. Thus the Purchase Department costs are best charged based on an analysis of what causes the Purchase Department to be manned and be operating at the present level. It could be the number of purchase requisitions, the no of items being ordered, the degree of inspection required by various items, the logistics requirements involved or a weighted combination of these.

13. After the overheads are allocated or apportioned to various cost centres, the costs apportioned to service cost centres are redistributed to production cost centres and other service cost centres, generally based on one of the bases described above.

14. Given the information processing capability, individual items of overheads or groups of them are taken up for redistribution.

15. Rendering of service by one or more service cost centres to other service cost centres or even rendering of services interse by service cost centres are adequately handled in a spread sheet environment.

16. It is useful to remember that the use of sophistication in distribution methods does not improve the quality of the costing system. It is the direct capturing of costs to cost centres, the appropriateness of defining the cost centres and the use of proper measures of benefits received that will improve the costing. Ultimately it is the analysis of what triggers the cost that is relevant.

17. Ultimately all overheads must be charged to products of services. Hence the total production overheads of Production Cost Centres are applied to products passing through them using a suitable absorption base. The absorption bases commonly used are listed below (*reproduced from Cost Accounting Standard 3 paragraph 5.6*)

Base 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

18. Before the final step of absorption, production overheads of production cost centres have to be segregated between fixed overheads and variable overheads. The fixed overheads are absorbed by products based on normal capacity or actual capacity utilization whichever is higher. Variable overheads are absorbed by products based on actual capacity utilization. This treatment is in line with Accounting Standard as well.

19. Under absorbed fixed overheads are charged to Costing Profit & Loss Account and shown as an item of Reconciliation with financial accounts.

20. Normal capacity is defined in *Cost Accounting Standard - 2* as 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. It is practical capacity minus the loss of productive capacity due to external factors[63]. In arriving at the practical capacity, the following are factored:
    - holidays
    - number of shifts
    - shift duration

63 CAS 2 Paragraph 4.4

- annual maintenance
- preventive maintenance if it involves overtime
- batch change over time
- lunch break, personnel changeover etc.,
- production per hour which is in turn based technical specifications, loss in efficiency due to ageing, operational constraints etc.

21. It is usual to employ a predetermined overheads rate throughout the year based on budgeted overheads and budgeted production base and to absorb overheads on the basis of actual production multiplied by the predetermined overhead rate.
22. The difference between the absorbed overheads and the actual overheads arises due to,
    - variation between the budgeted level of capacity utilization and actual production and
    - variation between budgeted level of overheads and actual overheads.
23. It is easy to lose perspective on the amount of overhead absorbed by different product in the web of calculations involved in allocation, apportionment and absorption. Operating managers have great difficulty in comprehending the result of a complex allocation, apportionment and absorption algorithm. A simple casual relationship is better understood. It may be preferable to limit complex distribution models if required to major items of overheads and to use simple adhoc methods for the balance overheads.

ADMINISTRATIVE OVERHEADS

1. Administrative overheads must be understood as costs of administrative functions in an entity and not as a collection of elements of costs such as travel, communication, printing and stationery etc.
2. Administrative overheads are of two types:
   (a) Costs of administrative support functions which support operations such as Purchase, Personnel, Accounts, Factory Administration, Marketing Support etc.,
   (b) Costs of policy making and strategic management such as Finance, Human Resource Development etc.
3. The functions covered in (a) above are generally attached to a unit like Factory Administration or Marketing administration and are readily identified with production or selling and distribution function.
4. Even when they are located in a Head Office or Corporate Office, it should make little difference, because they cater to the needs of specific functions in the entity. For example, purchase may be located in a central office but they cater to the requirements of specific factories or manufacturing and costs can be assigned to such units.
5. The assignment of such costs to functions and activities benefited by them is feasible subject to limits. The use of activity- based costing can lead to identification of activities within the administrate function and what causes them. Thus the Head office Purchase activity costs can be assigned to user functions based on some measure of activity like no of purchase requisitions.
6. The use of the terms "share of administrative overheads relating to production" and "share of administrative overheads relating to selling" in the erstwhile Companies (Cost Records and Audit) Rules, 2014 has led to arbitrary practices in some entities to assign all administrative overheads on an arbitrary ratio say 60:40 between production and selling. These terms can only refer to administrative costs of functions attached to production or selling. There will be a residuary head of "Administrative Overheads" which cannot be assigned to production or selling functions representing costs of policy making and strategic management and are to be treated as period costs. Also included in this category are expenses such as Directors sitting fees, audit fees, filing fees and other corporate expenses. Paragraph 6.3 in Cost Accounting Standard 3 on overheads should be interpreted in the light of the above discussions.

7. It is significant to note that the reporting format under the new Companies (Cost Records and Audit) Rules, 2014 has a separate line item for Administrative overheads.

8. The assignment of as much of the administrative overheads as possible based on identified cost drivers is recommended. The balance of administrative overheads can only be assigned to cost centres or objects based on capacity or sales value. It is usual in textile industry to charge corporate office cost to mills based on installed spindle capacity.

SELLING AND DISTRIBUTION OVERHEADS

1. The use of the term "Selling and Distribution Overheads" includes items of costs that are not "overheads" but are direct to products such as commission on sales, freight etc. The use of the term "Selling and Distribution Costs" is to be preferred.

2. It is necessary to distinguish "selling" costs from "distribution costs". The latter relate mainly to costs incurred before sales are generated and are therefore indirect to product while distribution costs are more direct to products.

3. It is also usual to speak of "order getting" costs and "order filling" costs to distinguish between the two sets of costs.

4. Selling costs are generally fixed in nature except for commission on sales and the like.

   Examples of selling costs are:

   a. Salaries of sales personnel
   b. Travelling expenses of sales personnel
   c. Commission to sales agents
   d. Advertisement costs
   e. Sales promotion expenses including cost of promotional material such as product brochures, catalogues etc.,
   f. Collection costs including legal expenses for recovery of dues
   g. After sales service costs
   h. Warranty costs etc.,

5. Selling overheads or selling costs are a combination of direct costs relating to selling of products or service and indirect costs of sales management.

6. Distribution overheads or distribution costs are the costs incurred in handling a product from the time it is ready for dispatch until it reaches the ultimate consumer.

7. Distribution costs include:

   a. Secondary packing cost
   b. Packing repacking / labelling at an intermediate storage location
   c. Transportation costs
   d. Cost of warehousing (cover depots, godowns, storage yards, stock yards etc.,)

8. Transportation costs comprises of the cost of freight, loading and unloading, transit insurance, costs of operating a fleet and other incidental charges whether incurred internally or paid to an outside agency for transportation of goods.

9. Broadly transportation costs are divided into two categories;

   a. Cost of operating own fleet
   b. Cost of hired transport

10. Costs under either category may include costs;

   a. Directly allocable to products or
   b. To be apportioned to products

11. A good costing system should be able to record separately transportation cost from factory to depots and from depot to customers place, wherever practicable and economically feasible.
12. Penalty, detention charges, demurrage charges and other abnormal costs are excluded from transportation cost.

INTEREST AND FINANCE CHARGES

1. This cost head includes the following items of cost;
   a. Interest on debentures and bonds
   b. Interest on long term loans
   c. Interest on working capital finance in the form of cash, credit or overdraft including short term loans
   d. Interest on overdue payments to suppliers and others
   e. Discounting charges on bills of exchange
   f. Bank charges on bills negotiated through Bank for sales or purchases
   g. Letter of credit charges
   h. Guarantee commission/ commitment charges
   i. Cash discount and many more

   Interest and Finance charges are accumulated under suitable heads as in (1) above in the financial books before they are taken to cost accounts.
2. For a long time, it was the practice in India to ignore interest as an element of cost following text book discussions on whether interest is a cost.
3. Interest and finance charges are shown separately in point no. 29 of annexure 2 of Part-B of CRA-3 of Companies (Cost Records and Audit) Rules, 2014.
4. Similarly it is usual to develop an average rate of interest paid on various forms of finance for working capital and apply it to working capital investment in product lines or products.
5. Working capital investment by product line is arrived at directly in most cases or apportioned on the following
   - Raw material stocks – Direct or on the basis of raw materials consumed
   - Stores – generally on the basis of stores consumed excluding special high value items which can be identified directly.
   - Work-in-process and finished goods - Direct
   - Book debts – Direct or on the basis of sales (gross)
   - Other current assets – except high value items which can be directly identified with products, on the basis of sales or cost of sales.
6. It is a also not unusual to arrive at the working capital investment on the basis of length of the operating cycle in no of days for each product line multiplied by cost of sales or sales.
7. Other finance charges are identified by product lines or products for big items of expenditure or otherwise grouped and charged to product lines or products based on cost of materials consumed, cost of production, and cost of sales or sales.
8. Where the assignment is done initially to product lines as for interest on long term loans, such charges are assigned to individual products on the basis of cost of sales or sales.

10. *Applicability of Cost Accounting Practices*

1. The above discussions embody the cost accounting practices followed in various industries while applying the cost accounting principles.

   However they may vary from practices adopted by specific regulated industries like banks, electricity, fertilisers. In many cases these practice are laid down by the regulator and are followed without fail in the industry. For example, depreciation rates based on life of equipment are prescribed by the regulatory agency in the electricity generation industry and will prevail over the practices mentioned earlier regarding depreciation rates.

4.2 COST ACCOUNTING STANDARDS

List of Cost Accounting Standards (CAS) prescribed by the Institute till date:-

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 128 of the Companies Act, 2013 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

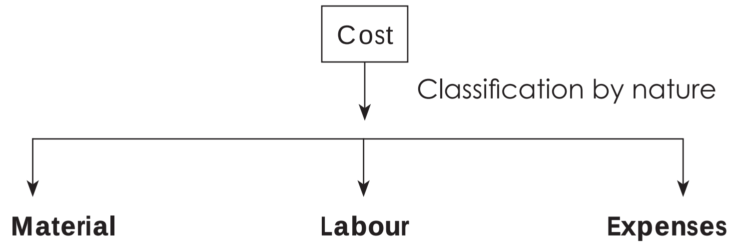
5.5 Classification of cost is the process of grouping the components of cost under a common designation on the basis of similarities of nature, attributes or relations. It is the process of identification of each item and the systematic placement of like items together according to their common features. 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, salex 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.

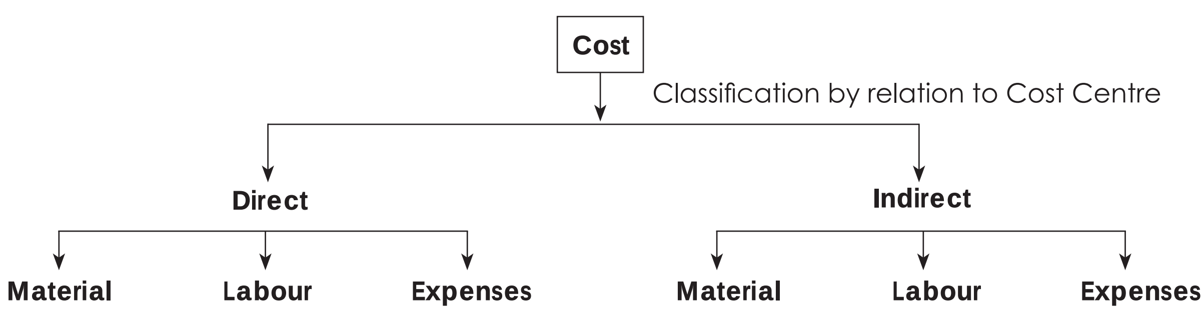
6.1.5 Labour cost include salaries and wages paid to permanent employees, temporary employees and also to employees of the contractor. Here, salaries & wages include all fringe benefits like Provident Fund contribution, gratuity, ESI, overtime, incentives, bonus, ex-gratia, leave encashment, wages for 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 an 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.



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.

6.2.4 Direct Labour Cost is the cost of wages of those workers who are readily identified or linked with a cost centre or cost object.

6.2.5 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.

6.2.6 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.

6.2.7 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

6.2.8 Indirect Material is the cost of material which can not be directly allocable to a particular cost centre or cost object.

6.2.9 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.

6.2.10 Indirect labour cost is the wages of the employees which are not directly allocable to a particular cost centre.

6.2.11 Examples of indirect labour :

- Salaries of staff in the administration and accounts department
- Salaries of security staff etc

6.2.12 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.

6.2.13 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 :

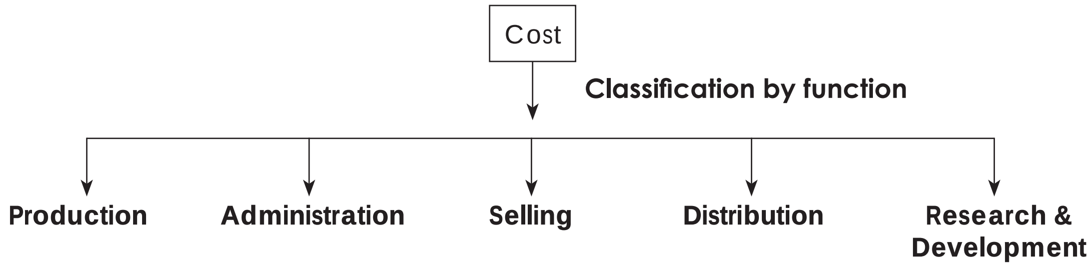
Production;

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 :

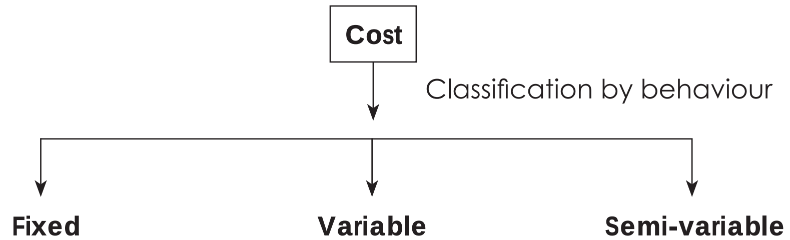
To arrive at value at different points as indicated above adjustment with opening and closing stock is necessary at following different points :

(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.

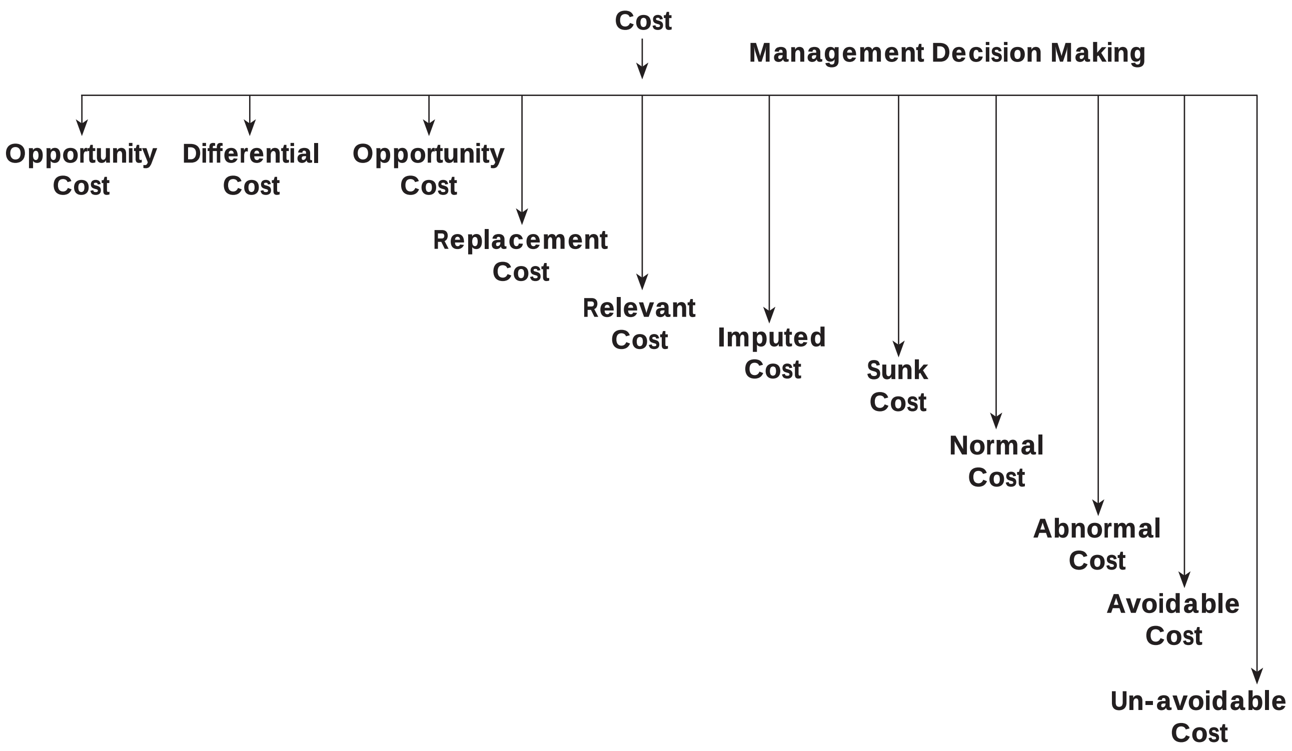
Note :

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 :

		Fixed Cost	Variable Cost
A.	Production		45,000 units
B.	Cost	₹ lakhs	₹ lakhs
	1. Material cost		4.50
	2. Labour cost		2.45
	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		₹ 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 Lakhs	Differential Unit in lakhs		Total Cost (₹ lakhs)	Differential cost (₹ lakhs)	Differential cost per unit (₹)
(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 ₹ 60,000 profit. Then the opportunity cost of using the machine is ₹ 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.

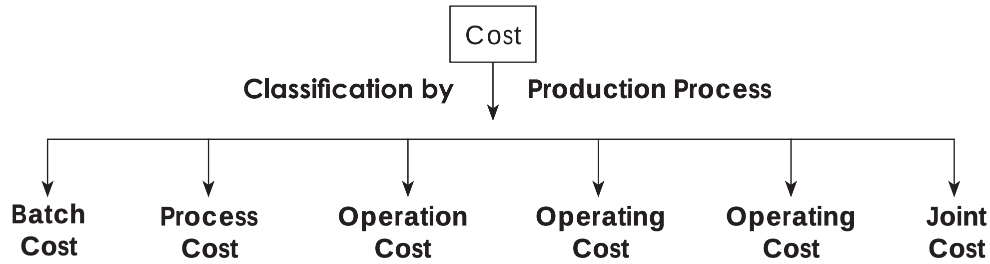
6.5.21 *Avoidable Costs are those costs which under given conditions of performance efficiency should not have been incurred.*

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 clauses are sometimes provided in the contract in order to take care of anticipated change in material price, labour cost etc.

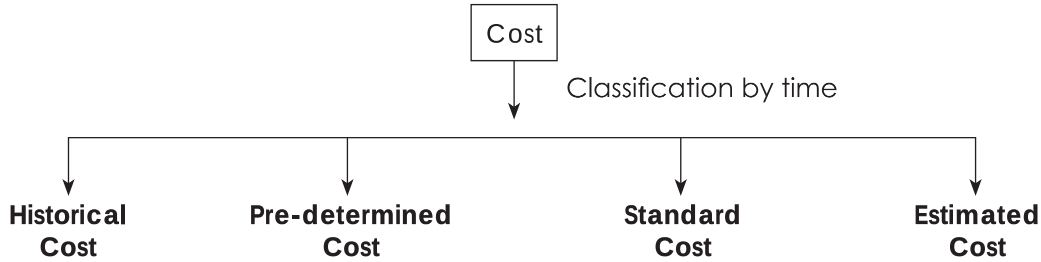
6.6.10 Joint Costs are the common cost of facilities or services employed in the output of two or more simultaneously produced or otherwise closely related operations, commodities or services.

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 (REVISED 2012)

COST ACCOUNTING STANDARD ON CAPACITY DETERMINATION

The following is the Cost Accounting Standard - 2 (Revised 2012) issued by the Cost Accounting Standards Board of the Institute of Cost Accountants of India on "Capacity Determination". 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:

1.1 This standard deals with the principles and methods of determining the capacity of a manufacturing facility of an entity.

1.2 Capacity is determined for assignment of overheads to cost objects. Principles of assignment of overheads have been stipulated in Cost Accounting Standard – 3 (Revised 2011) on Overheads.

1.3 ***This standard deals with the principles and methods of classification and determination of capacity of a plant of an entity for ascertainment of the cost of product, and the presentation and disclosure in cost statements.***

2. Objective:

The objective of this standard is to bring uniformity and consistency in the principles and methods of determination of capacity with reasonable accuracy.

3. Scope:

This standard shall be applied to the cost statements, including those requiring attestation, which require determination of capacity for assignment of overheads.

4. Definitions:

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal Idle Capacity: ***Abnormal idle capacity is the difference between normal capacity and actual capacity utilization where the actual capacity is lower than the normal capacity.***

4.2 Actual Capacity Utilization: ***Actual Capacity Utilization is the volume of production achieved in a specified period, expressed as a percentage of installed capacity.***

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are finally ascertained.***

4.4 Installed Capacity: ***Installed Capacity is the maximum productive capacity, according to the manufacturer's specifications or determined through an expert study.***

4.5 Normal Capacity: ***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 sometimes referred to as practical or achievable capacity.

4.6 Normal Idle Capacity: ***Normal Idle Capacity is the difference between installed capacity and normal capacity.***

5. Determination of Capacity:

5.1 ***Capacity shall be determined in terms of units of production or equivalent machine or man hours.***

5.2 Installed Capacity:

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

In case manufacturers' technical specifications are not available, the estimates by technical experts on capacity under ideal conditions shall be considered for determination of installed capacity.

In case any production facility is added or discarded the installed capacity shall be reassessed from the date of such addition or discard. In case the same is reassessed as per direction of the Government, it shall be in accordance with the principles laid down in the said directives.

In case of improvement in the production process, the installed capacity shall be reassessed from the date of such improvement.

5.3 Normal Capacity:

Normal capacity shall be determined vis-a-vis installed capacity after carrying out following adjustments:

(i) Holidays, normal shut down days and normal idle time,

(ii) Normal time lost in batch change over,

(iii) Time lost due to preventive maintenance and normal break downs of equipments,

(iv) Loss in efficiency due to ageing of the equipment,

(v) Number of shifts.

5.4 Capacity utilization:

Capacity utilization is actual production measured as a percentage of installed capacity.

Actual production refers to in-house production.

6. Presentation:

6.1 ***Cost Statements shall present Installed capacity in absolute terms.***

6.2 ***Actual Capacity utilization shall be presented in absolute terms and as a percentage of installed capacity.***

7. Disclosure:

7.1 The cost statements shall disclose the following:

1. Basis for arriving at different types of capacity.

2. Change in the installed capacity or normal capacity with reasons thereof.

3. Increase or decrease in capacity due to equipments taken on lease or leased out.

4. Details of production

(a) Self Manufactured

(b) Produced under leasing arrangements

(c) Produced on loan license / by third party on job work

5. Reasons for low capacity utilization.

6. Abnormal cost due to under-utilization of capacity.

7.2 *Disclosures shall be made only where material, significant and quantifiable.*

7.3 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.*

7.4 *Any change in the principles and methods applied for capacity determination and its impact during the period covered by the cost statement which has a material effect on the capacity determination. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

CAS-3 (Revised 2011)[1]

COST ACCOUNTING STANDARD ON "OVERHEADS" (Revised 2011)

The following is the revised COST ACCOUNTING STANDARD 3 (CAS-3) issued by the Council of The Institute of Cost Accountants of India on "Overheads". In this Standard, the standard portions have been set in ***bold italic*** type. This standard shall be read in the context of the background material, which has been set in normal type.

1. Introduction

1.1 ***This standard deals with the principles and methods of determining the Overheads.***

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of Overheads, for determination of the cost of product or service, and for the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Overheads with reasonable accuracy.

3. Scope

This standard shall be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of Overheads including those requiring attestation.

4. Definitions:

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and / or due to some abnormal situation of the production or operation.***[2]

4.2 Absorption of overheads: ***Absorption of overheads is charging of overheads to Cost Objects by means of appropriate absorption rate.***

Overhead Absorption Rate = Overheads of the Cost object / Quantum of base.

4.3 Administrative Overheads: ***Cost of all activities relating to general management and administration of an organisation.***

Administrative overheads shall exclude production overheads, marketing overheads and finance cost. Production overheads include administration costs relating to production, factory, works or manufacturing.[3]

4.4 Cost Centre: ***It is an organisational unit, in relation to which costs are accumulated.***

A cost centre includes a process, function, activity, location, item of equipment, group of persons or any other unit in relation to which cost are accumulated.

4.5 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which cost are ascertained.***

4.6 Distribution Overheads: ***Distribution overheads, also known as Distribution Cost, are the cost incurred in handling a product from the time it is ready for dispatch until it reaches the ultimate consumer.***[4]

Examples of Distribution Overheads are Cost towards Secondary Packing, Transportation of

1 This revised Cost Accounting Standard comes into force w.e.f. 1st April 2012 and supersedes the Cost Accounting Standard - 3 on Overheads issued by the Council on 3rd January 2003.)

2 Adapted from CAS 1 paragraph 6.5.19

3 From CAS 11 paragraph 4.3

4 From CAS 9 paragraph 4.7

Finished Goods, Warehousing of Finished Goods, Delivering the Finished Products to Customers, Clearing & Forwarding and Mending or Replacing Packing Materials at Distribution Point.

4.7 Imputed Cost: ***Hypothetical or notional cost, not involving cash outlay, computed for any purpose.*** [5]

4.8 Indirect Employee Cost: ***The employee cost, which cannot be directly attributed to a particular cost object.*** [6]

4.9 Indirect Expenses: ***Expenses, which cannot be directly attributed to a particular cost object.*** [7]

4.10 Indirect Material Cost: ***Materials, the cost of which cannot be directly attributed to a particular cost object.*** [8]

4.11 Marketing Overheads: ***Marketing Overheads comprises selling overheads and distribution overheads.*** [9]

4.12 Normal capacity: ***Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.*** [10]

4.13 Overheads: ***Overheads comprise costs of indirect materials, indirect employees and indirect expenses which are not directly identifiable or allocable to a cost object in an economically feasible manner.***

Overheads shall be classified on the basis of functions to which the overheads are related. For example:

- Production Overheads
- Administrative Overheads
- Marketing Overheads

In addition Overheads shall 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.
- Semi-variable overheads are partly affected by change in the production volume. They are further segregated into variable overheads and fixed overheads
- Fixed overheads comprise of expenses whose value does not change with the change in volume of production. For example, salaries, rent etc.

4.14 Production Overheads: ***Indirect cost involved in the production process or in rendering service.*** [11]

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably. Production overheads shall include administration cost relating to production, factory, works or manufacturing.

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5 Adapted from CAS 1 paragraph 6.5.13

6 Adapted from CAS 1 paragraph 6.2.10

7 Adapted from CAS 1 paragraph 6.2.12

8 Adapted from CAS 1 paragraph 6.2.8

9 From CAS 9 paragraph 4.10

10 Adapted from CAS 2 paragraph 4.4

11 From CAS 9 paragraph 4.13

4.15 Selling Overheads: ***Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***[12]

4.16 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference to compare the actual cost 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. Standard costs are also used for estimation.[13]

5. Principles of Measurement:

5.1 ***Overheads representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited.***

5.2 ***Overheads other than those referred to in paragraph 5.1 shall be determined on the basis of cost incurred in connection therewith.***

For example machinery spare fabricated internally or a repair job carried out internally will include cost incurred on material, employees and expenses.

5.3 ***Any abnormal cost where it is material and quantifiable shall not form part of the overheads.***

5.4 ***Finance costs incurred in connection with procured or self generated resources referred to in paragraph 5.1 and 5.2 shall not form part of overheads.***

5.5 ***Overheads shall not include imputed cost.***

5.6 ***Overhead variances attributable to normal reasons shall be treated as part of overheads. Overhead variances attributable to abnormal reasons shall be excluded from overheads.***

5.7 ***Any subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.***

5.8 ***Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the overheads.***

5.9 ***Credits / recoveries relating to the overheads, material and quantifiable, shall be deducted from the total overhead to arrive at the net overheads. Where the recovery exceeds the total overheads, the balance recovery shall be treated as other income.***

5.10 ***Any change in the cost accounting principles applied for the measurement of the overheads shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an entity.***

6. Assignment

6.1 ***While assigning overheads, traceability to a cost object in an economically feasible manner shall be the guiding principle. The cost which can be traced directly to a cost object shall be directly assigned.***

6.2 ***Assignment of overheads to the cost objects shall be based on either of the following two principles;***

(i) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost.

12 From CAS 9 paragraph 4.14

13 From CAS 7 paragraph 4.15

(ii) Benefits received – overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

In case of facilities created on a standby or ready to serve basis, the cost shall be assigned on the basis of expected benefits instead of actual.

6.3 ***Absorption of Production Overheads shall be as follows:***

6.3.1 ***The variable production overheads shall be absorbed to products or services based on actual capacity utilisation.***

6.3.2 ***The fixed production overheads shall be absorbed based on the normal capacity.***

6.4 ***Assignment of Administration Overheads shall be in accordance with CAS-11.***

6.5 ***Assignment of Marketing Overheads shall be as follows:***

6.5.1 ***Marketing Overheads that can be identified to a product or service shall be assigned to that product or service.***

6.5.2 ***Marketing Overheads that cannot be identified to a product or service shall be assigned to the products or services on the most appropriate basis.***

7. Presentation

7.1 ***Overheads shall be presented as separate cost heads like production, administration and marketing.***

7.2 Element wise and behaviour wise details of the overheads shall be presented, if material.

7.3 Any under-absorption or over-absorption of overheads shall be presented in the reconciliation statement.

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

1. ***The basis of assignment of overheads to the cost objects.***
2. ***Overheads incurred in foreign exchange.***
3. ***Overheads relating to resources received from or supplied to related parties*[14]*.***
4. ***Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable reduced from overheads.***
5. ***Credits / recoveries relating to the overheads.***
6. ***Any abnormal cost not forming part of the overheads.***
7. ***Any unabsorbed overheads.***

8.2 ***Disclosures shall be made only where material, significant and quantifiable.***

8.3 Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the overheads during the period covered by the cost statement which has a material effect on the overheads shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

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14 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

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% **(110% w.e.f. 05-08-2003)** 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

(i) Royalty based on production

(ii) Technical Assistance / know –how fees

(iii) Amortized cost of moulds, patterns, patents etc

(iv) Job charges

(v) Hire charges for tools and equipment

(vi) 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 need 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 does 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
	(₹/ MT)	(₹/MT)	(₹/MT)
1	2000	500	2500
2	2500	1000	3500
3	3500	1000	4500

If during the production process at stage 3, the scrap is produced and the same is recycled at stage 2 after making an expenditure of ₹ 200 per MT to make it suitable for re-processing at stage 2, then scrap will be valued @ ₹ (2500 – 200) i.e ₹ 2300. If no expenditure is involved to make scrap re-usable, the scrap value will be @ ₹ 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 128 of the Companies Act, 2013, 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 128 of the Companies Act, 2013, 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 (₹)**	**Cost/unit (₹)**
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

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 :

(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.

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, stock yards 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, 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 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**	(₹)
	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 :

1. Cost of Battery, and Tyres and Tubes shall to be amortised over its useful life.
2. Asset Register shall be maintained for determination of depreciation and amortization cost.
3. 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)**	(₹)
B1	Hired Transport Charges	
B2	Transit Insurance	
B3	Other (specify)	
B4	Total Transportation cost (B1 to B3)	

Name of the Manufacturer:

Appendix -3

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 (KM)											
B	**Outward Transport Cost (₹)**											
B1	Directly allocated own fleet transportation cost (₹)											
B2	Basis of Apportionment of own fleet cost (Specify)											
B3	Common own fleet transport cost to be apportioned											
B4	Directly allocated hired transportation charges (₹)											
B5	Basis of Apportionment of hired transportation cost (Specify)											
B6	Common hired transport charges to be apportioned											
B7	Total Transport Cost (B1+ B3+B4+B6)											
B8	Averaged transport cost per unit (₹) (B7/A1)											

* UM is the Unit of measurement

Seal and signature of Company's 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 :

Place :

Seal & Signature of Cost Accountant

Membership No.

CAS-6

COST ACCOUNTING STANDARD ON MATERIAL COST

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 "MATERIAL COST". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

1.1 This standard deals with principles and methods of determining the Material Cost.

Material for the purpose of this standard includes raw materials, process materials, additives, manufactured / bought out components, sub-assemblies, accessories, semi finished goods, consumable stores, spares and other indirect materials. This standard does not deal with Packing Materials as a separate standard is being issued on the subject.

1.2 This standard deals with the principles and methods of classification, measurement and assignment of material cost, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.

1.3 The Standard deals with the following issues.

- Principle of Valuation of receipt of materials.
- Principle of Valuation of issue of materials.
- Assignment of material cost to cost objects.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the material cost with reasonable accuracy.

3. Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of material costs including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation***[1]***.***

4.2 Administrative overheads: ***Expenses in the nature of indirect costs, incurred for general management of an organization***[2]***.***

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.4 Defectives: ***End Product and/or intermediate product units that do not meet quality standards. This may include reworks or rejects.***

4.4.1 Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***

Rework includes repairs, reconditioning and refurbishing.

1 Adapted fromCAS-1 Para 6.5.19

2 Adapted from CAS-1 Para 6.3.5

4.4.2 Rejects: ***Defectives which cannot meet the quality standards even after putting in additional resources.***

Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

4.5 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed only for the purpose of the decision making[3].***

4.6 Materials:

4.6.1 Direct Materials: ***Materials the costs of which can be attributed to a cost object in an economically feasible way[4].***

4.6.2 Indirect Materials: ***Materials, the costs of which cannot be directly attributed to a particular cost object[5].***

4.7 Material Cost: ***The cost of material of any nature used for the purpose of production of a product or a service[6].***

4.8 Production overheads: ***Indirect costs involved in the production process or in rendering service[7].***

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

4.9 Scrap: ***Discarded material having some value in few cases 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[8].***

4.10 Standard Cost: ***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 for deviation is placed.[9] 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.

4.11 Waste and spoilage:

4.11.1 Waste: ***Material loss during production or storage due to various factors such as evaporation, chemical reaction, contamination, unrecoverable residue, shrinkage, etc., and discarded material which may or may not have value[10].***

4.11.2 Spoilage: ***Production that does not meet with dimensional or quality standards in such a way that it cannot be rectified economically and is sold for a disposal value. Net Spoilage is the difference between costs accumulated up to the point of rejection and the salvage value.***

3 CAS 1- Para 6.5.13

4 Adapted from CAS 1-6.2.3

5 Adapted from CAS 1– 6.2.8

6 CAS-1-6.1.2

7 Adapted from CAS-1 Para 6.3.3 and 6.3.4

8 Adapted from Glossary of Management Accounting Terms- Page 62

9 Adapted from CAS 1_ Para 6.7.5

10 Adopted from Glossary of Management Accounting Terms page 70

5. Principles of Measurement

5.1 Principle of valuation of receipt of materials:

5.1.1 ***The material receipt should be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited by the taxing authorities) that can be quantified with reasonable accuracy at the time of acquisition.***

Examples of taxes and duties to be deducted from cost are cenvat credits, credit for countervailing customs duty, sales tax set off/ vat credits and other similar items of credit recovered/ recoverable.

5.1.2 ***Finance costs incurred in connection with the acquisition of materials shall not form part of material cost.***

5.1.3 ***Self manufactured materials shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads. In case of captive consumption, the valuation shall be in accordance with Cost Accounting Standard 4.***

5.1.4 ***Spares which are specific to an item of equipment shall not be taken to inventory, but shall be capitalized with the cost of the specific equipment. Cost of capital spares and/ or insurance spares, whether procured with the equipment or subsequently, shall be amortised over a period, not exceeding the useful life of the equipment.***

5.1.5 ***Normal loss or spoilage of material prior to reaching the factory or at places where the services are provided shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.***

5.1.6 ***Losses due to shrinkage or evaporation and gain due to elongation or absorption of moisture etc., before the material is received shall be absorbed in material cost to the extent they are normal, with corresponding adjustment in the quantity.***

The adjustment for moisture will depend on whether dry weight is used for measurement.

5.1.7 ***The forex component of imported material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the material cost.***

Explanation: The date on which a transaction (whether for goods or services) is recognised in accounting in conformity with generally accepted accounting principles

5.1.8 ***Any demurrage or detention charges, or penalty levied by transport or other authorities shall not form part of the cost of materials.***

5.1.9 ***Subsidy/Grant/Incentive and any such payment received/receivable with respect to any material shall be reduced from cost for ascertainment of the cost of the cost object to which such amounts are related.***

5.2 Principle of valuation of issue of material

5.2.1 ***Issues shall be valued using appropriate assumptions on cost flow.***

E.g. First In First Out, Last In First Out, Weighted Average Rate.

The method of valuation shall be followed on a consistent basis.

5.2.2 ***Where materials are accounted at standard cost, the price variances related to materials shall be treated as part of material cost.***

5.2.3 ***Any abnormal cost shall be excluded from the material cost.***

5.2.4 **Wherever,** ***material costs include transportation costs, determination of costs of transportation shall be governed by CAS 5 – Cost Accounting Standard on Determination of Average (Equalized) Cost of Transportation.***

5.2.5 ***Material cost may include imputed costs not considered in financial accounts.*** Such costs which are not recognized in financial accounts may be determined by imputing a cost to the usage or by measuring the benefit from an alternate use of the resource.

5.3 ***Self manufactured components and sub-assemblies shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads. In case of captive consumption, the valuation shall be in accordance with Cost Accounting Standard 4.***

5.4 ***The material cost of normal scrap/ defectives which are rejects shall be included in the material cost of goods manufactured. The material cost of actual scrap / defectives, not exceeding the normal shall be adjusted in the material cost of good production. Material Cost of abnormal scrap /defectives should not be included in material cost but treated as loss after giving credit to the realisable value of such scrap / defectives.***

6. Assignment of costs

The basis of assignment of costs to the cost of product or service is dealt within this section.

6.1 Assignment of costs – Materials

6.1.1 **Assignment of material costs to cost objects:** ***Material costs shall be directly traced to a Cost object to the extent it is economically feasible and /or shall be assigned to the cost object on the basis of material quantity consumed or similar identifiable measure and valued as per the principles laid under Paragraph 5.***

6.1.2 ***Where the material costs are not directly traceable to the cost object, these may be assigned on a suitable basis like technical estimates.***

6.2 Assignment of costs – Direct Expenses

6.2.1 ***Where a material is processed or part manufactured by a third party according to specifications provided by the buyer, the processing/ manufacturing charges payable to the third party shall be treated as part of the material cost.***

6.2.2 ***Wherever part of the manufacturing operations / activity is subcontracted, the subcontract charges related to materials shall be treated as direct expenses and assigned directly to the cost object.***

6.3 Assignment of costs– Indirect materials

6.3.1 ***The cost of indirect materials shall be assigned to the various Cost objects based on a suitable basis such as actual usage or technical norms or a similar identifiable measure.***

6.3.2 ***The cost of materials like catalysts, dies, tools, moulds, patterns etc, which are relatable to production over a period of time shall be amortized over the production units benefited by such cost.***

6.3.3 ***The cost of indirect material with life exceeding one year shall be included in cost over the useful life of the material.***

7. Presentation

Cost Statements governed by this standard, shall present material costs as detailed below:

7.1 ***Direct Materials shall be classified in the cost statement under suitable heads.***

E.g.

- Raw materials,
- Components,
- Semi finished goods and
- Sub-assemblies

7.2 ***Direct Materials shall be classified as Purchased - indigenous, imported and self manufactured.***

7.3 ***Indirect Materials shall be classified in the cost statement under suitable heads.***

Indirect materials may be grouped under major heads like tools, stores and spares, machinery spares, jigs and fixtures, consumable stores, etc., if they are significant.

8. Disclosures

The following information should be disclosed in the cost statements dealing with determination of material cost.

8.1 ***Quantity and rates of major items of materials shall be disclosed. Major items are defined as those who form 5% of cost of materials.***

8.2 ***The basis of valuation of materials shall be disclosed.***

8.3 ***Any change in the cost accounting principles and methods applied for the determination of the material cost during the period covered by the cost statement which has a material effect on the cost of the material shall be disclosed. Where the effect of such change is not ascertainable wholly or partly, the fact shall be indicated.***

8.4 ***Any abnormal cost excluded from the material cost shall be disclosed.***

8.5 ***Any demurrage or detention charges, penalty levied by transport or other authorities excluded from the material cost shall be disclosed.***

8.6 ***Any Subsidy/Grant/Incentive or any such payment reduced from material cost shall be disclosed.***

8.7 ***Cost of Materials procured from related parties[11] shall be disclosed***

8.8 ***Any cost imputed in arriving at the material cost shall be disclosed.***

8.9 ***Disclosures shall be made only where significant, material and quantifiable.***

8.10 ***Disclosures may be made in the body of the Cost statement or as a footnote or as a separate schedule.***

11 Related party as per the applicable legal requirements relating to the cost statement as on the date of statements

CAS-7

COST ACCOUNTING STANDARD ON EMPLOYEE COST

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 "EMPLOYEE COST". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the Employee cost.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of Employee cost, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Employee cost with reasonable accuracy.

3 Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Employee cost including those requiring attestation.

4 Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.***[1]

4.2 Abnormal Idle time: ***An unusual or atypical employee idle time occurrence of which is usually irregular and unexpected or due to some abnormal situations.***

E.g.: Idle time due to a strike, lockout or an accident

4.3 Administrative overheads: ***Expenses in the nature of indirect costs, incurred for general management of an organization***[2].

4.4 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are finally ascertained.***

4.5 Distribution Overheads: ***Distribution overheads, also known as Distribution Cost, are the costs incurred in handling a product from the time it is ready for despatch until it reaches the ultimate consumer.***[3]

The cost of any non manufacturing operations such as packing, repacking, labelling, etc. at an intermediate storage location will be part of distribution cost.

4.6 Direct Employee Cost: ***The cost of employees which can be attributed to a Cost Object in an economically feasible way.***[4]

4.7 Employee cost: ***The aggregate of all kinds of consideration paid, payable and provisions***

1 Adapted from CAS 1 paragraph 6.5.19

2 Adapted from CAS 1 paragraph 6.3.5

3 Adapted from CAS 1 paragraph 6.3.9

4 Adapted from CAS 1 paragraph 6.2.4 (Direct labour cost)

made for future payments for the services rendered by employees of an enterprise (including temporary, part time and contract employees). Consideration includes wages, salary, contractual payments and benefits, as applicable or any payment made on behalf of employee. This is also known as Labour Cost.[5]

Explanation:

1. Contract employees include employees directly engaged by the employer on contract basis but does not include employees of any contractor engaged in the organisation.
2. Compensation paid to employees for the past period on account of any dispute / court orders shall not form part of Employee Cost.
3. Short provisions of prior period made up in current period shall not form part of the employee cost in the current period.

Employee cost includes payment made in cash or kind.

For example:

- **Employee cost**
  - o Salaries, wages, allowances and bonus / incentives.
  - o Contribution to provident and other funds.
  - o Employee welfare
  - o Other benefits
- **Employee cost – Future benefits**
  - o Gratuity.
  - o Leave encashment.
  - o Other retirement/separation benefits.
  - o VRS/ other deferred Employee cost.
  - o Other future benefits

Benefits generally include

- Paid holidays.
- Leave with pay.
- Statutory provisions for insurance against accident or health scheme.
- Statutory provisions for workman's compensation.
- Medical benefits to the Employees and dependents.
- Free or subsidised food.
- Free or subsidised housing.
- Free or subsidised education to children.
- Free or subsidised canteen, crèches and recreational facilities.
- Free or subsidised conveyance.
- Leave travel concession.
- Any other free or subsidised facility.
- Cost of Employees' stock option.

5 Adapted from CAS 1 paragraph 6.1.4

4.8 Idle time: ***The difference between the time for which the employees are paid and the employees' time booked against the cost object.***

The time for which the employees are paid includes holidays, paid leave and other allowable time offs such as lunch, tea breaks.

4.9 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[6]

4.10 Indirect Employee Cost: ***The cost which can not be directly attributed to a particular cost object.***[7]

4.11 Marketing overheads: ***Marketing Overheads are also known as Selling and Distribution Overheads.***

4.12 Overtime Premium: ***Overtime is the time spent beyond the normal working hours which is usually paid at a higher rate than the normal time rate. The extra amount beyond the normal wages and salaries paid is called overtime premium.***

4.13 Production Overheads: ***Indirect costs involved in the production process or in rendering service.***[8]

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

4.14 Selling Overheads: ***Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***[9]

4.15 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

5. Principles of Measurement

5.1 ***Employee Cost shall be ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all the benefits.***

5.2 ***Bonus whether payable as a Statutory Minimum or on a sharing of surplus shall be treated as part of employee cost. Ex gratia payable in lieu of or in addition to Bonus shall also be treated as part of the employee cost.***

5.3 ***Remuneration payable to Managerial Personnel including Executive Directors on the Board and other officers of a corporate body under a statute will be considered as part of the Employee Cost of the year under reference whether the whole or part of the remuneration is computed as a percentage of profits.***

Explanation: Remuneration paid to non executive directors shall not form part of Employee Cost but shall form part of Administrative Overheads.

5.4 ***Separation costs related to voluntary retirement, retrenchment, termination etc. shall be amortised over the period benefitting from such costs.***

5.5 ***Employee cost shall not include imputed costs.***

6 Adapted from CAS 1 paragraph 6.5.13

7 Adapted from CAS 1 paragraph 6.2.10

8 Adapted from CAS 1 paragraph 6.3.3

9 Adapted from CAS 1 paragraph 6.3.7

5.6 ***Cost of Idle time is ascertained by the idle hours multiplied by the hourly rate applicable to the idle employee or a group of employees.***

5.7 ***Where Employee cost is accounted at standard cost, variances due to normal reasons related to Employee cost shall be treated as part of Employee cost. Variances due to abnormal reasons shall be treated as part of abnormal cost.***

5.8 ***Any Subsidy, Grant, Incentive or any such payment received or receivable with respect to any Employee cost shall be reduced for ascertainment of cost of the cost object to which such amounts are related.***

5.9 ***Any abnormal cost where it is material and quantifiable shall not form part of the Employee cost.***

5.10 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the Employee cost.***

5.11 ***The cost of free housing, free conveyance and any other similar benefits provided to an employee shall be determined at the total cost of all resources consumed in providing such benefits.***

5.12 ***Any recovery from the employee towards any benefit provided e.g. housing shall be reduced from the employee cost.***

5.13 ***Any change in the cost accounting principles applied for the determination of the Employee cost should be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.***

6. Assignment of costs

6.1 ***Where the Employee services are traceable to a cost object, such Employees' cost shall be assigned to the cost object on the basis such as time consumed or number of employees engaged etc or similar identifiable measure.***

6.2 ***While determining whether a particular Employee cost is chargeable to a separate cost object, the principle of materiality shall be adhered to.***

6.3 ***Where the Employee costs are not directly traceable to the cost object, these may be assigned on suitable basis like estimates of time based on time study.***

6.4 ***The amortised separation costs related to voluntary retirement, retrenchment, and termination etc. for the period shall be treated as indirect cost and assigned to the cost objects in an appropriate manner. However unamortised amount related to discontinued operations, shall not be treated as employee cost.***

6.5 ***Recruitment costs, training cost and other such costs shall be treated as overheads and dealt with accordingly.***

6.6 ***Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime.***

6.7 ***Idle time cost shall be assigned direct to the cost object or treated as overheads depending on the economic feasibility and the specific circumstances causing such idle time.***

Cost of idle time for reasons anticipated like normal lunchtime, holidays etc is normally loaded in the Employee cost while arriving at the cost per hour of an Employee/a group of Employees whose time is attributed direct to cost objects.

7. Presentation

7.1 ***Direct Employee costs shall be presented as a separate cost head in the cost statement.***

7.2 ***Indirect Employee costs shall be presented in cost statements as a part of overheads relating to respective functions e.g. manufacturing, administration, marketing etc.***

7.3 ***The cost statement shall furnish the resources consumed on account of Employee cost, category wise such as wages salaries to permanent, temporary, part time and contract employees piece rate payments, overtime payments, Employee benefits (category wise)etc wherever such items form a material part of the total Employee cost.***

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

1. ***Employee cost attributable to capital works or jobs in the nature of deferred revenue expenditure indicating the method followed in determining the cost of such capital work.***
2. ***Separation costs payable to employees.***
3. ***Any abnormal cost excluded from Employee cost.***
4. ***Penalties and damages paid etc excluded from Employee cost.***
5. ***Any Subsidy, Grant, Incentive and any such payment reduced from Employee cost***
6. ***The Employee cost paid to related parties[10].***
7. ***Employee cost incurred in foreign exchange.***

8.2 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Employee Cost during the period covered by the cost statement which has a material effect on the Employee Cost. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

8.3 ***Disclosures shall be made only where material, significant and quantifiable.***

8.4 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

10 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS-8

COST ACCOUNTING STANDARD ON COST OF UTILITIES

The following is the COST ACCOUNTING STANDARD – 8 (CAS-8) issued by the Council of The Institute of Cost and Works Accountants of India on "COST OF UTILITIES", for comments. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the cost of utilities.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of cost of utilities, for determination of the cost of product or service, and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the cost of utilities with reasonable accuracy.

3. Scope

3.1 ***This standard shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of cost of utilities including those requiring attestation.***

3.2 ***For determining the cost of production to arrive at an assessable value of excisable utilities used for captive consumption, Cost Accounting Standard 4 on Cost of Production for Captive Consumption (CAS 4) shall apply.***

3.3 ***This standard shall not be applicable to the organizations primarily engaged in generation and sale of utilities.***

3.4 ***This standard does not cover issues related to the ascertainment and treatment of carbon credits, which shall be dealt with in a separate standard.***

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 **Abnormal cost:** ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.***[1]

4.2 **Committed Cost:** ***The cost of maintaining stand-by utilities shall be the committed cost.***

4.3 **Cost Object:** ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.4 **Finance Costs:** ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[2]. The terms Finance costs and Borrowing costs are used interchangeably.

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1 Adapted from CAS 1 paragraph 6.5.19

2 Adapted from CIMA Terminology

4.5 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[3]

4.6 Normal capacity: ***Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.***[4]

In case of any standby utility the normal capacity will be the same as actual production of the utility.

The normal capacity of a utility meant for captive consumption would be based on the normal capacity for the production facility of the end product of the consuming unit.

4.7 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

4.8 Utilities: ***Significant inputs such as power, steam, water, compressed air and the like which are used for manufacturing process but do not form part of the final product.***

4.9 Stand-by utilities: ***Any utility created to safeguard against the failure of the main source of inputs.***

5. Principles of measurement

5.1 ***Each type of utility shall be treated as a distinct cost object.***

5.2 ***Cost of utilities purchased shall be measured at cost of purchase including duties and taxes, transportation cost, insurance and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified with reasonable accuracy at the time of acquisition.***

5.3.1 ***Cost of self generated utilities for own consumption shall comprise direct material cost, direct employee cost, direct expenses and factory overheads.***

5.3.2 ***In case of Utilities generated for the purpose of inter unit transfers, the distribution cost incurred for such transfers shall be added to the cost of utilities determined as per paragraph 5.3.1.***

5.3.3 ***Cost of Utilities generated for the inter company transfers shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost and share of administrative overheads.***

5.3.4 ***Cost of Utilities generated for the sale to outside parties shall comprise direct material cost, direct employee cost, direct expenses, factory overheads, distribution cost, share of administrative overheads and marketing overheads.***

The sale value of such utilities will also include the margin.

5.4 ***Finance costs incurred in connection with the utilities shall not form part of cost of utilities.***

5.5 ***The cost of utilities shall include the cost of distribution of such utilities.***

The cost of distribution will consist of the cost of delivery of utilities up to the point of consumption.

5.6 ***Cost of utilities shall not include imputed costs.***

3 Adapted from CAS 1 paragraph 6.5.13

4 Adapted from CAS 2 paragraph 4.4

5.7 *Where cost of utilities is accounted at standard cost, the price variances related to utilities shall be treated as part of cost of utilities and the portion of usage variances due to normal reasons shall be treated as part of cost of utilities. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.*

5.8 *Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to any cost of utilities shall be reduced for ascertainment of the cost to which such amounts are related.*

5.9 *The cost of production and distribution of utilities shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost*[5]*. Cost of a Stand-by Utility shall include the committed costs of maintaining such a utility.*

5.10 *Any abnormal cost where it is material and quantifiable shall not form part of the cost of utilities.*

5.11 *Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of utilities.*

5.12 *Credits/recoveries relating to the utilities including cost of utilities provided to outside parties, material and quantifiable, shall be deducted from the total cost of utility to arrive at the net cost of utility.*

5.13 *Any change in the cost accounting principles applied for the measurement of the cost of utilities should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.*

6. Assignment of costs

6.1 *While assigning cost of utilities, traceability to a cost object in an economically feasible manner shall be the guiding principle.*

6.2 *Where the cost of utilities is not directly traceable to cost object, it shall be assigned on the most appropriate basis.*

6.3 *The most appropriate basis of distribution of cost of a utility to the departments consuming services is to be derived from usage parameters.*

7. Presentation

7.1 *Utilities costs shall be presented as a separate cost head for each type of utility in the cost statement, if material.*

7.2 *Where separate cost statements are prepared for utilities, cost of utilities shall be classified as purchased or generated. Such statement shall also include cost of utilities consumed along with quantitative information by individual consuming units, inter unit transfers, inter company transfers and sale to outside parties wherever applicable.*

8. Disclosures

8.1 *The cost statements shall disclose the following:*

1. *The basis of distribution of Cost of Utility to the consuming centres.*
2. *The cost of purchase, production, distribution, marketing and price with reference to sales to outside parties.*
3. *Where cost of utilities is disclosed at standard cost, the price and usage variances.*
4. *The cost and price of Utility received from/supplied to related parties*[6]*.*

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5 Adapted from paragraph 5.7 of CAS 3

6 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

5. *The cost and price of Utility received from/supplied as inter unit transfers and inter company transfers*
6. *Cost of utilities incurred in foreign exchange.*
7. *Any Subsidy/Grant/Incentive and any such payment reduced from Cost of utilities.*
8. *Credits/recoveries relating to the Cost of utilities.*
9. *Any abnormal cost excluded from Cost of utilities.*
10. *Penalties and damages paid etc excluded from cost of utilities.*

8.2 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the Cost of utilities during the period covered by the cost statement which has a material effect on the Cost of utilities. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

8.3 *Disclosures shall be made only where material, significant and quantifiable.*

8.4 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.*

CAS-9

COST ACCOUNTING STANDARD ON PACKING MATERIAL COST

The following is the COST ACCOUNTING STANDARD - (CAS - 9) issued by the Council of The Institute of Cost and Works Accountants of India on "PACKING MATERIAL COST", for comments. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the Packing Material Cost.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of Packing Material Cost, for determination of the cost of product, and the presentation and disclosure in cost statements.***

1.3 ***Packing Materials for the purpose of this standard are classified into primary and secondary packing materials.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the packing material cost with reasonable accuracy.

3. Scope

This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of Packing Material Cost including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost***: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.***[1]

For example: the cost of packing material which is rejected after issue due to abnormal causes such as misprinting, use of material of wrong specification etc. (net of realisable value) may be treated as abnormal cost.

4.2 Administrative Overheads: ***Cost of all activities relating to general management and administration of an organisation.*** Administrative overheads shall exclude any overhead relating to production, operations and marketing.

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.4 Direct Employee Cost: ***The cost of employees which can be attributed to a Cost Object in an economically feasible way.***[2]

4.5 Direct Expenses: ***Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material or direct employee cost***[3]***.*** Examples of Direct Expenses are royalties charged on production, job charges, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling Expenses for a specific job.

1 Adapted from CAS 1 Para 6.5.19

2 Adapted from CAS 7 Para 4.6

3 Adapted from CAS 1 Para 6.2.6 and also proposed in the CAS on Direct Expenses

4.6 Direct Materials: ***Materials the costs of which can be attributed to a cost object.***[4]

4.7 Distribution Overheads: ***Distribution overheads, also known as Distribution Cost, are the costs incurred in handling a product from the time it is ready for despatch until it reaches the ultimate consumer.***[5]

For example:

- Secondary packing
- Transportation cost
- Warehousing cost
- Cost of delivering the products to customers etc.
- Clearing and forwarding charges
- Cost of mending or replacing packing materials at distribution point.

4.8 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[6]. The terms Finance costs and Borrowing costs are used interchangeably.

4.9 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[7]

For example: packing material supplied by the customer**.**

4.10 Marketing overheads: ***Marketing Overheads comprises selling overheads and distribution overheads.***

4.11 Packing Materials: Materials used to hold, identify, describe, store, protect, display, transport, promote and make the product marketable and communicate with the consumer.

4.11.1 Defectives: ***Packing materials that do not meet quality standards. This may include reworks or rejects.***[8]

4.11.1.1 Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***[9]

Rework includes repairs, reconditioning and refurbishing.

4.11.1.2 Rejects: ***Defectives which can not meet the quality standards even after putting in additional resources.***[10]

Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

4.11.2 Packing Material Cost: The cost of material of any nature used for the purpose of packing of a product.

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4 Adapted from CAS 6 Para 4.6.1

5 Adapted from CAS 1 Para 6.3.9

6 Adapted from CIMA Terminology

7 Adapted from CAS 1 Para 6.5.13

8 Adapted from CAS 6 Para 4.4

9 Adapted from CAS 6 Para 4.4.1

10 Adapted from CAS 6 Para 4.4.2

4.11.3 Primary Packing Material: Packing material which is essential to hold the product and bring it to a condition in which it can be used by or sold to a customer.

For example:

- Pharmaceutical industry: Insertions related to product, Foils for strips of tablets/ capsules, vials.
- Industrial gases: Cylinders / bottles used for filling the gaseous products
- Confectionary Industry: Butter paper and wrappers.

4.11.4 Reusable Packing Material: ***Packing materials that are used more than once to pack the product.***

4.11.5 Scrap: ***Discarded packing material having some value in a few cases and which is usually either disposed of without further treatment or reintroduced into the production of packing material.***[11]

4.11.6 Secondary Packing Material: ***Packing material that enables to store, transport, inform the customer, promote and otherwise make the product marketable.***

For example:

- Pharmaceutical industry: Cartons used for holding strips of tablets and card board boxes used for holding cartons.
- Textile industry: Card board boxes used for holding cones on which yarn is woven.
- Confectionary Industry: Jars for holding wrapped chocolates, Cartons containing packs of biscuits.

4.12 Packing Material Development Cost: ***Cost of evaluation of packing material such as pilot test, field test, consumer research, feed back, and final evaluation cost.***

4.13 Production overheads: ***Indirect costs involved in the production process or in rendering service***[12]***.***

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably. Production overheads shall include administration cost relating to production, factory, works or manufacturing.

4.14 Selling Overheads: ***Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***[13]

4.15 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***[14]

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

5. Principles of Measurement

5.1 Principle of valuation of receipts of packing material:

5.1.1 ***The packing material receipts should be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable or to be credited) that can be quantified at the time of acquisition.***

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11 Adapted from Para 4.9 of CAS 6

12 Adapted from CAS-1 Para 6.3.3 and 6.3.4

13 Adapted from CAS 1 Para 6.3.7

14 Adapted from CAS 6 Para 4.15

Examples of taxes and duties to be deducted from cost are CENVAT credits, credit for countervailing customs duty, sales tax set off/ vat credits and other similar items of credit recovered/ recoverable.

5.1.2 ***Finance costs directly incurred in connection with the acquisition of Packing Material shall not form part of Packing Material Cost.***

5.1.3 ***Self manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads including share of administrative overheads comprising factory management and administration and share of research and development cost incurred for development and improvement of existing process or product.***

5.1.4 ***The valuation of captive consumption of packing materials shall be in accordance with paragraph 5 of Cost Accounting Standard 4.***

5.1.5 ***Normal loss or spoilage of packing material prior to receipt in the factory shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.***

5.1.6 ***The forex component of imported packing material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the packing material cost.***

Explanation: The date on which a transaction (whether for goods or services) is recognised in accounting in conformity with generally accepted accounting principles.

5.1.7 ***Any demurrage, detention charges or penalty levied by the transport agency or any authority shall not form part of the cost of packing materials.***

5.1.8 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to packing material shall be reduced for ascertainment of the cost to which such amounts are related.***

5.2 Principle of valuation of issue of packing material

Issues shall be valued using appropriate assumptions on cost flow.

For example: First In First Out, Last In First Out, Weighted Average Rate.

The method of valuation shall be followed on a consistent basis.

5.3 ***Wherever, packing material costs include transportation costs, determination of costs of transportation shall be governed by CAS 5 – Cost Accounting Standard on determination of average (equalized) cost of transportation.***

5.4 ***Packing Material Costs shall not include imputed costs. However in case of Cost of Production of Excisable Goods for Captive Consumption the computation of cost shall be as per CAS 4.***

5.5 ***Where packing materials are accounted at standard cost, the price variances related to such materials shall be treated as part of packing material cost and the portion of usage variances due to normal reasons shall be treated as part of packing material cost. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.***

5.6 ***The normal loss arising from the issue or consumption of packing materials shall be included in the packing materials cost.***

5.7 ***Any abnormal cost where it is material and quantifiable shall be excluded from the packing material cost.***

5.8 ***The credits/recoveries in the nature of normal scrap arising from packing materials if any, should be deducted from the total cost of packing materials to arrive at the net cost of packing materials.***

6. **Assignment of Cost**

6.1 **Assignment of packing material costs to cost objects:** ***Packing material costs shall be directly traced to a cost object to the extent it is economically feasible.***

6.2 ***Where the packing material costs are not directly traceable to the cost object, these may be assigned on the basis of quantity consumed or similar measures like technical estimates.***

6.3 ***The packing material cost of reusable packing shall be assigned to the cost object taking into account the number of times or the period over which it is expected to be reused.***

6.4 ***Cost of primary packing materials shall form part of the cost of production.***

6.5 ***Cost of secondary packing materials shall form part of distribution overheads.***

7. **Presentation**

7.1 ***Packing Materials shall be classified as primary and secondary and within this classification as purchased – indigenous, imported and self manufactured.***

7.2 ***Where separate cost statements are prepared for packing costs, the cost of packing materials consumed shall be presented in terms of type of packing in which the materials are used (For example; Bale, Bag, Carton, Pallet). Such statements shall also include cost and quantitative information, wherever it is found material and quantifiable.***

8. **Disclosures**

8.1 ***The cost statements shall disclose the following:***

1. ***The basis of valuation of Packing Materials.***
2. ***Where Packing Materials Cost is disclosed at standard cost, the price and usage variances.***
3. ***The cost and price of Packing Materials received from/supplied to related parties[15].***
4. ***Packing Materials cost incurred in foreign exchange.***
5. ***Any Subsidy/Grant/Incentive and any such payment reduced from Packing Materials Costs.***
6. ***Credits/recoveries relating to the Packing Materials Costs.***
7. ***Any abnormal cost excluded from Packing Materials Costs.***
8. ***Penalties and damages paid etc. excluded from Packing Materials Costs.***

8.2 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Packing Materials Costs during the period covered by the cost statement which has a material effect on the Packing Materials Cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

8.3 ***Disclosures shall be made only where material, significant and quantifiable.***

8.4 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

15 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS-10

COST ACCOUNTING STANDARD ON DIRECT EXPENSES

The following is the COST ACCOUNTING STANDARD – 10 (CAS-10) issued by the Council of The Institute of Cost and Works Accountants of India on "DIRECT EXPENSES", for comments. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the Direct Expenses.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of Direct Expenses, for determination of the cost of product or service, and the presentation and disclosure in cost statements.***

2. Objective

***The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Direct Expenses with reasonable accuracy*.**

3. Scope

***This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of Direct Expenses including those requiring attestation*.**

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 **Abnormal cost*: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.*** [1]

4.2 **Cost Object:** ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.3 **Direct Employee Cost:** ***The cost of employees which can be attributed to a cost object in an economically feasible way.*** [2]

4.4 **Direct Expenses:** ***Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material cost and direct employee cost*** [3]***.*** Examples of Direct Expenses are royalties charged on production, job charges, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling Expenses for a specific job.

4.5 **Direct Material Cost:** ***The cost of material which can be attributed to a cost object in an economically feasible way*** [4]***.***

4.6 **Finance Costs:** ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs [5]. The terms Finance costs and Borrowing costs are used interchangeably.

1 Adapted from CAS 1 paragraph 6.5.19

2 Adapted from CAS 1 paragraph 6.2.4 (Direct labour cost)

3 Adapted from CAS 1 paragraph 6.2.6

4 Adapted from CAS 1-6.2.3

5 Adapted from CIMA Terminology

4.7 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[6]

4.8 Overheads: ***Overheads comprise of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object.***[7]

4.9 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

5. Principles of Measurement:

5.1 ***Identification of Direct Expenses shall be based on traceability in an economically feasible manner.***

5.2.1 ***Direct expenses incurred for the use of bought out resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of trade discounts, rebates, taxes and duties refundable or to be credited.***

5.2.2 ***Direct expenses other than those referred to in paragraph 5.2.1 shall be determined on the basis of amount incurred in connection therewith.***

Examples: in case of dies and tools produced internally, the cost of such dies and tools will include direct material cost, direct employee cost, direct expenses, factory overheads including share of administrative overheads relating to production comprising factory management and administration.

In the case of research and development cost, the amount traceable to the cost object for development and improvement of the process for the existing product shall be included in Direct Expenses.

5.2.3 ***Direct Expenses paid or incurred in lump-sum or which are in the nature of 'one – time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from such direct expenses.***

Examples: Royalty or Technical know-how fees, or drawing designing fees, are paid for which the benefit is ensued in the future period. In such case, the production / service volumes shall be estimated for the effective period and based on volume achieved during the Cost Accounting period, the charge for amortisation be determined.

5.3 ***If an item of Direct Expenses does not meet the test of materiality, it can be treated as part of overheads.***

5.4 ***Finance costs incurred in connection with the self generated or procured resources shall not form part of Direct Expenses.***

5.5 ***Direct Expenses shall not include imputed costs. In case of goods produced for captive consumption, treatment of imputed cost shall be in accordance with Cost Accounting Standard – 4 (CAS-4).***

5.6 ***Where direct expenses are accounted at standard cost, variances due to normal reasons shall be treated as part of the Direct Expenses. Variances due to abnormal reasons shall not form part of the Direct Expenses.***

6 Adapted from CAS 1 paragraph 6.5.13

7 Adapted from CAS 3 paragraph 4.1

5.7 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to any Direct Expenses shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.***

5.8 ***Any abnormal portion of the direct expenses where it is material and quantifiable shall not form part of the Direct Expenses.***

5.9 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the Direct Expenses.***

5.10 ***Credits/ recoveries relating to the Direct Expenses, material and quantifiable, shall be deducted to arrive at the net Direct Expenses.***

5.11 ***Any change in the cost accounting principles applied for the measurement of the Direct Expenses should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Direct Expenses that are directly traceable to the cost object shall be assigned to that cost object.***

7. Presentation

7.1 ***Direct Expenses, if material, shall be presented as a separate cost head with suitable classification.*** e.g.

- Subcontract charges
- Royalty on production

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

1. ***The basis of distribution of Direct Expenses to the cost objects/ cost units.***
2. ***Quantity and rates of items of Direct Expenses, as applicable.***
3. ***Where Direct Expenses are accounted at standard cost, the price and usage variances.***
4. ***Direct expenses representing procurement of resources and expenses incurred in connection with resources generated.***
5. ***Direct Expenses paid/ payable to related parties[8].***
6. ***Direct Expenses incurred in foreign exchange.***
7. ***Any Subsidy/Grant/Incentive and any such payment reduced from Direct Expenses.***
8. ***Credits/recoveries relating to the Direct Expenses.***
9. ***Any abnormal portion of the Direct Expenses.***
10. ***Penalties and damages excluded from the Direct Expenses***

8.2 ***Disclosures shall be made only where material, significant and quantifiable.***

8.3 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Direct Expenses during the period covered by the cost statement which has a material effect on the Direct Expenses. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

8 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS - 11

COST ACCOUNTING STANDARD ON ADMINISTRATIVE OVERHEADS

The following is the COST ACCOUNTING STANDARD – (CAS-11) issued by the Council of The Institute of Cost and Works Accountants of India on "ADMINISTRATIVE OVERHEADS". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the administrative overheads.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of administrative overheads, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the administrative overheads with reasonable accuracy.

3. Scope

This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of administrative overheads including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.***[1]

4.2 Absorption of overheads: ***Absorption of overheads is charging of overheads to Cost Objects by means of appropriate absorption rate.***[2]

Overhead Absorption Rate = Overheads of the Cost object / Quantum of base.

4.3 Administrative Overheads: ***Cost of all activities relating to general management and administration of an organisation.***

Administrative overheads shall exclude production overheads[3], marketing overheads[4] and finance cost. Production overheads includes administration cost relating to production, factory, works or manufacturing.

4.4 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.5 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in

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1 Adapted from CAS 1 Para 6.5.19

2 Adapted from CAS 3 Para 4.6

3 Paragraph reference 4.13 CAS -9

4 Paragraph reference 4.11 CAS -7

respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[5]. The terms Finance costs and Borrowing costs are used interchangeably.

4.6 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[6]

4.7 Normal capacity: ***Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.***[7]

4.8 Overheads: ***Overheads comprise of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object.***[8]

5. Principles of Measurement

5.1 ***Administrative overheads shall be the aggregate of cost of resources consumed in activities relating to general management and administration of an organisation.***

It usually represents the cost of shared services, cost of infrastructure and general management costs. Administrative overheads comprise items such as employee costs, utilities, office supplies, legal expenses and outside services. The principles of measurement of Material Cost, Employee Costs, Utilities, Repairs and Maintenance and Depreciation found in the respective standards will apply to these elements included in administrative overheads.

5.2 ***In case of leased assets, if the lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a financial lease, the finance cost portion shall be segregated and treated as part of finance costs.***

5.3 ***The cost of software (developed in house, purchased, licensed or customised), including up-gradation cost shall be amortised over its estimated useful life.***

When hardware requires up-gradation along with software up-gradation, it is recommended that compatible estimated lives be used for the two sets of cost.

5.4 ***The cost of administrative services procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited.***

5.5 ***Any Subsidy/Grant/Incentive or any amount of similar nature received/receivable with respect to any Administrative overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.***

5.6 ***Administrative overheads shall not include any abnormal administrative cost.***

Example: Expense incurred in a situation of natural calamity.

5.7 ***Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the administrative overheads.***

5.8 ***Credits/ recoveries relating to the administrative overheads including those rendered without any consideration, material and quantifiable, shall be deducted to arrive at the net administrative overheads.***

5.9 ***Any change in the cost accounting principles applied for the measurement of the administrative overheads should be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

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5 Adapted from CIMA Terminology

6 Adapted from CAS 1 Para 6.5.13

7 Adapted from CAS 2 Para 4.4

8 Adapted from CAS 3 Para 4.1

6. Assignment of Cost

6.1 ***While assigning administrative overheads, traceability to a cost object in an economically feasible manner shall be the guiding principle.***

6.2 ***Assignment of administrative overheads to the cost objects shall be based on either of the following two principles;***

(i) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost.

(ii) Benefits received – overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.[9]

The costs of shared services should be assigned to user activities on the basis of actual usage.

Where the resources by way of infrastructure are shared the cost should be assigned on a readiness to serve basis.

General management costs should be assigned on rational basis.

For example: Number of employees, turnover, investment size etc.

7. Presentation

7.1 ***Administrative overheads shall be presented as a separate cost head in the cost statement.***

7.2 ***Element wise details of the administrative overheads based on materiality shall be presented.***

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

- ***The basis of assignment of administrative overheads to the cost objects.***
- ***Any imputed cost included as a part of administrative overheads.***
- ***Administrative overheads incurred in foreign exchange.***
- ***Cost of administrative activities received from or supplied to related parties***[10]***.***
- ***Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable reduced from administrative overheads.***
- ***Credits / recoveries relating to the administrative overheads.***
- ***Any abnormal portion of the administrative overheads.***
- ***Penalties and damages excluded from the administrative overheads.***

8.2 ***Disclosures shall be made only where material, significant and quantifiable.***

8.3 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the administrative overheads during the period covered by the cost statement which has a material effect on the administrative overheads shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

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9 Adapted from of CAS 3 Para 5.1

10 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS – 12

COST ACCOUNTING STANDARD ON REPAIRS AND MAINTENANCE COST

The following is the COST ACCOUNTING STANDARD – 12 (CAS - 12) issued by the Council of The Institute of Cost and Works Accountants of India on "REPAIRS AND MAINTENANCE COST". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the repairs and maintenance cost.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of repairs and maintenance cost, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the repairs and maintenance cost with reasonable accuracy.

3. Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of repairs and maintenance cost including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.2 Direct Expenses: ***Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material cost and direct employee cost.***

Examples of Direct Expenses are royalties charged on production, job charges, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling Expenses for a specific job.

4.3 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[1]. The terms Finance costs and Borrowing costs are used interchangeably.

4.4 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[2]

4.5 Normal capacity: Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.[3]

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1 Adapted from CIMA Terminology

2 Adapted from CAS 1 Para 6.5.13

3 Adapted from CAS 2 paragraph 4.4

4.6 Production overheads: ***Indirect costs involved in the production process or in rendering service[4].***

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably. Production overheads shall include administration cost relating to production, factory, works or manufacturing.

4.7 Repairs and maintenance cost: ***Cost of all activities which have the objective of maintaining or restoring an asset in or to a state in which it can perform its required function at intended capacity and efficiency.***

Repairs and Maintenance activities for the purpose of this standard include routine or preventive maintenance, planned (predictive or corrective) maintenance and breakdown maintenance.

The repair or overhaul of an asset which results in restoration of the asset to intended condition would also be a part of Repairs and Maintenance activity.

Major overhaul is a periodic (generally more than one year) repair work carried out to substantially restore the asset to intended working condition.

4.8 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

5. Principles of Measurement:

5.1 ***Repairs and maintenance cost shall be the aggregate of direct and indirect cost relating to repairs and maintenance activity.***

Direct cost includes the cost of materials, consumable stores, spares, manpower, equipment usage, utilities and other identifiable resources consumed in such activity. Indirect cost includes the cost of resources common to various repairs and maintenance activities such as manpower, equipment usage and other costs allocable to such activities.

5.2 ***Cost of in-house repairs and maintenance activity shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such activity.***

5.3 ***Cost of repairs and maintenance activity carried out by outside contractors inside the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other costs incurred by the entity for such jobs.***

5.4 ***Cost of repairs and maintenance jobs carried out by contractor at its premises shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited. This cost shall also include the cost of other resources provided to the contractors.***

5.5 ***Cost of repairs and maintenance jobs carried out by outside contractors shall include charges made by the contractor and cost of own materials, consumable stores, spares, manpower, equipment usage, utilities and other costs used in such jobs.***

5.6.1 ***Each type of repairs and maintenance shall be treated as a distinct activity, if material and identifiable.***

For example, routine or preventive maintenance, planned (predictive or corrective) maintenance and breakdown maintenance should be identified separately.

4 Adapted from CAS-1 Para 6.3.3 and 6.3.4

5.6.2 ***Cost of repairs and maintenance activity shall be measured for each major asset category separately.***

5.7 ***Cost of spares replaced which do not enhance the future economic benefits from the existing asset beyond its previously assessed standard of performance shall be included under repairs and maintenance cost.***

5.8 ***High value spare, when replaced by a new spare and is reconditioned, which is expected to result in future economic benefits, the same shall be taken into stock. Such a spare shall be valued at an amount that measures its service potential in relation to a new spare which amount shall not exceed the cost of reconditioning the spare. The difference between the total of the cost of the new spare and the reconditioning cost and the value of the reconditioned spare should be treated as repairs and maintenance cost.***

Example: The cost of new spare is ₹1 crore and the value of the existing spare after reconditioning is estimated at ₹ 20 lacs, the difference of ₹ 80 lacs should be treated as repairs and maintenance cost.

5.9 ***The cost of major overhaul shall be amortized on a rational basis.***

5.10 ***Finance costs incurred in connection with the repairs and maintenance activities shall not form part of Repairs and maintenance costs.***

5.11 ***Repairs and maintenance costs shall not include imputed costs.***

5.12 ***Price variances related to repairs and maintenance, where standard costs are in use, shall be treated as part of repairs and maintenance cost. The portion of usage variances attributable to normal reasons shall be treated as part of repairs and maintenance cost. Usage variances attributable to abnormal reasons shall be excluded from repairs and maintenance cost.***

5.13 ***Subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to repairs and maintenance activity, if any, shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.***

5.14 ***Any repairs and maintenance cost resulting from some abnormal circumstances, if material and quantifiable, shall not form part of the repairs and maintenance cost.***

Example: Major fire, explosions, flood and similar events are abnormal circumstances referred above.

5.15 ***Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the repairs and maintenance cost.***

Example: A penalty imposed by a regulatory authority for wrongful construction or damages paid to third party for the loss caused due to improper working of property, plant & equipment, should not be included in repairs and maintenance cost.

5.16 ***Credits/ recoveries relating to the repairs and maintenance activity, material and quantifiable, shall be deducted to arrive at the net repairs and maintenance cost.***

5.17 ***Any change in the cost accounting principles applied for the measurement of the repairs and maintenance cost should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Repairs and maintenance costs shall be traced to a cost object to the extent economically feasible.***

6.2 ***Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following two principles;***

- ***(i)*** ***Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost.***
- ***(ii)*** ***Benefits received – overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.***

6.3 ***If the repairs and maintenance cost (including the share of the cost of reciprocal exchange of services) is shared by several cost objects, the related cost shall be measured as an aggregate and distributed among the cost objects as per principles laid down in Cost Accounting Standard – 3.***

7. Presentation

7.1 ***Repairs and maintenance cost, if material, shall be presented in the cost statement as a separate item of cost.***

7.2 ***Asset category wise details of repairs and maintenance cost, if material, shall be presented separately.***

7.3 ***Activity wise details of repairs and maintenance cost, if material, shall be presented separately.***

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

1. ***The basis of distribution of repairs and maintenance cost to the cost objects/ cost units.***
2. ***Where standard cost is applied in repairs and maintenance cost, the price and usage variances.***
3. ***Repairs and maintenance cost of Jobs done in-house and outsourced separately.***
4. ***Cost of major overhauls, asset category wise and the basis of amortisation.***
5. ***Repairs and maintenance cost paid/ payable to related parties[5].***
6. ***Repairs and maintenance cost incurred in foreign exchange.***
7. ***Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable reduced from repairs and maintenance cost.***
8. ***Any credits / recoveries relating to the repairs and maintenance cost.***
9. ***Any abnormal portion of the repairs and maintenance cost.***
10. ***Penalties and damages excluded from the repairs and maintenance cost.***

8.2 ***Disclosures shall be made only where material, significant and quantifiable.***

8.3 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the repairs and maintenance cost during the period covered by the cost statement which has a material effect on the repairs and maintenance cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

5 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS – 13

COST ACCOUNTING STANDARD ON COST OF SERVICE COST CENTRE

The following is the COST ACCOUNTING STANDARD – 13 (CAS - 13) issued by the Council of The Institute of Cost and Works Accountants of India on "Cost of Service Cost Centre". 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

1.1 This standard deals with the principles and methods of determining the cost of Service Cost Centre.

1.2 This standard covers the Service Cost Centre as defined in paragraph 4.11 of this standard. It excludes Utilities and Repairs & Maintenance Services dealt with in CAS-8 and CAS-12 respectively.

1.3 ***This standard deals with the principles and methods of classification, measurement and assignment of Cost of Service Cost Centre, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Cost of Service Cost Centre with reasonable accuracy.

3. Scope

This standard should be applied to the preparation and presentation of cost statements, which require classification, measurement and assignment of Cost of Service Cost Centre, including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and / or due to some abnormal situation of the production or operation.***[1]

4.2 Administrative Overheads: ***Cost of all activities relating to general management and administration of an organisation.***

Administrative overheads shall exclude production overheads[2], marketing overheads[3] and finance cost. Production overheads includes administration cost relating to production, factory, works or manufacturing.

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are finally ascertained.***

4.4 Distribution Overheads: ***Distribution Overheads, also known as Distribution Cost, are the costs incurred in handling a product / service from the time it is ready for despatch until it reaches the ultimate consumer including the units receiving the product / service in an inter-unit transfer.***[4]

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1 Adapted from CAS 1 paragraph 6.5.19

2 Paragraph reference 4.13 CAS -9

3 Paragraph reference 4.11 CAS -7

4 Adapted from CAS 1 Paragraph 6.3.9

The cost of any non manufacturing operations such as packing, repacking, labelling, etc. at an intermediate storage location will be part of distribution cost.

4.5 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[5]. The terms Finance costs and Borrowing costs are used interchangeably.

4.6 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[6]

4.7 Marketing overheads: ***Marketing Overheads are also known as Selling and Distribution Overheads.***

4.8 Normal capacity: ***Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.***[7]

4.9 Production Overheads: ***Indirect costs involved in the production process or in rendering service.***[8]

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

4.10 Selling Overheads: ***Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***[9]

4.11 Service Cost Centre: ***The cost centre which primarily provides auxiliary services across the enterprise.***

The cost centre which provides services to Production, Operation or other Service Cost Centre but not directly engaged in manufacturing process or operation is a service cost centre. A service cost centre renders services to other cost centres / other units and in some cases to outside parties.

Examples of service cost centres are engineering, workshop, research & development, quality control, quality assurance, designing, laboratory, welfare services, safety, transport, Component, Tool stores, Pollution Control, Computer Cell, dispensary, school, crèche, township, Security etc.

Administrative Overheads include cost of administrative Service Cost Centre.

4.12 Standard Cost: ***A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***[10]

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

5 Adapted from CIMA Terminology

6 Adapted from CAS 1 paragraph 6.5.13

7 Adapted from CAS 2 paragraph 4.4

8 Adapted from CAS 1 paragraph 6.3.3

9 Adapted from CAS 1 paragraph 6.3.7

10 Adapted from CAS 6 Paragraph 4.15

4.13 Stand-by service: ***Any facility created to safeguard against the failure of the main source of service.***

5. Principles of Measurement

5.1 ***Each identifiable service cost centre shall be treated as a distinct cost object for measurement of the cost of services subject to the principle of materiality.***

5.2.1 ***Cost of service cost centre shall be the aggregate of direct and indirect cost attributable to services being rendered by such cost centre.***

5.2.2 ***Cost of in-house services shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such service.***

Cost of other resources includes related overheads.

5.2.3 ***Cost of services rendered by contractors within the facilities of the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources provided to the contractors for such services.***

5.2.4 ***Cost of services rendered by contractors at their premises shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited. This cost shall also include the cost of resources provided to the contractors.***

5.2.5 ***Cost of services for the purpose of inter unit transfers shall also include distribution costs incurred for such transfers.***

5.2.6 ***Cost of services for the purpose of inter-company transfers shall also include distribution cost incurred for such transfers and administrative overheads.***

5.2.7 ***Cost of services rendered to outside parties shall also include distribution cost incurred for such transfers, administrative overheads and marketing overheads.***

5.3 ***Finance costs incurred in connection with the Service Cost Centre shall not form part of the cost of Service Cost Centre.***

5.4 ***The cost of service cost centre shall not include imputed costs.***

5.5 ***Where the cost of service cost centre is accounted at standard cost, the price and usage variances related to the services cost Centre shall be treated as part of cost of services. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.***

5.6 ***Any Subsidy / Grant / Incentive or any such payment received / receivable with respect to any service cost centre shall be reduced for ascertainment of the cost to which such amounts are related.***

5.7 ***The cost of production and distribution of the service shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost[11]. Cost of a Stand-by service shall include the committed costs of maintaining such a facility for the service.***

5.8 ***Any abnormal cost where it is material and quantifiable shall not form part of the cost of the service cost centre.***

5.9 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of the service cost centre.***

11 Adapted from Paragraph 5.7 of CAS 3

5.10 ***Credits/recoveries relating to the service cost centre including charges for services rendered to outside parties, material and quantifiable, shall be reduced from the total cost of that service cost centre.***

5.11 ***Any change in the cost accounting principles applied for the measurement of the cost of Service Cost Centre shall be made, only if it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an enterprise.***

6. Assignment of Cost

6.1 ***While assigning cost of services, traceability to a cost object in an economically feasible manner shall be the guiding principle.***

6.2 ***Where the cost of services rendered by a service cost centre is not directly traceable to a cost object, it shall be assigned on the most appropriate basis.***

6.3 ***The most appropriate basis of distribution of cost of a service cost centre to the cost centres consuming services is to be derived from logical parameters which could be related to the usage of the service rendered. The parameter shall be equitable, reasonable and consistent.***

7. Presentation

7.1 ***Cost of service cost centre shall be presented as a separate cost head for each type of service in the cost statement, if material.***

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

1. ***The basis of distribution of cost of each service cost centre to the consuming centres.***
2. ***The cost of purchase, production, distribution, marketing and price of services with reference to sales to outside parties***
3. ***Where the cost of service cost centre is disclosed at standard cost, the price and usage variances***
4. ***The cost of services received from / rendered to related parties[12].***
5. ***Cost of service cost centre incurred in foreign exchange.***
6. ***Any Subsidy/Grant/Incentive and any such payment reduced from cost of Service Cost Centre.***
7. ***Credits/ recoveries relating to the cost of Service Cost Centre***
8. ***Any abnormal cost excluded from cost of Service Cost Centre***
9. ***Penalties and damages paid excluded from cost of Service Cost Centre.***

8.2 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the cost of service cost centre during the period covered by the cost statement which has a material effect on the cost of service cost centre shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be disclosed.***

8.3 ***Disclosures shall be made only where material and significant.***

8.4 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule prominently.***

12 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS - 14

COST ACCOUNTING STANDARD ON POLLUTION CONTROL COST

The following is the Cost Accounting Standard - 14 (CAS - 14) issued by the Council of The Institute of Cost Accountants of India on "POLLUTION CONTROL COST". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

This standard deals with principles and methods of determining the Pollution control costs.

This standard deals with the principles and methods of classification, measurement and assignment of pollution control costs, for determination of Cost of product or service, and the presentation and disclosure in cost statements.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Pollution Control Costs with reasonable accuracy.

3. Scope

This standard should to be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Pollution Control Costs including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Air pollutant: ***Air Pollutant means any solid, liquid or gaseous substance (including noise) present in the atmosphere in such concentration as may be or tend to be injurious to human beings or other living creatures or plants or property or environment***[1]**.**

4.2 Air Pollution: ***Air pollution means the presence in the atmosphere of any air pollutant.***[2]

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.4 Direct Expenses: ***Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material cost and direct employee cost.***[3]

4.5 Environment: ***Environment includes water, air and land and the inter-relationship which exists among and between water, air and land, and human beings, other living creatures, plants, micro-organism and property.***[4]

4.6 Environmental Pollutant: ***Environmental Pollutant means any solid, liquid or gaseous substance present in such concentration as may be, or tend to be, injurious to environment.***[5]

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1 Section 2 (a) of The Air (Prevention and Control of Pollution) Act, 1981

2 Section 2 (b) of The Air (Prevention and Control of Pollution) Act, 1981

3 Adapted from Paragraph 4.4 of CAS - 10

4 Section 2 (a) of The Environment (Protection) Act, 1986

5 Section 2 (b) of The Environment (Protection) Act, 1986

4.7 Environment Pollution: ***Environmental pollution means the presence in the environment of any environmental pollutant.***[6]

4.8 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds***. This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.[7] The terms Finance costs and Borrowing costs are used interchangeably.

4.9 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose***.[8]

4.10 Normal capacity: ***Normal Capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance***[9]**.**

4.11 Pollution Control: ***Pollution Control means the control of emissions and effluents into environment. It constitutes the use of materials, processes, or practices to reduce, minimize, or eliminate the creation of pollutants or wastes. It includes practices that reduce the use of toxic or hazardous materials, energy, water, and / or other resources.***

4.12 Production overheads: ***Indirect costs involved in the production process or in rendering service.***[10]

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

Production overheads shall include administration cost relating to production, factory, works or manufacturing.

4.13 Soil Pollutant: ***Soil Pollutant is a substance such as cadmium, copper, arsenic, mercury, oil and organic solvent, which is the source of soil contamination.***

4.14 Soil Pollution: ***Soil pollution means the presence of any soil pollutant(s) in the soil which is harmful to the living beings when it crosses its threshold concentration level.***

4.15 ***Standard Cost: A predetermined cost of resource inputs for the cost object computed with reference to set of technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference 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. Standard costs are also used for estimation.

4.16 Water pollution: ***Pollution means such contamination of water or such alteration of the physical, chemical or biological properties of water or such discharge of any sewage or trade effluent or of any other liquid, gaseous or solid substance into water (whether directly or indirectly) as may, or is likely to, create a nuisance or render such water harmful or injurious to public health or safety, or to domestic, commercial, industrial, agricultural or other legitimate uses, or to the life and health of animals or plants or of aquatic organisms.***[11]

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6 Section 2 (c) of The Environment (Protection) Act, 1986

7 Adapted from CIMA Terminology

8 Adapted from CAS 1 paragraph 6.5.13

9 Adapted from CAS 2 paragraph 4.4

10 Adapted from CAS-1 Para 6.3.3 and 6.3.4

11 Section 2 (e) of The Water (Prevention and Control of Pollution) Act, 1974

5. Principles of Measurement:

5.1 ***Pollution Control costs shall be the aggregate of direct and indirect cost relating to Pollution Control activity***.

Direct cost includes the cost of materials, consumable stores, spares, manpower, equipment usage, utilities, resources for testing & certification and other identifiable resources consumed in activities such as waste processing, disposal, remediation and others.

Indirect cost includes the cost of resources common to various Pollution Control activities such as Pollution Control Registration and such like expenses.

5.2 ***Costs of Pollution Control which are internal to the entity should be accounted for when incurred. They should be measured at the historical cost of resources consumed.***

5.3 ***Future remediation or disposal costs which are expected to be incurred with reasonable certainty as part of Onerous Contract or Constructive Obligation, legally enforceable shall be estimated and accounted based on the quantum of pollution generated in each period and the associated cost of remediation or disposal in future.***

For example future disposal costs of solid waste generated during the current period should be estimated on, say, a per tonne basis.

5.4 ***Contingent future remediation or disposal costs e.g. those likely to arise on account of future legislative changes on pollution control shall not be treated as cost until the incidence of such costs become reasonably certain and can be measured.***

External costs of pollution which are generally the costs imposed on external parties including social costs are difficult to estimate with reasonable accuracy and are excluded from general purpose cost statements.

Social costs of pollution are measured by economic models of cost measurement. The cost by way of compensation by the polluting entity either under future legislation or under social pressure cannot be quantified by traditional models of cost measurement. They are best kept out of general purpose cost statements.

5.5 ***Cost of in-house Pollution Control activity shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such activity***.

5.6 ***Cost of Pollution Control activity carried out by outside contractors inside the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other costs incurred by the entity for such jobs.***

5.7 ***Cost of Pollution Control jobs carried out by contractor at its premises shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited. This cost shall also include the cost of other resources provided to the contractors.***

5.8 **Cost of Pollution Control jobs carried out by outside contractors shall include charges made by the contractor and cost of own materials, consumable stores, spares, manpower, equipment usage, utilities and other costs used in such jobs**.

5.9 ***Each type of Pollution Control e.g. water, air, soil pollution shall be treated as a distinct activity, if material and identifiable.***

5.10 ***Finance costs incurred in connection with the Pollution Control activities shall not form part of Pollution Control costs***.

5.11 ***Pollution Control costs shall not include imputed costs.***

5.12 ***Price variances related to Pollution Control, where standard costs are in use, shall be treated as part of Pollution Control cost. The portion of usage variances attributable to normal reasons***

shall be treated as part of Pollution Control cost. Usage variances attributable to abnormal reasons shall be excluded from Pollution Control cost.

5.13 ***Subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to Pollution Control activity, if any, shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.***

5.14 ***Any Pollution Control cost resulting from abnormal circumstances, if material and quantifiable, shall not form part of the Pollution Control cost.***

5.15 ***Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the Pollution Control cost.***

5.16 ***Credits / recoveries relating to the Pollution Control activity, material and quantifiable, shall be deducted to arrive at the net Pollution Control cost.***

5.17 ***Research and development cost to develop new process, new products or use of new materials to avoid or mitigate pollution shall be treated as research and development costs and not included under pollution control costs. Development costs incurred for commercial development of such product, process or material shall be included in pollution control costs.***

5.18 ***Any change in the cost accounting principles applied for the measurement of the Pollution Control cost should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Pollution Control costs shall be traced to a cost object to the extent economically feasible.***

Direct costs of pollution control such as treatment and disposal of waste shall be assigned directly to the product, where traceable economically.

Where these costs are not directly traceable to the product but are traceable to a process which causes pollution, the costs shall be assigned to the products passing through the process based on the quantity of the pollutant generated by the product.

6.2 ***Where the Pollution Control cost is not directly traceable to cost object, it shall be treated as overhead and assigned based on either of the following two principles;***

(i) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost.

(ii) Benefits received – overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

Typical of such costs are costs such as administration costs relating to pollution control activities, costs of certification such as ISO 14000 and registration fees payable to pollution control authorities

6.3 ***If the Pollution Control cost (including the share of the cost of reciprocal exchange of services) is shared by several cost objects, the related cost shall be measured as an aggregate and distributed among the cost objects as per principles laid down in Cost Accounting Standard –3.***

7. Presentation

7.1 ***Pollution Control cost, if material, shall be presented in the cost statement as a separate item of cost.***

7.2 ***Pollution control costs shall be presented duly classified as follows:***

(a) Direct and Indirect cost

(b) Internal and External costs

(c) Current and future costs

(d) Domain area e.g. water, air and soil.

7.3 *Activity wise details of Pollution Control cost, if material, shall be presented separately.*

8. Disclosures

8.1 *The cost statements shall disclose the following:*

1. *The basis of distribution of Pollution Control cost to the cost objects/ cost units.*
2. *Where standard cost is applied in Pollution Control cost, the price and usage variances.*
3. *Pollution Control cost of Jobs done in-house and outsourced separately.*
4. *Pollution Control cost paid/ payable to related parties[12].*
5. *Pollution Control cost incurred in foreign exchange.*
6. *Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable reduced from Pollution Control cost.*
7. *Any credits / recoveries relating to the Pollution Control cost.*
8. *Any abnormal portion of the Pollution Control cost.*
9. *Penalties and damages excluded from the Pollution Control cost.*

8.2 *Disclosures shall be made only where material, significant and quantifiable.*

8.3 *Cost incurred on pollution control relating to prior periods and taken to reconciliation directly shall be disclosed separately.*

8.4 *Where estimates are made of future costs to be incurred on pollution control, the basis of estimate shall be disclosed separately.*

8.5 *If a descriptive note dealing with the social cost of pollution caused by the entity and the control of such pollution is contained in the same document as the cost statement, the cost Statement shall carry a reference to such descriptive note.*

8.6 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.*

8.7 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the Pollution Control cost during the period covered by the cost statement which has a material effect on the Pollution Control cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

12 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS - 15

COST ACCOUNTING STANDARD ON SELLING AND DISTRIBUTION OVERHEADS

The following is the COST ACCOUNTING STANDARD -15 (CAS-15) issued by the Council of The Institute of Cost Accountants of India on "**SELLING AND DISTRIBUTION OVERHEADS**". 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

This standard deals with the principles and methods of determining the Selling and Distribution Overheads.

This standard deals with the principles and methods of classification, measurement and assignment of Selling and Distribution Overheads, for determination of the cost of sales of product or service, and the presentation and disclosure in cost statements.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Selling and Distribution Overheads with reasonable accuracy.

3. Scope

This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of Selling and Distribution Overheads including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost***: An unusual or atypical cost whose occurrence is usually irregular and unexpected and / or due to some abnormal situation of the production or operation.***[1]

4.2 Absorption of overheads: ***Absorption of overheads is charging of overheads to Cost Objects by means of appropriate absorption rate.***[2]

Overhead Absorption Rate = Overheads of the Cost object / Quantum of base.

4.3 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which cost are ascertained.***[3]

4.4 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[4]

4.5 Indirect expenses: ***Expenses which cannot be directly attributed to a particular cost object.***

4.6 Overheads: ***Overheads comprise costs of indirect materials, indirect employees and indirect expenses which are not directly identifiable or allocable to a cost object in an economically feasible manner.***[5]

4.7 ***Distribution costs or Distribution overheads: Distribution Overheads are the costs incurred in handling a product or service from the time it is ready for delivery until it reaches the ultimate consumer.***

The cost of packing, repacking, labelling, etc. at an intermediate storage location will be part of distribution cost.

1 CAS 3 (Revised 2011) Para 4.1
2 CAS 3 (Revised 2011) Para 4.2
3 CAS 3 (Revised 2011) Para 4.5
4 CAS 3 (Revised 2011) Para 4.7
5 CAS 3 (Revised 2011) Para 4.13

For Example:

1. Packing, repacking / labelling at an intermediate storage location
2. Transportation cost
3. Cost of warehousing (cover depots, godowns, storage yards, stock yards etc.,)

Note:

In case of machinery involving technical help in installation, such expenses for installation are part of cost of production and not considered as cost of Selling and Distribution Overheads.

4.8 Selling Overheads: ***Selling Overheads, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***[6]

For Example:

1. Salaries of sales personnel
2. Travelling expenses of sales personnel
3. Commission to sales agents
4. Sales and brand promotion expenses including advertisement, publicity, sponsorships, endorsements and similar other expenses.
5. Receivable Collection costs
6. After sales service costs
7. Warranty costs

4.9 Marketing Overheads: ***Marketing Overheads comprises Selling Overheads and Distribution Overheads.***[7]

5. Principles of Measurement

5.1 ***Selling and Distribution Overheads shall be the aggregate of the cost of resources consumed in the selling and distribution activities of the entity. The cost of resources procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited by the Tax Authorities.***

Post sales costs such as warranty cost, product liability cost, after sales service shall be estimated on a reasonable basis.

5.2 ***Selling and Distribution Overheads, the benefits of which are expected to be derived over a long period, shall be amortised on a rational basis.***

5.3 Selling and distribution overheads shall not include imputed cost.

5.4 ***Cost of after Sales Service provided in terms of sale agreement for a class of transactions, shall be determined on rational and scientific basis, net of any recovery on the service.***

5.5 ***Any Subsidy / Grant / Incentive or any such payment received / receivable with respect to any Selling and Distribution Overheads shall be reduced from the cost of the sales of the cost object.***

5.6 ***Any abnormal cost relating to selling and distribution activity shall be excluded from the Selling and Distribution Overheads.***

5.7 ***Any demurrage or detention charges, or penalty levied by transportation or other authorities in respect of distribution activity shall not form part of the Selling and Distribution Overhead.***

5.8 ***Penalties and damages paid to statutory authorities or other third parties shall not form part of the Selling and Distribution Overheads.***

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6 CAS 3 (Revised 2011) Para 4.15

7 CAS 3 (Revised 2011) Para 4.11

5.9 ***Credits / recoveries relating to the Selling and Distribution Overheads including those rendered without any consideration, material and quantifiable, shall be deducted to arrive at the net Selling and Distribution Overheads.***

5.10 ***Any change in the cost accounting principles applied for the measurement of the Selling and Distribution Overheads shall be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an entity.***

6. Assignment of Cost

6.1 ***Selling and Distribution Overheads directly traceable shall be assigned to the relevant product sold or services rendered.***

6.2 ***Transportation cost relating to distribution shall be assigned as per CAS – 5, where relevant and applicable.***

6.3 ***Assignment of Selling and Distribution Overheads to the cost objects shall be based on either of the following two principles;***

(i) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost.

(ii) Benefits received – overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

7. Presentation

7.1 ***Selling and Distribution overheads shall be presented as a separate cost head in the cost statement.***

A reporting entity may use the term marketing Oveheads in place of Selling and Distribution overheads.

7.2 ***Element wise details of the Selling and Distribution overheads shall be presented, if material.***

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

1. ***The basis of distribution of Selling and Distribution Overheads to the cost objects.***
2. ***Selling and Distribution Overheads incurred in foreign exchange.***
3. ***Cost of Selling and Distribution services rendered to related parties[8].***
4. ***Any Subsidy / Grant / Incentive and any such payment reduced from Selling and Distribution Overheads.***
5. ***Credits / recoveries relating to the Selling and Distribution Overheads.***
6. ***Penalties and damages excluded from the Selling and Distribution Overheads.***

8.2 ***Disclosures shall be made only where material and significant.***

8.3 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Selling and Distribution Overheads during the period covered by the cost statement which has a material effect on the Selling and Distribution Overheads shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

9. Effective date:

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April 2013 for being applied for the preparation and certification of General Purpose Cost Accounting Statements.

8 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS -16

COST ACCOUNTING STANDARD ON DEPRECIATION AND AMORTISATION

The following is the COST ACCOUNTING STANDARD – 16 (CAS – 16) issued by the Council of The Institute of Cost Accountants of India on **"DEPRECIATION AND AMORTISATION"**. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. **Introduction**

   This standard deals with the principles and methods of measurement and assignment of Depreciation and Amortisation for determination of the cost of product or service, and the presentation and disclosure in cost statements.

2. **Objective**

   The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Depreciation and Amortisation with reasonable accuracy.

3. **Scope**

   This standard shall be applied to cost statements which require measurement, assignment, presentation and disclosure of Depreciation and Amortisation, including those requiring attestation.

4. **Definitions**

   The following terms are being used in this standard with the meaning specified:-

   4.1 **Amortisation: Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.**

   It refers to expensing the acquisition cost minus the residual value of intangible assets such as Franchise, Patents and Trademarks or Copyrights in a systematic manner over their estimated useful economic life so as to reflect their consumption in the production of goods and services.

   4.2 ***Asset: The terms Asset, Fixed Asset and Intangible Asset will have the same meaning as in the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006.***

   An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. In case of some assets which are acquired for safety or environmental reasons, the acquisition of such assets may not provide future economic benefits directly but may be necessary for an entity to obtain the future economic benefits from other assets. Such items also qualify for recognition as assets.

   4.3 ***Cost Object: This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

   4.4 ***Depreciation: Depreciation*** **is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the estimated useful life of the asset.**

   4.5 ***Depreciable amount*** **of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.**

   4.6 ***Depreciable*** **fixed and Intangible assets are assets which**:

   (i) are expected to be used during more than one accounting period;

(ii) have a limited useful life; and

(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

Land is not a depreciable asset as it does not have a defined useful life.

4.7 ***Residual (salvage) value:*** **Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.**

4.8 ***Useful life of asset is either***

(i) the period over which a depreciable asset is expected to be used by the enterprise; or

(ii) the number of production or similar units expected to be obtained from the use of the asset by the entity

5. Principles of Measurement

5.1 ***Depreciation and Amortisation shall be measured based on the depreciable amount and the useful life.***

The residual value of an intangible asset shall be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

I. residual value can be determined by reference to that market; and

II. it is probable that such a market will exist at the end of the asset's useful life.

III. The residual value of a fixed asset shall be considered as zero if the entity is unable to estimate the same with reasonable accuracy.

The minimum amount of depreciation to be provided shall not be less than the amount calculated as per principles and methods as prescribed by any law or regulations applicable to the entity and followed by it.

5.2 In case of regulated industry the amount of depreciation shall be the same as prescribed by the concerned regulator.

5.3 ***While estimating the useful life of a depreciable asset, consideration shall be given to the following factors:***

(a) Expected physical wear and tear;

(b) Obsolescence; and

(c) Legal or other limits on the use of the asset.

5.4 The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset.

If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. The useful life of a re-acquired right recognised as an intangible asset in a business combination is the remaining contractual period of the contract in which the right was granted and shall not include renewal periods.

The useful life of an intangible asset, in any situation, shall not exceed 10 years from the date it is available for use.

5.5 ***Depreciation shall be considered from the time when a depreciable asset is first put into use.***

An asset which is used only when the need arises but is always held ready for use. Example: fire extinguisher, stand by generator, safety equipment shall be considered to be an asset in use. Depreciable assets will be considered to be put into use when commercial production of goods and services commences.

Depreciation on an asset which is temporarily retired from production of goods and services shall be considered as abnormal cost for the period when the asset is not in use.

5.6 ***Depreciation of any addition or extension to an existing depreciable asset which becomes an integral part of that asset shall be based on the remaining useful life of that asset.***

5.7 ***Depreciation of any addition or extension to an existing depreciable asset which retains a separate identity and is capable of being used after the expiry of the useful life of that asset shall be based on the estimated useful life of that addition or extension.***

5.8 ***The impact of higher depreciation due to revaluation of assets shall not be assigned to cost object.***

5.9 ***Impairment loss on assets shall be excluded from cost of production.***

5.10 ***The method of depreciation used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.***

5.11 ***An entity can use any of the methods of depreciation to assign depreciable amount of an asset on a systematic basis over its useful life.***

For example:

(a) Straight-line method;

(b) Diminishing balance method; and

(c) Units of production method.

5.12 ***The method of amortisation of intangible asset shall reflect the pattern in which the economic benefits accrue to entity.***

5.13 ***The methods and rates of depreciation applied shall be reviewed at least annually and, if there has been a change in the expected pattern of consumption or loss of future economic benefits, the method applied shall be changed to reflect the changed pattern.***

5.14 ***Spares purchased specifically for a particular asset, or class of assets, and which would become redundant if that asset or class of asset was retired or use of that asset was discontinued, shall form part of that asset. The depreciable amount of such spares shall be allocated over the useful life of the asset.***

5.15 ***Cost of small assets shall be written off in the period in which they were purchased as per the accounting policy of the entity.***

5.16 ***Depreciation of an asset shall not be considered in case cumulative depreciation exceeds the original cost of the asset, net of residual value.***

5.17 ***Where depreciation for an addition of an asset is measured on the basis of the number of days for which the asset was used for the preparation and presentation of financial statements, depreciation of the asset for assigning to cost of object shall be measured in relation to the period, the asset actually utilized.***

6. Assignment of Costs

6.1 ***Depreciation shall be traced to the cost object to the extent economically feasible.***

6.2 ***Where the depreciation is not directly traceable to cost object, it shall be assigned based on either of the following two principles:***

i. ***Cause and effect - cause is a process or operation or activity and effect is the incurrence of cost.***

ii. ***Benefits received– depreciation is to be apportioned to the various cost objects in proportion to the benefits received by them.***

7. Presentation

Depreciation and Amortisation, if material, shall be presented in the cost statement as a separate item of cost.

8. Disclosures

8.1 ***The cost statement shall disclose the following:-***

1. ***The basis of distribution of Depreciation and Amortisation to the cost objects.***
2. ***Any credits / recoveries relating to Depreciation and Amortisation.***
3. ***Additional Depreciation on account of revaluation of asset, which is not included in cost.***
4. ***Amount of depreciation that is not included in cost because of temporary retirement of assets from production of goods and services.***

8.2 ***Disclosure shall be made only where material, significant and quantifiable.***

8.3 ***Disclosures shall be made in the body of the cost statement or as a foot note or in a separate schedule.***

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of Depreciation and Amortisation during the period covered by the cost statement which has a material effect on Depreciation and Amortisation shall be disclosed. Where the effect of such change is not ascertainable wholly or partly, the fact shall be indicated.***

9. Effective date:

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April 2014 for being applied for the preparation and certification of General Purpose Cost Accounting Statements.

CAS-17

COST ACCOUNTING STANDARD ON INTEREST AND FINANCING CHARGES

The following is the Cost Accounting Standard (CAS 17) on **"INTEREST AND FINANCING CHARGES"**. 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

This standard deals with the principles and methods of classification, measurement and assignment of Interest and Financing Charges.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles, methods of determining and assigning the Interest and Financing Charges with reasonable accuracy.

3. Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Interest and Financing Charges including those requiring attestation.

This standard does not deal with costs relating to risk management through derivatives.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Asset: The terms Asset, Fixed Asset, Tangible Fixed Asset, Intangible Fixed Asset, Qualifying asset, current asset will have the same meaning as in the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules,2006.

4.2 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.3 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose***.

4.4 Interest and Financing charges: ***Costs incurred by an enterprise in connection with the borrowing of fund or other costs which in effect represent payment for the use of non- equity fund.***

Examples are:

1. interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. amortisation of discounts or premium related to borrowings:
3. amortisation of ancillary cost incurred in connection with the arrangements of borrowings:
4. Financing Charges in respect of finance leases and other similar arrangements: and
5. exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.[1]
6. Cash discount allowed to customers.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

1 Adapted from CIMA Terminology

4.5 ***Net current asset: Net current asset is the excess of current assets over current liabilities***

Current Liabilities shall include *short term borrowings and that part of long term borrowings which are classified as current liabilities.*

Short term borrowing is the borrowing which is repayable within one year from the date of disbursal as per Loan Agreement.

Long term borrowing is the borrowing which is repayable after one year from the date of disbursal as per Loan Agreement.

5. Principles of Measurement:

5.1 ***Interest and Financing Charges incurred shall be identified for :***

(a) acquisition / construction/ production of qualifying assets including fixed assets; and

(b) Other finance costs for production of goods/ operations or services rendered which cannot be classified as qualifying assets.

5.2 ***Interest and Financing Charges directly attributable to the acquisition /construction/ production of a qualifying asset shall be included in the cost of the asset.***

5.3 Interest and Financing Charges shall not include imputed costs.

5.4 Subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to Interest and Financing Charges if any, shall be reduced to ascertain the net interest and financing charges.

5.5 Penal Interest for delayed payment, Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the Interest and Financing Charges.

In case the company delays the payment of Statutory dues beyond the stipulated date, interest paid for delayed payment shall not be treated as penal interest.

5.6 Interest paid for or received on investment shall not form part of the other financing charges for production of goods / operations or services rendered;

6. Assignment of costs

6.1 Assignment of Interest and Financing Charges to the cost objects shall be based on either of the following principles;

I. Cause and effect- cause is the process or operation or activity and effect is the incurrence of cost.

II. Benefits received- Interest and Financing Charges are to be apportioned to the various cost objects in proportion to the benefits received by them.

7. Presentation

Interest and Financing Charges shall be presented in the cost statement as a separate item of cost of sales.

8. Disclosures

8.1 The cost statements shall disclose the following:

1. The basis of distribution of Interest and Financing Charges to the cost objects/ cost units.

2. Where predetermined cost is applied in Interest and Financing Charges, the rate and usage variances.

3. Interest and Financing Charges paid/ payable to related parties.

4. ***Interest and Financing Charges incurred in foreign exchange.***

5. ***Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable reduced Interest and Financing Charges.***

8.2 Disclosures shall be made only where material, significant and quantifiable.

8.3 Interest and Financing Charges incurred relating to prior periods and taken to reconciliation directly shall be disclosed separately.

8.4 Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.

8.5 Any change in the cost accounting principles and methods applied for the measurement and assignment of the Interest and Financing Charges during the period covered by the cost statement which has a material effect on the Interest and Financing Charges shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.

9. Effective date:

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April 2014 for being applied for the preparation and certification of General Purpose Cost Accounting Statements.

CAS-18

COST ACCOUNTING STANDARD ON RESEARCH AND DEVELOPMENT COSTS

The following is the Cost Accounting Standard-18 (CAS-18) on "RESEARCH AND DEVELOPMENT COSTS". The standard deals with methods of determining the Research and Development Costs. 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

This standard deals with the principles and methods of determining the Research, and Development Costs and their classification, measurement and assignment for determination of the cost of product or service, and the presentation and disclosure in cost statements.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Research, and Development Costs with reasonable accuracy and presentation of the same.

3. Scope

This standard should be applied to cost statements that require classification, measurement, assignment, presentation and disclosure of Research, and Development Costs including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: ***An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.***[1]

4.2 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are finally ascertained.***

4.3 Direct Materials: ***The cost of materials which can be attributed to a cost object in an economically feasible way.***[2]

4.4 Direct Employee Cost: ***The cost of employees which can be attributed to a Cost Object in an economically feasible way.***[3]

4.5 Direct Expenses: ***Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material or direct employee cost***[4]***.***

Examples of Direct Expenses are royalties charged on production, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling Expenses for a specific job.

4.6 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed only for the purpose of decision making.***[5]

1 Adapted from CAS 1 paragraph 6.5.19

2 Adapted from CAS 1-6.2.3

3 Adapted from CAS 1 Para 6.2.4 (Direct labour cost)

4 Adapted from CAS 1 Para 6.2.6

5 Adapted from CAS 1 paragraph 6.5.13

4.7 Indirect Employee Cost: ***The employee cost which cannot be directly attributed to a particular cost object.***

4.8 Indirect Material Cost: ***The cost of materials which cannot be directly attributed to a particular cost object.***

4.9 Indirect expenses: ***Expenses which cannot be directly attributed to a particular cost object.***

4.10 Overheads: ***Overheads comprise of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object.***

4.11 Research and Development:

4.11.1 Research: ***Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding[6].***

4.11.2 ***Development: Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use[7].***

5. Principles of Measurement

5.1 ***Research, and Development Costs shall include all the costs that are directly traceable to research and/or development activities or that can be assigned to research and development activities strictly on the basis of a) cause and effect or b) benefits received. Such costs shall include the following elements:***

1. The cost of materials and services consumed in Research, and Development activities.
2. Cost of bought out materials and hired services as per invoice or agreed price including duties and taxes directly attributable thereto net of trade discounts, rebates, taxes and duties refundable or to be credited.
3. The salaries, wages and other related costs of personnel engaged in Research, and Development activities;
4. The depreciation of equipment and facilities, and other tangible assets, and amortisation of intangible assets to the extent that they are used for Research, and Development activities;
5. Overhead costs, other than general administrative costs, related to Research, and Development activities.
6. Costs incurred for carrying out Research, and Development activities by other entities and charged to the entity; and
7. Expenditure incurred in securing copyrights or licences
8. Expenditure incurred for developing computer software
9. Costs incurred for the design of tools, jigs, moulds and dies
10. Other costs that can be directly attributed to Research, and Development activities and can be identified with specific projects.

5.2 ***Subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to Research, and Development Activity, if any, shall be reduced from the cost of such Research, and Development Activity.***

6 Adapted AS 26

7 Adapted AS 26

5.3 ***Any abnormal cost where it is material and quantifiable shall not form part of the Research, and Development Cost.***

5.4 ***Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the Research, and Development Cost.***

5.5 ***The amortisation of an intangible asset arising from the development activity shall be treated as set out in the CAS 16 relating to Depreciation and Amortisation.***

5.6 ***Research, and Development costs shall not include imputed costs.***

5.7 ***Credits/recoveries relating to Research, and Development cost, if material and quantifiable, including from the sale of output produced from the Research and Development activity shall be deducted from the Research and Development cost.***

6. Assignment of costs

6.1 ***Research, and Development costs attributable to a specific cost object shall be assigned to that cost object directly.***

Research, development costs that are not attributable to a specific product or process shall not form part of the product cost.

6.2 Development cost which results in the creation of an intangible asset shall be amortised over its useful life

6.3 Assignment of Development Costs shall be based on the principle of "benefits received".

6.4 Reseach and Development Costs incurred for the development and improvement of an existing process or product shall be included in the cost of production.

In case the Research and Developmnet activity related to the improvement of an existing process or product continues for more than one accounting period, the cost of the same shall be accumulated and amortised over the estimated period of use of the improved process or estimated period over which the improved product will be produced by the entity after the commencement of commercial production, as the case may be, if the improved process or product is distinctly different from the existing process or product and the product is marketed as a new product. The amount allocated to a particular period shall be included in the cost of production of that period. If the expenditure is only to improve the quality of the existing product or minor modifications in attributes, the principle shall not be applied.

6.5 Development costs attributable to a saleable service e.g providing technical know-how to outside parties shall be accumulated separately and treated as cost of providing the service.

7. Presentation

7.1 Research and Development costs relating to improvement of the process or products or services shall be presented as a separate item of cost in the cost statement under cost of production.

7.2 Research, and Development costs which are not related to improvement of the process, materials, devices, processes, systems, product or services shall be presented as a part of the reconciliation statement.

8. Disclosures

8.1 The cost statements shall disclose the following:

1. ***The basis of accumulation and assignment of Research and Development costs.***
2. ***The Research, and Development costs paid to related parties***[8]***.***

8 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

3. ***Credit/recoveries from related parties***
4. ***Research, and Development cost incurred in foreign exchange.***
5. ***Any Subsidy/Grant/Incentive and any such payment reduced from Research, and Development cost.***
6. ***Credits/recoveries deducted from the Research, and Development cost.***
7. ***Any abnormal cost excluded from Research, and Development cost including cost of abandoned projects and research activities considered abnormal.***
8. ***Penalties and damages paid etc. excluded from Research, and Development cost.***

8.2 Any change in the cost accounting principles and methods applied for the measurement and assignment of the Research, and Development cost during the period covered by the cost statement that has a material effect on the Research, and Development cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.

8.3 Disclosures shall be made only where material, significant and quantifiable.

8.4 Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.

CAS-19

COST ACCOUNTING STANDARD ON JOINT COSTS

The following is the Cost Accounting Standard – 19 (CAS - 19) on "JOINT COSTS". In this standard, the standard portions have been set in ***bold Italic*** type. These are to be read in context of the background material which has been set in normal type.

1. Introduction

The standard deals with the principles and methods of measurement and assignment of Joint Costs and the presentation and disclosure in cost statement.

2. Objective

The objective of this standard is to bring uniformity, consistency in the principles, methods of determining and assigning Joint Costs with reasonable accuracy.

3. Scope

The standard shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Joint Costs including those requiring attestation.

4. Definitions

The following terms are being used in this standard within the meaning specified.

4.1 By-Product: output of some value produced incidentally while manufacturing the main product.

4.2 Cost Object: This includes a product, service, cost centre, activity, sub activity, project, customer or distribution channel or any other units in relation to which costs are ascertained.

4.3 Imputed Cost: Hypothetical or notional costs, not involving any cash outlay computed for any purpose[1].

4.4 Joint Costs: Joint costs are the cost of common resources used to produce two or more products or services simultaneously.

4.5 Joint product : two or more products produced by the same process and separated in processing, each having a sufficiently high saleable value to merit recognition as a main product[2].

4.6 Scrap: Discarded material having some value in few cases 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[3].

4.7 Split off point: The point in the production process at which joint products become separately identifiable. The terms split off point and separation point are used interchangeably.

4.8 Waste: Material loss during production or storage due to various factors such as evaporation, chemical reaction, contamination, unrecoverable residue, shrinkage, etc. and discarded material which may or may not have a value[4].

1 Adapted from CAS 1 paragraph 6.5.13

2 Adapted from CIMA Terminology

3 Adapted from CAS 6 paragraph 4.9

4 Adapted from CAS 6 paragraph 4.11.1

5. Principles of Measurement

5.1 **The principles and methods for measuring Joint costs upto the split off point will be the same as stipulated in other cost accounting standards.**

5.2 ***Cost incurred after split-off point on product separately identifiable shall be measured for the resources consumed for each Joint/By-Product.***

5.3 **Cost incurred *after split- off point for further processing of joint product/By-Product shall be the aggregate of direct and indirect costs.***

5.4 **Cost *of further processing of joint product/By-Product carried out by outside parties shall be determined at invoice or agreed price including duties and taxes, net of discounts (other than cash discount) taxes and duties refundable or to be credited and other expenditure directly attributable to such processing . This cost shall also include the cost of resources provided to outside parties.***

5.5 ***In case the production process generates scrap or waste, realized or realizable value, net of disposal cost, of scrap and waste shall be deducted from the cost of Joint Product.***

5.6 ***Any Subsidy / Grant / Incentive or any such payment received / receivable with respect to any joint product /By-Product shall be reduced for ascertainment of the cost to which such amounts are related.***

5.7 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of the joint product /By-Product.***

6. Assignment

6.1 ***Joint cost incurred shall be assigned to joint products based on benefits received, which is measured using any of the following methods:***

(a) Physical Units Method.

(b) Net Realisable Value at split-off point.

Net realisable value for this purpose means the net selling price per unit multiplied by quantity (Quantity sold). Net realizable value is to be adjusted for the post- split off costs.

(c) Technical estimates

6.2 ***The value of By-Product shall be estimated using any of the following methods for adjusting joint costs :***

a. ***Net* realizable *value***

Net realizable value for this purpose means the net selling price per unit multiplied by quantity (Quantity sold). Net realizable value is to be adjusted for the post- split off costs.

b. ***Technical Estimates***

This method may be adopted where the By-Product is not saleable in the condition in which it emerges or comparative prices of similar products are not available.

7. Presentation

The Cost Statement shall present the element wise cost of individual products produced jointly and the value assigned to By-Products.

8. Disclosures

8.1 ***The Cost statement shall disclose the basis of allocation of Joint costs to individual products and the value assigned to the By-Products***

8.2 The Cost statement shall also disclose:

8.3 The disclosure should be made only where material, significant & quantifiable.

8.4 Disclosures shall be made in the body of Cost Statements or as a foot note or as a separate schedule.

8.5 Any change in the cost accounting principles and methods applied for the measurement and assignment of the Joint costs and the value assigned to by-product during the period covered by the cost statement which has a material effect on the Joint/ By-Products shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.

9. Effective date:

This Cost Accounting Standard shall be effective from the period commencing on or after ..... for being applied for the preparation and certification of General Purpose Cost Accounting Statements.

CAS-20

COST ACCOUNTING STANDARD ON ROYALTY AND TECHNICAL KNOW-HOW FEE

The following is the Exposure Draft of the Cost Accounting Standard- (CAS-20) on "**ROYALTY AND TECHNICAL KNOW-HOW FEE**". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the amount of Royalty and Technical Know-how Fee .

1.2 This standard deals with the principles and methods of classification, measurement and assignment of the amount of Royalty and Technical Know-how Fee, for determination of the cost of product or service, and their presentation and disclosure in cost statements.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the amount of Royalty and Technical Know-how Fee with reasonable accuracy.

3. Scope

This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of the amount of Royalty and Technical Know-how Fee including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

4.2 Royalty is a compensation/ periodic payments for the use of asset (tangible and/or intangible) to the owner for use of his asset in the production, selling and distribution by an entity.

Royalty is often expressed as a percentage of the revenues obtained by use of the owners asset(tangible and/or intangible); per unit of production or sales value. It may relate to use of: Non-renewable resource (petroleum and mineral resources) ; Patents; Trade marks; Franchise rights; Copy rights; art-work, software and the like.

The terms Assets, tangible assets and intangible assets will have the same meaning as in the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006.

4.3 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[1]. The terms Finance costs and Borrowing costs are used interchangeably.

1 Adapted from CIMA Terminology

4.4 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[2]

4.5 Technical Know-how Fee: Technical Know-how Fee is a lump sum or periodical amount payable to provider of technical Know-how in the form of design, drawings ,training of personnel, or practical knowledge , skills or experience.

5. Principles of Measurement:

5.1 ***Royalty and Technical Know-how Fee paid or incurred in lump-sum or which are in the nature of 'one – time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from the related asset.***

Examples: Amortisation of the amount of Royalty or Technical Know-how fee paid for which the benefit is ensued in the current or future periods shall be determined based on the production/ service volumes estimated for the period over which the asset is expected to benefit the entity.

5.2 ***Amount of the Royalty and Technical Know-how Fee shall not include finance costs and imputed costs.***

5.3 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to amount of Royalty and Technical Know-how fee shall be reduced to measure the amount of royalty and technical know- how fee.***

5.4 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the amount of Royalty and Technical Know-how fee*****.**

5.5 ***Credits/ recoveries relating to the amount Royalty and Technical Know-how fee, material and quantifiable, shall be deducted to arrive at the net amount of Royalty and Technical Know-how fee.***

5.6 ***Any change in the cost accounting principles applied for the measurement of the*** **amount** ***of Royalty and Technical Know-how Fee should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Royalty and Technical Know-how fee that is directly traceable to a cost object shall be assigned to that cost object. In case such fee is not directly traceable to a cost object then it shall be assigned on any of the following basis:***

a. Units produced

b. Units sold

c. Sales value

6.2 The amount of Royalty fee paid for mining rights shall form part of the cost of material.

6.3 The amount of Royalty and Technical Know-how fee shall be assigned on the nature/ purpose of such fee.

The amount of royalty and technical know-how fee related to product or process know how shall be treated as cost of production; if it is related to trademarks or brands shall be treated as cost of sales.

7. Presentation

7.1 The amount ***Royalty and Technical Know-how fee shall be presented as a separate cost head with suitable classification.***

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2 Adapted from CAS 1 paragraph 6.5.13

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

1. ***The basis of distribution of* the amount *Royalty and Technical Know-how fee to the cost objects/ cost units.***
2. ***Quantity and the related rate of items of* the amount *of Royalty and Technical Know-how fee, as applicable.***
3. ***Royalty and Technical Know-how fee paid/ payable to related parties[3].***
4. ***Royalty and Technical Know-how fee incurred in foreign exchange.***
5. ***Any Subsidy/Grant/Incentive and any such payment reduced from* the amount *of Royalty and Technical Know-how fee.***
6. ***Credits/recoveries relating to* the amount *of Royalty and Technical Know-how fee.***
7. ***Penalties and damages excluded from* the amount *of Royalty and Technical Know-how fee***

8.2 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.3 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of* the amount *Royalty and Technical Know-how fee during the period covered by the cost statement which has a material effect on the* amount *Royalty and Technical Know-how fee. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

3 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS-21

COST ACCOUNTING STANDARD ON QUALITY CONTROL

The following is the Exposure Draft of the Cost Accounting Standard (CAS -21) on "**QUALITY CONTROL**". In this standard, the standard portions have been set in ***bold Italic*** type. These are to be read in context of the background material which has been set in normal type.

1. ***Introduction***

   The standard deals with the principles and methods of measurement and assignment of Quality Control cost and the presentation and disclosure in cost statement.

2. ***Objective***

   The objective of this standard is to bring uniformity, consistency in the principles, methods of determining and assigning Quality Control cost with reasonable accuracy.

3. ***Scope***

   The standards shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Quality Control cost including those requiring attestation.

4. ***Definitions***

   The following terms are being used in this standard with the meaning specified.

   4.1 Abnormal cost*: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation.*[1]

   4.2 Cost Object: ***This includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.***

   4.3 Defectives: ***End Product and/or intermediate product units that do not meet quality standards. This may include reworks or rejects.***

   4.3.1 Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***

   Rework includes repairs, reconditioning and refurbishing.

   4.3.2 Rejects: ***Defectives which cannot meet the quality standards even after putting in additional resources.***

   Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

   4.4 Finance Costs: ***Costs incurred by an enterprise in connection with the borrowing of funds.*** This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortisation of discounts or premium related to borrowings, amortisation of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs[2]. The terms Finance costs and Borrowing costs are used interchangeably.

   4.5 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***[3]

1 Adopted from CAS 1 paragraph 6.5.19

2 Adapted from CIMA Terminology

3 Adapted from CAS 1 paragraph 6.5.13

4.6 Overheads: ***Overheads comprise of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object.***[4]

4.7 **Quality:** ***Quality is the conformance to requirements or specifications.***

The quality of a product or service is fitness of that product or service for meeting its intended use as required by customer.

4.8 **Quality control:** ***A procedure or a set of procedures exclusively designed to ensure that the manufactured products or performed service adhere to a defined set of quality criterion or meets requirement of the client or the customer.***

4.9 Quality Control cost: **This represents** ***Cost of resources consumed towards quality control procedures.***

4.10 Scrap: ***Discarded material having some value in few cases 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***[5].

4.11 Waste and spoilage:

4.11.1 Waste: ***Material loss during production or storage due to various factors such as evaporation, chemical reaction, contamination, unrecoverable residue, shrinkage, etc., and discarded material which may or may not have value***[6].

4.11.2 Spoilage: ***Production that does not meet with dimensional or quality standards in such a way that it cannot be rectified economically and is sold for a disposal value. Net Spoilage is the difference between costs accumulated up to the point of rejection and the salvage value.***

5. Principles of Measurement:

5.1 Quality Control cost incurred in-house shall be the aggregate of the cost of resources consumed in the Quality Control activities of the entity. The cost of resources procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited by the Tax Authorities.

Such cost shall include:

- *Cost of conformance to quality: (a) prevention cost; and (b) appraisal cost.*

5.2 Identification of Quality Control costs shall be based on traceability in an economically feasible manner.

5.3 ***Quality Control costs other than those referred to in paragraph 5.2 shall be determined on the basis of amount incurred in connection therewith.***

5.4 ***Finance costs incurred in connection with the self generated or procured resources shall not form part of Quality Control cost.***

5.5 ***Quality Control costs shall not include imputed costs.***-

5.6 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to any Quality Control cost shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.***

5.7 ***Any abnormal portion of the Quality Control cost where it is material and quantifiable shall not form part of the Cost of Quality Control*****.**

4 Adapted from CAS 3 paragraph 4.1

5 Adapted from Glossary of Management Accounting Terms- Page 62

6 Adopted from Glossary of Management Accounting Terms page 70

5.8 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the Quality Control cost.***

5.9 ***Any change in the cost accounting principles applied for the measurement of the Quality Control cost shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Quality Control cost that is directly traceable to the cost object shall be assigned to that cost object.***

6.2 ***Assignment of Quality Control cost to the cost objects shall be based on benefits received by them.***

(i) ***Benefits received – Quality Control cost is to be apportioned to the various cost objects in proportion to the benefits received by them.***

For example : On the basis of number of tests performed for a product.

7. Presentation

7.1 ***Quality Control cost, if material, shall be presented as a separate cost head with suitable classification.***

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

8.1.1 The basis of distribution of Quality Control cost to the cost objects/ cost units.

8.1.2 Quantity and Cost of resources used for Quality Control cost as applicable.

8.1.3 Quality Control cost paid/ payable to related parties[7].

8.1.4 Quality Control cost incurred in foreign exchange.

8.1.5. Any abnormal portion of the Quality Control cost.

8.1.6 Penalties and damages excluded from the Quality Control cost

8.2 ***Disclosures shall be made only where material, significant and quantifiable.***

8.3 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Quality Control cost during the period covered by the cost statement which has a material effect on the Quality Control cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

7 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

CAS – 22

COST ACCOUNTING STANDARD ON MANUFACTURING COST

The following is the COST ACCOUNTING STANDARD – 22 (CAS - 22) issued by the Council of The Institute of Cost Accountants of India for determination of **"MANUFACTURING COST".** In this Standard, the standard portions have been set in bold italic type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the **Manufacturing Cost of excisable goods.**

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment for determination of the Manufacturing Cost of excisable goods and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Manufacturing Cost of excisable goods.

3. Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Manufacturing Cost of excisable goods.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 ***Abnormal and non-recurring cost: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/or due to some abnormal situation of the production or operation.***

4.2 ***Administrative Overheads: Cost of all activities relating to general management and administration of an organisation.***

Administrative overheads need to be analysed in relation to production/manufacturing activities and other activities. Administrative overheads in relation to production/manufacturing activities shall be included in the manufacturing cost.

Administrative overheads in relation to marketing, projects management, corporate office or any other expense not related to the manufacturing activity shall be excluded from manufacturing cost.

4.3 ***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), as defined in section4(3) of the Central Excise Act, 1944.***

4.4 Defectives: End Product and/or intermediate product units that do not meet quality standards. This may include reworks or rejects.

An intermediate product is a product that might require further processing before it is saleable to the ultimate consumer.

4.4.1 Reworks: Defectives which can be brought up to the standards by putting in additional resources.

Rework includes repairs, reconditioning, retro-fitment and refurbishing.

4.4.2 Rejects: Defectives which cannot meet the quality standards even after putting in additional resources.

Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

4.5 Depreciation: Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes. Depreciation does not include impairment loss.

Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the estimated useful life of the asset.

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Useful life of asset is either

(i) the period over which a depreciable asset is expected to be used by the enterprise; or

(ii) the number of production or similar units expected to be obtained from the use of the asset by the entity.

Depreciation that is charged in audited financial statement should be considered.

4.6 Direct Expenses: Expenses relating to manufacture of an excisable good, which can be identified to such excisable good other than direct material cost and direct employee cost.

4.7 Employee Cost: The aggregate of all kinds of consideration paid, payable and provisions made for future payments for the services rendered by employees of an enterprise (including temporary, part time and contract employees). Consideration includes wages, salary, contractual payments and benefits, as applicable or any amount paid or payable on behalf of employee. This is also known as Labour Cost.

4.7.1 Direct Employee Cost: The cost of employees which can be attributed to an excisable good in an economically feasible way.

4.7.2 Indirect Employee Cost: The cost of employees which cannot be directly attributed to a particular excisable good.

4.8 Interest and Finance Costs: Costs incurred by an enterprise in connection with the borrowing of funds.

4.9 Manufacturing Cost: Manufacturing cost of an excisable good is the aggregate of costs of all resources used in the process of its manufacturing.

Manufacturing cost includes cost of Materials (including process materials), Employee Cost, Cost of Utilities, Packing Cost, Direct Expenses, Repairs &Maintenance Cost, Pollution Control Cost, Quality Control Cost, Research & Development Cost, Cost of Inputs received free of cost or received at concessional value from the buyer of the excisable good, Depreciation and Amortisation (including amortisation cost of free tools, patterns ,dies, drawings, blue prints, technical maps, charts, engineering, development, art work, design work, plans, sketches, packaging material and the like necessary for production of excisable goods), Cost of Rework, reconditioning, retro-fitment, Manufacturing Overheads, other costs allocable to such activity, adjustment for stock of work-in-process and recoveries for sales of scrap and wastages and the like but does not include expenses of the above nature incurred for post manufacturing purposes.

Manufacturing Cost and Cost of Production are used interchangeably.

4.10 Manufacturing Overheads: Indirect costs involved in the manufacturing process

The terms Manufacturing Overheads, Factory Overheads, Works Overheads and Production Overheads have the same meaning and are used interchangeably. Manufacturing overheads shall include administration cost relating to production, factory, works or manufacturing and depot.

Manufacturing Overheads shall be classified on the basis of behaviour as Variable Manufacturing Overheads and Fixed Manufacturing Overheads.

Variable Manufacturing Overheads comprise of expenses which vary in proportion to the change in volume of production. For example, cost of utilities etc.

Fixed Manufacturing overheads comprise of expenses which does not change with the change in volume of production. For example, salaries, rent, repairs & maintenance, etc.

4.11 Material Consumed: Material Consumed includes materials directly identified for production of excisable goods such as:

(a) Indigenous materials

(b) Imported materials

(c) Bought out items

(d) Self-manufactured items

(e) Process materials and other items

(f) Materials received free of cost or at concessional value from the buyer

(g) Accessories, on which cenvat credit is admissible, and which are cleared along with the final product

(h) goods used for providing free warranty for excisable goods

Cost of material consumed consists of cost of material, duties and taxes, freight inwards, insurance and other expenditure directly attributable to procurement. Trade discount, rebates and other similar items are 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 entity are also deducted.

4.12 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.

Capacity may be determined in terms of units of production or equivalent machine or man hours.

4.13 Packing Material Cost: The cost of material of any nature used for the purpose of packing of excisable good.

4.14 Quality Control Cost: The quality control cost is the expenses incurred relating to quality control activities for adhering to quality standard. These expenses include salaries & wages relating to employees engaged in quality control activity and other related expenses.

4.15 Repairs & Maintenance Cost: Cost of all activities which have the objective of maintaining or restoring an asset in or to a state in which it can perform its required function at intended capacity and efficiency.

4.16 Research and Development Cost: The research and development cost incurred for development and improvement of the process or the excisable good.

4.17 Royalty: Royalty is compensation/periodic payments for the use of asset (tangible and/ or intangible) to the owner for use of his asset in the production/manufacture, selling and distribution by an entity.

4.18 Scrap: Discarded material having some value in few cases and which is usually either disposed of without further treatment (other than reclamation and handling) or reintroduced into the production process.

4.19 Technical Know-how Fee: Technical Know-how Fee is a lump sum or periodical amount payable to provider of Technical Know-how in the form of design, drawings, training of personnel, or practical knowledge, skills or experience.

4.20 Waste and Spoilage:

4.20.1 Waste: Material lost during production or storage due to various factors such as evaporation, chemical reaction, contamination, unrecoverable residue, shrinkage, etc., and discarded material which may or may not have any value.

4.20.2 Spoilage: Production that does not meet with dimensional or quality standards in such a way that it cannot be rectified economically and is sold for a disposal value. Net Spoilage is the difference between costs accumulated up to the point of rejection and the salvage value.

5. Principles of Measurement

5.1 Manufacturing cost for each excisable good shall be measured separately.

5.2 Manufacturing cost of each excisable good shall be the aggregate of direct and indirect cost relating to manufacturing activity.

5.3 Material cost shall be measured separately for each type of material, that is, for indigenous material, imported material, bought out components and process materials, self-manufactured items, accessories for each type of excisable good.

Cost of Inputs received free of cost or at concessional value from the buyer of the excisable good shall be considered for determination of manufacturing cost.

5.4 The material cost of normal scrap/defectives which are rejects shall be included in the material cost of excisable goods manufactured. The material cost of actual scrap/ defectives, not exceeding the normal quantity shall be adjusted in the material cost of good production. Realized or realizable value of scrap or waste shall be deducted for determination of manufacturing cost. Material Cost of abnormal scrap /defectives should not be included in material cost but treated as loss after deducting the realisable value of such scrap / defectives.

5.5 Employee Cost for each excisable good shall be measured separately.

5.6. The cost of utilities consumed for manufacturing of excisable good shall be measured for each type of utility.

5.7 Packing material cost used for each type of excisable good shall be measured separately.

If excisable goods are transferred/dispatched duly packed, the cost of such packing shall include cost of all types of packing in which the excisable goods are removed from the place of removal.

5.8 The Direct Expenses for manufacturing of excisable goods shall be measured for each excisable good separately.

5.9 Repairs and maintenance cost for manufacturing of excisable goods shall be measured for each excisable good separately.

5.10 Depreciation and Amortisation cost for manufacturing of excisable goods shall be measured for each excisable good separately.

5.11 Research & Development cost for manufacturing of excisable goods shall be measured for each excisable good separately.

5.12 Cost incurred for manufacturing of excisable goods after split-off point shall be measured for each Joint/By-Product.

In case the manufacturing process generates scrap or waste, realized or realizable value net of cost of disposal, of such scrap and waste shall be deducted from the cost of Joint Product.

5.13 ***Royalty and Technical Know-how Fee for manufacturing of excisable goods paid or incurred in lump-sum or which are in the nature of 'one-time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from the related Technical Know how.***

Royalty paid on sales shall not form part of manufacturing cost of excisable good.

5.14 ***Quality Control cost incurred in-house for manufacturing of excisable goods shall be the aggregate of the cost of resources used in the Quality Control activities in relation to each excisable good. The cost of resources procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts, taxes and duties refundable or to be credited as input credit.***

5.15 ***Manufacturing Overheads for excisable goods representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts; taxes and duties refundable or to be credited as input credit.***

Manufacturing Overheads other than those referred to above shall be determined on the basis of cost incurred in connection therewith.

5.16 ***Any abnormal cost, where it is material and quantifiable, shall not form part of the manufacturing cost of excisable good.***

5.17 ***Interest and other Finance costs are not part of manufacturing cost of excisable good.***

5.18 ***Manufacturing cost of excisable good shall include cost of inputs received free of cost or at concessional value from the buyer of excisable good and amortisation cost of free tools, pattern, dies, drawings, blue prints, technical maps, charts, engineering, development, art work, design work, plans, sketches,*** **and the like necessary for production of excisable good. It shall also include cost of rework, reconditioning, retro-fitment, Manufacturing Overheads and other costs allocable to such activity, adjustment for stock of work-in-process and recoveries from sales of scrap and wastages and the like** ***necessary for production of excisable good.***

In case any input material, whether of direct or indirect nature, including packing material, is supplied free of cost or at concessional value by the buyer of the excisable good, the cost of such material shall be included in the manufacturing cost.

For example: Amortisation Cost of Moulds, Tools, Dies & Patterns and Cost of Packing Material etc. received free of cost or at concessional value from the buyer of excisable good shall be included in manufacturing cost.

5.19 ***Any Subsidy/Grant/Incentive or any such payment received/receivable, from other entity, other than the buyer with respect to any manufacturing cost of excisable good shall be deducted for ascertainment of the manufacturing cost of excisable good to which such amounts are related.***

5.20 ***The manufacturing cost of excisable good shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost.***

5.21 ***Fines, penalties, damages, demurrage and similar levies paid to statutory authorities or other third parties shall not form part of the manufacturing cost of excisable good.***

5.22 ***The forex component of imported material or other element of cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of manufacturing cost of excisable good.***

5.23 ***Credits/recoveries relating to the manufacturing cost, which are material and quantifiable, shall be deducted from the total manufacturing cost to arrive at the net manufacturing cost of excisable good.***

5.24 Work in process/progress stock shall be measured at cost computed for different stages of completion.

Stock of work-in-process/progress shall be valued at cost on the basis of stages of completion as per cost accounting principles. Opening and closing stock of work-in-process/progress shall be adjusted for computation of manufacturing cost of an excisable good.

6. Assignment of Cost

6.1 While assigning various elements of manufacturing cost of excisable goods, traceability to an excisable good in an economically feasible manner shall be the guiding principle. The cost which can be traced directly to each excisable good shall be directly assigned.

6.2 Assignment of manufacturing cost of excisable goods, which are not directly traceable to the excisable good shall be based on either of the following two principles;

6.2.1 Cause and Effect – Cause is the process or operation or activity and effect is the incurrence of cost.

6.2.2 Benefits received – to be apportioned to various cost objects in proportion to the benefits received by them.

6.3 ***The variable manufacturing/production overheads shall be absorbed based on actual production.***

6.4 The fixed manufacturing/production overheads and other similar item of fixed costs such as quality control cost, research and development costs and administrative overheads relating to manufacturing shall be absorbed in the manufacturing cost on the basis of the normal capacity or actual capacity utilization of the plant, whichever is higher.

6.5 In case a production process results in more than one product being produced simultaneously, treatment of joint products and by-products shall be as under:

6.5.1 In case joint products are produced, joint costs are allocated between the products on a rational and consistent basis.

6.5.2 In case by-products are produced, the net realisable value of by-products is credited to the manufacturing cost of the main product.

6.6 Miscellaneous Income relating to production/manufacture shall be adjusted in the determination of manufacturing cost.

For example, income from sale of empty containers used for procurement of raw material shall be deducted in determination of manufacturing cost.

7. Presentation

7.1 Cost statement as per Appendix 1 to this standard or as near thereto shall present following information:

7.1.1 Actual capacity utilization in absolute terms and as a percentage of normal capacity.

7.1.2 Cost information relating to various elements of Cost shall be presented separately.

8. Disclosures

8.1 Disclosure shall be made only where material, significant and quantifiable.

8.2 If there is any change in cost accounting principles and practices during the period under review which may materially affect the manufacturing cost of excisable good in terms of comparability with previous period(s), the same shall be disclosed.

9. Effective date

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April 2015 for being applied for the preparation and certification of Cost Accounting Statements for excisable goods.

Appendix 1

Cost Statement showing Manufacturing Cost of (Name of excisable good) for the period:

	Name of the Manufacturer	
	Address of the Manufacturer	
	Excise Registration Number	
	Name of the unit	
	Address of the unit	
	Central Excise Tariff Heading	

A	**Quantitative Information**	**Unit**	**Quantity**
1	Normal/Installed Capacity		
2	Production		
3	Captive Consumption		
4	Production as %age of Normal/Installed Capacity		

B	**Cost Information**	**Unit**	**Quantity**	**Rate**	**Amount**	**Cost per Unit**
	Materials (specify)					
1	A.					
	B.					
	C.					
	D …..					
	Total Materials Consumed					
2	Process Materials					
3	Utilities					
4	Direct Employee Cost					
5	Direct Expenses					
6	Consumable Stores and Spares					
7	Repairs and Maintenance Cost					
8	Quality Control Cost					
9	Research & Development Cost					
10	Technical Know-how Fee/Royalty, if any					
11	Depreciation/Amortization					
12	Other Manufacturing Overheads					
13	Total (1 to 12)					
14	Add/Less Work-in-Progress Adjustments					
15	Less Credit for Recoveries , if any					
16	Packing Cost					
17	Cost of Inputs Received Free or at concessional value from the buyer of the excisable good					
18	Manufacturing Cost (13 to 17)					

Date: Seal & Signature of the 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 and Cost Accounting Standards followed by the entity, I/we certify that the above cost data reflects true and fair view of the manufacturing cost of the above excisable good.

Date: Seal & Signature of Cost Accountant

Place: Membership No.: Firm Regn. No.:

Note: Separate Cost Statement(s) shall be prepared for each *excisable good*

4.3 GLOSSARY OF TERMS USED IN COST ACCOUNTING STANDARDS

Glossary of Term

A	
Abnormal cost	An unusual or atypical cost whose occurrence is usually irregular and unexpected and/or due to some abnormal situation of the production or operation.
Abnormal idle capacity	Abnormal idle capacity is the difference between normal capacity and actual capacity utilization where the actual capacity is lower than the normal capacity.
Abnormal idle time	An unusual or atypical idle time occurrence of which is irregular and unexpected or due to some abnormal situations.
Absorption of overheads	Assigning of overheads to cost objects by means of appropriate absorption ra te.
Actual capacity utilization	Actual capacity utilization is the volume of production achieved or service provided in a specified period, expressed as a percentage of installed capacity.
Administrative overheads	Cost of all activities relating to general management and administration of an entity.
Air pollutant	Means any solid, liquid or gaseous substance (including noise) present in the atmosphere in such concentration as may be or tend to be injurious to human beings or other living creatures or plants or property or environment.
Air pollution	Air pollution means the presence in the atmosphere of any air pollutant.
Allocation of overheads	Allocation of overheads is assigning total amount of an item of cost directly to a cost object.
Amortisation	Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.
Apportionment of overhead	Assigning of overhead is distribution of overheads to more than one cost objects on some equitable basis.
Asset	An Asset is a resource; (a) controlled by an entity as a result of past events; and (b) from which future economic benefits are expected to flow to the entity.
B	
By-product	Product with relatively low value produced incidentally in the manufacturing of the product or service.
C	
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 entity or related undertaking for manufacturing other product(s).
Cartage	The expenses incurred for movement of goods covering short distance for further transportation for delivery to customer or storage.
Collection of overheads	Collection of overheads means the pooling of items of indirect expenses from books of account and supportive/corroborative records in logical groups having regards to their nature and purpose.
Conversion cost	Conversion cost is the production cost excluding the cost of direct materials.
Cost	Cost is a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services.

Cost centre	Any unit of an entity selected with a view to accumulating all cost under that unit. The unit can be division, department, section, group of plant and machinery, group of employees or combination of several units.
Cost object	An activity, contract, cost centre, customer, product, process, project, service or any other object for which costs are ascertained.
Cost of production	Cost of production of a product or a service consists of cost of materials consumed, direct employee costs, direct expenses, production overheads, quality control costs, packing costs, research and development costs and administrative overheads relating to production.
Cost of transportation	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.
Cost unit	Cost unit is a form of measurement of volume of production of a product or a service. Cost unit is generally adopted on the basis of convenience and practice in the industry concerned.
Current assets	An entity shall classify an asset as current when : (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle; (b) it holds the asset primarily for the purpose of trading; (c) it expects to realise the asset within twelve months after the reporting period; or (d) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.
Current liabilities	An entity shall classify a liability as current when : (a) it expects to settle the liability in its normal operating cycle; (b) it holds the liability primarily for the purpose of trading; (c) the liability is due to be settled within twelve months after the reporting period ; or (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.
D	
Defectives	Materials, products or intermediate products that do not meet quality standards. This may include reworks or rejects.
Depreciable amount	The cost of an asset, or other amount substituted for cost in the financial statement, less its residual value.
Depreciation	Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.
Development	Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.
Development cost	Development cost is the cost for application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.
Direct employee cost	Employee cost, which can be attributed to a cost object in an economically feasible way.

Direct expenses	Expenses relating to manufacture of a product or rendering a service, which can be identified or linked with the cost object other than direct material cost or direct employee cost.
Direct materials	Materials, the costs of which can be attributed to a cost object in an economically feasible way.
Distribution overheads	Distribution overheads, also known as distribution costs, are the costs incurred in handling a product or service from the time it is ready for despatch or delivery until it reaches the ultimate consumer including the units receiving the product or service in an inter-unit transfer.
E	
Employee cost	Benefits paid or payable for the services rendered by employees (including temporary, part time and contract employees) of an entity.
Environment pollution	Environmental pollution means the presence in the environment of any environmental pollutant.
Environment	Environment includes water, air and land and the inter-relationship which exists among and between water, air and land, and human beings, other living creatures, plants, micro-organism and property.
Environmental pollutant	Environmental pollutant means any solid, liquid or gaseous substance present in such concentration as may be, or tend to be, injurious to environment.
Excess capacity utilization	Excess capacity utilization is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is more than installed capacity.
F	
Factory overheads	Same as production overheads.
Fixed costs	Fixed costs are costs which do not vary with the change in the volume of activity. Fixed indirect costs are termed fixed overheads.
Freight	Freight is the charges paid or payable for transporting materials/ goods from one location to another.
I	
Idle capacity	Idle capacity is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is less than installed capacity.
Idle time	The difference between the time for which employees are paid/payable to employees and the employees' time booked against cost objects.
Imputed cost	Notional cost, not involving cash outlay, computed for any purpose.
Indirect employee cost	Employee cost, which cannot be directly attributed to a particular cost object.
Indirect expenses	Expenses, which cannot be directly attributed to a particular cost object.
Indirect material cost	Material cost that cannot be directly attributed to a particular cost object.
Indirect materials	Materials, the costs of which cannot be directly attributed to a particular cost object.
Installed capacity	Installed capacity is the maximum capacity of producing goods or providing services, according to the manufacturer's specifications or determined through an expert study.
Intangible asset	An intangible asset is an identifiable non-monetary asset without physical substance.

Interest and Finance charges	Interest, including any payment in the nature of interest for use of non equity funds and incidental cost that an entity incurrs in arranging those funds.
Intermediate product	An intermediate product is a product that requires further processing before it is saleable.
J	
Joint costs	Joint costs are the cost of common resources used to produce two or more products or services simultaneously.
Joint product	Products or services that are produced simultaneously, by the same process, identifiable at the end of the process and recognised as main products or services having sufficient value.
M	
Manufacturing cost	Same as cost of production.
Manufacturing overheads	Indirect costs involved in the manufacturing process.
Marketing overheads	Marketing overheads comprise of selling overheads and distribution overheads.
Material cost	The cost of material used for the purpose of production of a product or rendering a service.
N	
Net current asset	Net current asset is the excess of current assets over current liabilities.
Normal capacity	Normal capacity is the production achieved or achievable on an average over a number of periods or seasons under normal circumstances taking into account the loss of capacity resulting from planned maintenance.
Normal idle capacity	Normal idle capacity is the difference between installed capacity and normal capacity.
O	
Overheads	Overheads comprise costs of indirect materials, indirect employees and indirect expenses.
Overtime premium	The extra amount payable beyond the normal wages and salaries for beyond the normal working hours.
P	
Packing materials	Materials used to hold, identify, describe, store, protect, display, transport, promote and make the product marketable.
Packing material cost	The cost of material of any nature used for the purpose of packing of a product.
Pollution control	Pollution control means the control of emissions and effluents into environment. it constitutes the use of materials, processes, or practices to reduce, minimize, or eliminate the creation of pollutants or wastes. It includes practices that reduce the use of toxic or hazardous materials, energy, water, and / or other resources.
Primary packing material **Prime cost**	Packing material which is essential to hold and preserve the product for its use by the customer. Prime cost is the aggregate of direct material cost, direct employee cost and direct expenses.
Production overheads	Indirect costs involved in the production of a product or in rendering service.

Q	
Qualifying asset	An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.
Quality	Quality is the conformance to requirements or specifications.
Quality control	A procedure or a set of procedures exclusively designed to ensure that the manufactured products or performed services adhere to a defined set of quality criterion or meet requirements of the client or the customer.
Quality control cost	Cost of resources consumed towards quality control procedures.
R	
Rejects	Defectives which cannot meet the quality standards even after putting in additional resources.
Repairs and maintenance cost	Cost of all activities which have the objective of maintaining or restoring an asset in or to a state in which it can perform its required function at intended capacity and efficiency.
Research	Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
Research cost	Research cost is the cost of original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding,
Residual(salvage) value	The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the assets were already of the age and in the condition expected at the end of its useful life.
Rework	Defectives which can be brought up to the standards by putting in additional resources.
Royalty	Royalty is any consideration for the use of asset (tangible and/or intangible) to the owner.
S	
Scrap	Discarded material having no or insignificant value and which is usually either disposed off without further treatment (other than reclamation and handling) or reintroduced into the process in place of raw material.
Secondary packing material	Packing material that enables to store, transport, inform the customer, promote and otherwise make the product marketable.
Selling overheads	Selling overheads are the expenses related to sale of products or services and include all indirect expenses incurred in selling the products or services.
Semi variable costs	Semi variable costs are the costs that contain both fixed and variable elements. They partly change with the change in the level of activity.
Soil pollutant	Soil pollutant is a substance which is the source of soil contamination.
Soil pollution	Soil pollution means the presence of any soil pollutant(s) in the soil which is harmful to the living beings when it crosses its threshold concentration level.
Split off point	The point in the production process at which joint products become separately identifiable.
Spoilage	Production that does not meet the quality requirements or specifications and cannot be rectified economically.
Standard cost	A predetermined cost of a product or service based on technical specifications and efficient operating conditions.

Stand-by service	Any facility created as backup against any failure of the main source of service.
Stand-by utilities **Support- Service Cost centre**	Any utility created as backup against any failure of the main source of utilities. The cost centre which primarily provides auxiliary services across the entity.
T	
Technical service fee	Technical service fee is any consideration payable to provider of technical or managerial services.
Transit insurance cost	Transit insurance cost is the amount of premium to be paid to cover the risk of loss/damage to the goods in transit.
U	
Useful life of the asset	Useful life of asset is either : (a) the period over which a asset is expected to be available for use by an entity; or (b) the number of production or similar units expected to be obtained from use of the asset by the entity.
Utilities	Significant inputs such as power, steam, water, compressed air and the like which are used for manufacturing process but do not form part of the final product.
V	
Variable costs	Variable costs are the cost which tends to directly vary with the volume of activity.
W	
Waste	Material lost during production or storage and discarded material which may or may not have any value.
Water pollution	Water pollution means such contamination of water or such alteration of the physical, chemical or biological properties of water or such discharge of any sewage or trade effluent or of any other liquid, gaseous or solid substance into water (whether directly or indirectly) as may, or is likely to, create a nuisance or render such water harmful or injurious to public health or safety, or to domestic, commercial, industrial, agricultural or other legitimate uses, or to the life and health of animals or plants or of aquatic organisms.
Works overheads	Same as production overheads.

Disclaimer

There are some provisions though spelt under the Companies Act, 2013, but not yet notified/enforced "till date of publication of this Study Material". Hence, for such provisions, the relevant and corresponding Sections/Provisions of the Companies Act, 1956 is applicable. All concerned are requested to follow both – the MCA, GOI website as well as Clarification/Circular issued/to be issued by the Institute from time to time – on applicability of sections of Companies Act for CMA Examinations.

Study Note - 4

COST BUILDING PROCESS

This Study Note includes

4.1 Introduction and Objectives

4.2 Essentials of Cost Building Process

4.3 The System - Basic Parameters

4.4 Integrated Accounting

4.5 Classification of Costs

4.1 INTRODUCTION AND OBJECTIVES

A cost accounting system is a detailed and well organized industrial accounting process comprising of classifying, accumulating, analyzing and finally reporting cost information to appropriate levels of management. The efficiencies and service value of the system depends primarily upon its ability to furnish the right type of information at the right time and at reasonable costs. In other words, a cost accounting system must serve its objectives promptly and economically.

The objective of a cost system may be appropriately identified with the purposes the cost information is desired and used for by the management. In earlier days, the cost information was required primarily employed for product pricing. It was also used for inventory valuation necessary for the preparation of periodic financial statements. Lately, however, management have been wanting cost information, and in fact they are depending more and more on it, for the following broad purposes.

a) Operation Planning - decide what to buy/sale; when, where and how to do it etc.

b) Operation Control - assess performance vis-a-vis set plans, and decide appropriate measures to ensure continued progress as per the plans.

c) The changed economic climate in India has brought in competition from domestic as well as international markets. This has led to the need for severe cost control measures to face the competition.

It is not difficult to comprehend that the above broad purposes cover almost each and every aspect of a business organization. It should be so since every business activity incurs cost. It is, therefore, important to realize that several specific purposes are implicit in the aforesaid broad purposes. One must further recognize that the type and content of cost information varies from one specific purpose to another and that one kind of cost information does not serve every purpose.

4.2 ESSENTIALS OF COST BUILDING PROCESS

If a cost accounting system is to effectively serve the various purposes set forth above, it must incorporate in itself the following essential features.

Recognition of Diverse Behaviour of Cost Components

Cost of a product, a process or function comprises of several components, such as raw materials, direct operating labour, electricity, rent etc. It is now well recognized that all these do not behave in similar fashion with respect to volume of output and/or time. Obviously, larger quantities of raw materials are necessary to produce larger volumes of a finished product. However, supervision and rent might remain the same as long as the increased production can be handled with existing facilities.

Fixation of Control Responsibility for various Costs

A cost accounting system must recognize that control of costs be best exercised at the source. This implies that costs can be appropriately controlled by persons which in fact incur or have authority to incur them. Since the authority to incur various costs is not vested in one individual or place in the organization but is delegated to several individuals and functional areas throughout the organization, it is obvious that the control responsibility for various costs must likewise fall on several persons or places in the organization. A cost accounting system must, therefore, appropriately assign responsibility for different types of costs and must provide for classification, accumulation and reporting of cost information in accordance with control responsibility which in turn will aid the management in exercising effective control.

Provision of Yardstick for Performance Management

From control angle, the knowledge of actual cost of a product, a process, an event or an activity is not enough in itself. Simultaneously, one would like to know just how much it should have been in normal circumstances, and further would like to compare the actual with what "should have been". In other words, one would desire to measure one's own cost performance or the cost performance of those responsible to him. The measurement of cost performance helps to reveal and direct attention to the inefficient areas.

4.3 THE SYSTEM - BASIC PARAMETERS

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 state that for the purposes of sub-section (1) of section 148 of the Act, the class of companies, including foreign companies defined in clause (42) of section 2 of the Act engaged in the production of the goods or providing services, specified in the Table below, having an overall turnover from all its products and services of rupees **thirty five crore or more** during the immediately preceding financial year, shall include cost records for such products or services in their books of account.

Rule 4(a) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (A) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **fifty crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **twenty five crore or more**.

Rule 4(b) of the Companies (Cost Records and Audit) Rules, 2014 state that every company specified in item (B) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees **one hundred crore or more** and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees **thirty five crore or more**.

Control is effected by means of records and the records needs to be suitably analyzed and grouped to serve the desired objectives. The reports derived from these records should be utilized by the management to exercise control.

The modern concept of control of costs rests on capturing of cost elements according to its nature and activity. Broadly, cost is classified under two categories because of their nature of variability and these are Fixed Costs and Variable Costs. The Variable Costs are those which vary with change in the volume of cost objective whereas the Fixed Costs remain constant irrespective of the volume of cost objective. So the identification of variable costs can be made objectively, without any significant change in its measurement. But the allocation of fixed costs to arrive at total cost is a matter of subjective decision and gives rise to arbitrariness, as the selection of base for distribution influences fluctuation in incidence of fixed cost which is difficult to measure with accuracy.

4.4 INTEGRATED ACCOUNTING

The statutory maintenance of cost accounting records do not envisage a separate set of books of accounts. As explained earlier, it propagates that same set of books for both financial accounting and cost accounting, i.e., a system of integrated accounting. Integrated Account implies a single set of accounts which fulfils the need for both financial accounts and cost accounts. In this case, the cost accounts are not distinct from the financial accounts as in the system of inter-locking of accounts and needs no separate reconciliation at the end of a financial period except for such items that are specifically financial in nature and not considered as a part of product/activity costing. The reconciliation is progressively obtained by judicious use of Control Accounts for the major elements of expenses, e.g., Raw Materials, Salaries & Wages, Stores & Spares, Expenses etc. A scheme of Internal Audit should supplement the system by proper checking of records which is in addition to normal checks exercised at the operation centres for initiation of payments and recording of actuals. It is pertinent to note here that effective ERP systems are available with in-built cost modules which performs the integration task conveniently and efficiently provided the costing module is configured properly with proper defined cost codes.

The primary requirement of cost accounting is to record different types of cost data, i.e., historical costs which are recorded element-wise in the accounts and summarized in periodic reports.

For the above purpose, the term cost accounting process is divided into the following functional classifications:

a) Cost book-keeping involving the recording of costs according to some required classification.

b) Cost analysis requiring presentation of cost data to indicate where costs have deviated from plan and to identify the reasons.

c) Cost control involving determination of whether the current costs represent what is regarded as satisfactory performance.

d) Cost comparison of alternative products, activities, methods or areas of production.

e) Cost planning for the cost system or planning the procedure of work.

The following processes are usually involved to arrive at the product unit cost:

a) Cost classification by grouping of costs according to their common characteristics.

b) Grouping of costs identified with cost units or cost centres and which are common.

c) Arriving at unit product cost from costs collected under each cost centre.

4.5 CLASSIFICATION OF COSTS

The classification of costs into various groups by nature and location is the first step in costing. But the important point about this classification of costs is that the characteristics according to which a cost is classified is not an intrinsic characteristic of that cost, but a characteristic which arises out of the relationship between that cost and the location in relation to which it is incurred. For example, a company having three manufacturing units at three different locations. The corporate/administrative office may be located in a city different from the manufacturing locations. The Material procurement department may be centralized and located at the administrative office. In such a case, the expenses pertaining to the Material procurement department would not form part of the administrative overheads but would be a part of production overheads of the respective manufacturing units.

The collection of costs in a systematic manner is the first essential step in booking of the expenses. The uniformity is maintained when the expenses are classified in accordance with an approved code of classification. For this purpose, a scheme of Cost Codes has to be outlined for the required heads of accounts for collection of costs for the suggested costing system.

For the sake of control and identification of location for incurrence of costs, the organization needs to be divided into different sectors, termed Cost Centres, and all expenses related to such cost centres are required to be collected under respective cost centres so that the cost of a particular cost centre is readily available in one place and the economy or otherwise, achieved in the cost centre can be easily assessed.

This division into Cost Centres may be a location, person or item of equipment (or group of these) for which costs may be ascertained and used for the purpose of cost control and this division may not necessarily coincide with the administrative grouping of departments as may be existing in the organization. But of necessity, it can be adapted to the Cost Centre concept as, otherwise, difficulty may be faced for operation of Budgetary Control.

The company maintains its accounts in the ERP environment where the cost accounts is integrated with the financial accounts. Each item of expenses, at the time of incurrence, is booked under account codes selected according to its incidence and nature. The costs are pulled under different cost centres and are automatically reconciled with the financial books.

For cost classification purposes, the expenses are classified under production/utility cost centres and overheads. Expenses directly identifiable to a cost centre are allocated to that centre/utility. Expenses of common nature, not directly identifiable to any of the production cost centre or utility centre are accumulated under the different Overheads depending on its nature of incidence.

Study Note - 5

COST AUDITING STANDARDS

This Study Note includes

5.1 Cost Auditing Standards

5.1 COST AUDITING STANDARDS

Introduction

This Preface to the Standards on Quality Control, Auditing, Assurance, Review, and Related Services rendered by the Cost Accountants (CMAs) has been issued to facilitate understanding of the scope and authority of the pronouncements of the Cost Audit and Assurance Standards Board (CAASB) issued under the authority of the Council of the Institute of Cost Accountants of India.

The Institute of Cost Accountants of India is committed to the goal of developing the cost and management accountancy profession in India. In furtherance of this goal, the Institute develops and promulgates technical standards and other professional literature.

The Institute of Cost Accountants of India is a founder member of the International Federation of Accountants (IFAC). The International Auditing and Assurance Standards Board (IAASB) established by the IFAC has issued series of International Standards on Auditing, which primarily focus on the Financial audit. There are fundamental differences between the scope and methodology of financial and cost audit. Therefore, it will not be appropriate to adopt in full or with modifications the International Standards on Auditing issued by the IAASB. However in formulating the standards, the CAASB will ensure that the framework and other aspects of the International Standards are considered, to the extent relevant and applicable to cost audit.

Government of India, Ministry of Corporate Affairs, vide their letter no. 52/33/CAB/2013 dated 10th September, 2015 has, under section 148(3) of the Companies Act, 2013, granted Central Government's approval to the following Cost Auditing Standards:

1. Cost Auditing Standard-101 on Planning an audit of Cost Statements;

2. Cost Auditing Standard-102 on Cost Audit Documentation;

3. Cost Auditing Standard-103 on Overall objectives of the independent cost auditor; and

4. Cost Auditing Standard-104 on Knowledge of business, its processes and the business

Cost Auditing Standard on Planning an Audit of Cost Statements - 101

The following is the **Cost Auditing Standard (Cost Auditing Standard- 101)** on "**Planning an Audit of Cost Statements**". In this Standard, the standard portions have been set in ***bold italic*** type. This Standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

Planning an audit of cost statements, records and other related documents is considered necessary to ensure achievement of audit objectives with available resources and securing coordination with the auditee on audit work.

2. Objective

The objective of this Standard is to guide the members in planning for the audit of cost statements so that it is performed in an efficient and effective manner. Audit planning shall also include establishing the overall audit strategy and audit plan for the conduct of the audit.

3. Scope

This Standard deals with the auditors' responsibility to plan an audit of cost statements, records and other related documents. The auditor shall prepare and document the overall audit strategy and audit plan.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 ***Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.***

4.2 ***Audit Partner: Audit partner means the partner in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the audit and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.***

4.3 ***Audit Plan: A record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.***

4.4 ***Audit Risk: Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.***

(a) ***The risk of material misstatement has two components viz. Inherent Risk and Control risk.***

(1) ***Inherent risk: the susceptibility of an assertion about the measurement, assignment or disclosure of cost to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.***

(2) ***Control risk: the risk that a misstatement that could occur in an assertion about the measurement, assignment or disclosure of cost and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal, operational and management control.***

(b) ***Detection risk: the risk that the procedures followed by the cost auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.***

4.5 ***Audit Team:* Audit team means all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.**

4.6 ***Auditee:* Auditee means a company or any other entity for which cost audit is being carried out.**

4.7 ***Cost Audit:* Cost audit is an independent examination of cost statements, cost records and other related information of an entity including a non-profit entity, when such an examination is conducted with a view to expressing an opinion thereon.**

4.8 ***Cost Auditor:* "Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under subsection (1) of section 6 and who is deemed to be in practice under subsection (2) of section 2 of that Act and includes a firm of cost accountants.**

4.9 ***Firm:* Firm means a sole practitioner, partnership including LLP (Limited Liability Partnership) or any other entity of professional cost accountants as may be permitted by law and constituted under The Cost and Works Accountants Act & Regulations.**

4.10 ***Initial Audit:* Initial audit means an audit where:-**

(a) ***The entity is subject to audit for the first time, as per the applicable laws, or***

(b) ***The audit of the entity for the prior period was conducted by a different audit firm.***

4.11 ***Misstatement:* A difference between the amounts, classification, presentation or disclosure of a reported cost statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable cost reporting framework. Misstatements can arise from error or fraud.**

Where the cost auditor expresses an opinion on whether the cost statements give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the cost auditor's judgment, are necessary for the cost statements to be presented fairly, in all material respects, or to give a true and fair view.

4.12 ***Overall Audit Strategy:* Overall Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.**

4.13 ***Risk Assessment:* The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the overall cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof.**

5. Requirements

5.1 Prior to entering the planning phase, the Cost Auditor shall ensure that:

(a) the appointment as cost auditor is proper, he has received the letter of appointment and legal formalities regarding his appointment have been complied with;

(b) the ethical requirements as per the regulations continue to be satisfied; (Refer 6.3)

(c) an understanding of the terms of reference including the units to be covered, products/ services to be covered, scope of coverage where the regulations leave it to be agreed between the auditor and the auditee.

5.2 The audit partner and other key members of an audit team shall be involved in planning the audit, including planning and participating in the discussion among audit team members. (Refer 6.4)

5.3 ***The Cost Auditor shall formulate an Overall audit strategy that sets the scope, timing and direction of the audit.***

The overall audit strategy guides the development of the audit plan.

5.4 ***In formulating the Overall audit strategy, the Cost Auditor shall consider all relevant factors. (Refer 6.5)***

These relevant factors include:

(a) results of preliminary activities as specified in 5.1 above

(b) knowledge from previous audits and other engagements with the auditee

(c) knowledge of business

(d) nature and scope of the audit

(e) statutory deadlines and reporting format

(f) relevant factors determining the direction of the audit efforts

(g) nature, timing and extent of resources required for the audit.

5.5 ***The Cost Auditor shall develop an audit plan.***

The audit plan will include the nature, extent and timing of risk assessment, audit procedures and other activities (Refer 6.5, 6.6)

5.6 ***The Cost Auditor shall plan the nature, extent and timing of the direction and supervision of audit team members and the review of their work.(Refer 6.7)***

5.7 ***The Cost Auditor shall update the Overall audit strategy and the audit plan as required during the course of audit. (Refer 6.8)***

5.8 ***The Cost Auditor shall document the overall audit strategy, the audit plan and any significant changes made therein during the audit engagements and the reasons for the changes.***

5.9 ***In the initial audit, the Cost Auditor shall perform procedures regarding the acceptance of the client relationship and the specific audit.***

In case where the audit of the entity for the prior period was conducted by a different audit firm, the auditor shall communicate with the previous auditor. (Refer 6.9)

6. Application Guidance

6.1 The nature and extent of planning activities will vary according to the:

(a) size and complexity of the entity's activities, the number of products to be covered, the processes and operations involved.

(a) the audit team members' previous experience with the entity and the industry.

(b) changes in circumstances that occur during the audit.

6.2 Planning is not a discrete phase of an audit, but rather a continuous and iterative process. Planning includes scheduling which involves determining the priority of audit procedures and their inter dependence. For example, the risk assessment procedures are planned early in the audit process.

6.3 Prior to the performance of other significant activities for the current year's audit, the auditor shall ensure that {Refer 5.1 (b)} :

(a) After the Cost Auditor has accepted the appointment for an entity, there are no changes in his position in relation to the entity that impede his arm's length relationship with the entity. Such as, acceptance of an assignment relating to designing and implementation of cost accounting system for the entity.

(b) Subsequent to his acceptance of the assignment, no issues about management integrity has cropped up that may affect the auditor's willingness to continue the engagement.

6.4 The involvement of the audit partner and other key members of the audit team in planning the audit draws on their experience and insights, thereby enhancing the effectiveness and efficiency of the planning process.(Refer 5.2)

6.5 Matters that are relevant in formulating the overall audit strategy and drawing up the audit plan include, in addition to those mentioned earlier, the following (Refer 5.4, 5.5):

(a) The cost reporting framework generally prescribed, under the Companies Act and Rules prescribed thereunder, as well as under any other law as applicable, on the basis of which the cost information to be audited has been prepared, including need for reconciliation with financial reporting framework.

(b) Industry regulators' requirement as to how costs will be handled.

(c) Unique features of an industry that influence audit requirements such as definition of product in the newspaper industry.

(d) Reliance that can be placed on the work of financial auditors, other cost auditors appointed by the entity and internal auditors. such as their attendance in annual stocktaking

(e) State of IT (Information Technology) implementation, whether the entity is using an ERP (Enterprise Resource Planning) system or internally developed systems and the reliance that can be placed on them.

(f) Statutory timelines for cost reporting, which can be modified by the management for early completion.

(g) Timelines for Board/ audit committee meetings, which can set the time limits for completion of audit work.

(h) Resources required and available in terms of manpower, equipment and others and the assignment of these to specific parts of the work.

6.6 The audit plan is more detailed than the overall audit strategy as it includes the nature, timing and extent of audit procedures to be performed by audit team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. (Refer 5.5)

6.7 The nature, extent and timing of the direction and supervision of audit team members and review of their work vary depending on, among others, the size and complexity of the entities activities, risk assessment results and the capabilities and competence of the individual team members performing the audit work. (Refer 5.6)

6.8 As a result of unexpected events, changes in conditions or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan. (Refer 5.7)

6.9 Additional Consideration in Initial Audit Engagements (Refer 5.9): The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For the initial audit, additional matters the auditor may consider in formulating the overall audit strategy and audit plan include the following.

(a) The planning activities may expand to cover consultations with the previous auditor, review of previous year's audit working papers, if not prohibited by other Law or regulation, and previous year's transactions having an impact on current year's cost.

(b) Any major issues (including the application of cost accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as cost auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.

(c) The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (such as Inventory).

(d) Other procedures required by the firm's system of quality control for initial cost audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

6.10 In audits of small entities where the entire audit may be conducted by a small audit team comprising the audit partner working with say one team member, formulating the audit strategy and drawing up the audit plan need not be elaborate. Nonetheless it is necessary to have regard to the matters mentioned under Requirements.

7. Effective Date

This Standard is effective for audits on or after September 11, 2015.

Cost Auditing Standard on Cost Audit Documentation – 102

The following is the **Cost Auditing Standard (Cost Auditing Standard- 102)** on "**Cost Audit Documentation**". In this Standard, the standard portions have been set in ***bold italic*** type. This Standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

The purpose of this Standard is to provide guidance to the members in preparation of Audit Documentation in the context of the audit of cost statements, records and other related documents.

Nature and Purpose of Cost Audit Documentation

Cost Audit documentation that meets the requirement of this Cost Auditing Standard and the specific documentation requirements of other relevant Cost Auditing Standards provides:

(a) Evidence of the cost auditor's basis for a conclusion about the achievement of the overall objectives of the cost auditor; and

(b) Evidence that the cost audit was planned and performed in accordance with Cost Auditing Standards and applicable legal and regulatory requirements.

Cost Audit documentation serves a number of additional purposes, including the following:

(a) Assisting the audit team to plan and perform the cost audit.

(b) Assisting members of the audit team responsible for supervision to direct and supervise the cost audit work, and to discharge their review responsibilities.

(c) Enabling the audit team to be accountable for its work.

(d) Retaining a record of matters of continuing significance to future cost audits.

(e) Enabling the conduct of quality control reviews in accordance with the Guidance Manual for Audit Quality issued by Quality Review Board (QRB).

(f) Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

2. Objective

The objective of this Standard is to guide the members to prepare documentation that provides:

(a) A sufficient and appropriate record of the basis for the Cost Auditor's Report; and

(b) Evidence that the audit was planned and performed in accordance with Cost Auditing Standards and applicable legal & regulatory requirements.

3. Scope

This Standard deals with the cost auditor's responsibility to prepare audit documentation for the audit of cost statements, records and other related documents. The specific documentation requirements of other Cost Auditing Standard's do not limit the application of this Cost Auditing Standard. Laws or regulations may establish additional documentation requirements.

4. Definitions

The following terms are being used in this Standard with the meaning specified.

4.1 Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

4.2 Audit documentation: Audit Documentation means the records, in physical or electronic form, including working papers prepared by and for, or obtained and retained by the Cost auditor, in connection with the performance of the audit.

4.3 Audit file: Audit file means one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific Assignment or audit.

4.4 Audit Partner: Audit partner means the partner in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the audit and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

4.5 Audit Team: Audit team means all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

4.6 Audit working papers: Audit working papers are the documents which record all audit evidence obtained during audit. Such documents are used to support the audit work done in order to provide assurance that the audit was performed in accordance with the relevant Cost Auditing Standards.

4.7 Cost Auditor: "Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under subsection (1) of section 6 and who is deemed to be in practice under subsection (2) of section 2 of that Act and includes a firm of cost accountants.

4.8 Firm: Firm means a sole practitioner, partnership including LLP (Limited Liability Partnership or any other entity of professional cost accountants as may be permitted by law and constituted under The Cost and Works Accountants Act & Regulations.

5. Requirements

5.1 The cost auditor as part of the audit documentation shall record audit procedures performed, relevant audit evidence obtained, and conclusions reached. (Refer 6.1)

5.2 The Cost Auditor shall prepare audit documentation that is sufficient to enable another competent person, having no previous connection with the said audit, including person undertaking peer review to understand:

(a) Conformance of audit procedures performed with legal and regulatory requirements;

(b) Conformance to Cost Auditing Standards. (Refer 6.6)

(c) The results of audit procedures performed

(d) The audit evidence obtained

(e) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.(Refer 6.7 & 6.8)

5.3 The Cost Auditor shall record the discussions of significant matters with client personnel and outsiders. (Refer 6.9).

5.4 The Cost Auditor shall record any departure from the standard requirement in a Cost Auditing Standard. (Refer 6.11)

5.5 In documenting the nature, timing and extent of audit procedures performed, the Cost Auditor shall record the characteristics of the specific items or matters tested, the persons responsible for performing and reviewing such procedures with relevant dates and extent of review. (Refer 6.12)

5.6 The Cost Auditor shall prepare audit documentation on a timely basis. (Refer 6.14)

5.7 If, in exceptional circumstances, Cost Auditor performs any new or additional audit procedures or draws new conclusions, after the date of Cost Audit Report, then he shall document such circumstances and details of such procedures performed. (Refer 6.15)

5.8 The cost auditor shall assemble the audit documentation in an audit file. (Refer 6.16)

6. Application Guidance

6.1. The Cost Audit documentation will usually contain:

(a) *Checklists*

Example: Checklist of compliance with:-(1) The Rules, regarding maintenance of Cost Records, as prescribed under the Companies Act,

(2) The Cost Accounting Standards (CAS) as prescribed by the Institute

(3) The Generally Accepted Cost Accounting Principles (GACAP) as prescribed by the Institute

(b) *Audit programs*

Example: Audit Program for Material Cost, Employee Cost and others

(c) *Analysis*

Cost Audit relies more on analytical review than on substantive testing to establish true and fair view.

Example: Calorific value of different fuels used and average Cost per unit of calorific value and Specific Heat Consumption.

(d) *Audit Query List*

Contains a log of audit queries raised and their resolution

(e) *Abstracts of significant contracts relating to costs and revenues*

Example: Supply of materials indicating price, quality terms, O & M contracts, Terms of supply of contract labour and others

(f) *Letters of confirmation*

Example: Stock of materials with subcontractors.

(g) *Letter of Representation from Management Correspondence (including e-mail) concerning significant matters.*

Example: Correspondence regarding terms of supply of goods and services.

(h) *Abstract or copies of the entity's records*

6.2. Audit documentation may be in paper form or electronic form. Where it is in electronic form, special care may be required to protect against accidental deletion, or tampering.

6.3. The content and form of audit documentation will depend on a number of factors such as:

(a) the size and complexity of the operations of the auditee,

(b) the extent of computerization of cost records,

(c) the assessed risks of material misstatement of cost,

(d) the cost audit methodology and tools used. For example whether automated queries were used to get audit evidence from cost records.

(e) the nature of the audit procedure to be performed.

6.4. In particular, it is necessary to document the basis for a conclusion, not readily determinable from other documentation. For example: consumption of materials by a product from technical norms, normal price for a related party contract from Cost Auditor's own sources of data of the industry.

6.5. Audit documentation must be sufficient and appropriate, and oral explanations by the Cost Auditor cannot substitute for such documentation.

6.6. Audit documentation must contain evidence of conformance to requirements of Cost Auditing Standards in respect of this Standard and other standards {Refer 5.2(b)}:

Typical of such evidence are:

(a) an adequately documented audit plan

(b) the signed appointment letter from the auditee

(c) Minutes of discussion with client personnel, with names of members of audit team present, particularly of the audit partner when he is present

(d) Minutes of audit team discussions, with names of members of audit team present, particularly of the audit partner when he is present.

6.7. Matters that give rise to significant risks of a material misstatement are significant matters. Those that causes a revision of the Cost Auditor's previous assessment of the risks of material misstatement is also a significant matter. The Cost Auditor may have reached a certain conclusion regarding the misstatement of the Material Cost in a Cost statement based on the availability of a well documented Bill of Materials but his assessment of risk may undergo a change if he finds that there is considerable use of substitute and alternate materials in the actual production process. Matters that cause the Cost Auditor significant difficulty in applying necessary audit procedures are also significant, as for example heaps of bulk material in irregular shapes which make volumetric measurement of stock in a physical stock taking unreliable. {Refer 5.2(e)}

6.8. Determining what are significant matters in an audit to warrant their inclusion in the documentation must be objectively done. The conclusions reached and the application of professional judgment in respect of these also needs to be documented. For example the determination of the normal capacity for applying overheads is a significant matter in Cost Audit and requires not mere calculations but considerable judgment. These should be adequately documented. {Refer 5.2(e)}

6.9. Records of discussions include Minutes of discussion of significant matters with management, those charged with governance and others. It also includes Discussion with third parties seeking information or confirmation. (Refer 5.3)

6.10. The Cost Audit Documentation in respect of smaller entities may be less detailed than what is indicated but must include at the minimum the following:

(a) A description of the entity, the products produced, services provided and other activities

(b) An organization Chart showing the responsibility centres and the person responsible

(c) A description, preferably a flow chart of the manufacturing process

(d) Internal controls over material cost, labour cost and expenses

(e) The risks of material misstatement assessed, for example, in respect of scrap recovery and disposal

(f) Tests of materiality used

(g) The overall audit strategy and audit plan

(h) Significant matters noted during the audit, and conclusions reached

6.11. If, in exceptional circumstances, the Cost Auditor finds it necessary to perform alternative audit procedures different from a corresponding requirement in a Cost Auditing Standards, the Cost Auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. (Refer 5.4)

6.12. It is necessary in a Cost Audit to identify the specific matters or items tested. In connection with a Cost Audit these may include Purchase Orders for supply of key raw materials, Goods Receipt Notes for materials, Issue notes for materials, bills of contractors for supply of contract labour among others. Where the Cost Auditor resorts to test checking, the basis used for selection, for example issues of spares above a certain value, and the documents selected. (Refer 5.5)

6.13. Names of the team member preparing specific audit documents and details of their review by the Cost Auditor are a necessary part of the Audit Documentation.

6.14. Preparing the audit Documentation on timely basis helps to enhance the quality of audit. Documentation prepared after the audit work has been performed is likely to be less accurate than the documentation prepared during execution. (Refer 5.6)

6.15. Facts which become known to the Cost Auditor after the date of the audit report but which if known earlier would have caused the cost statements to be changed or the Cost Audit Report to be modified should be added to the Cost Audit Documentation. The resulting changes to the audit documentation must also be reviewed as the original documentation. (Refer 5.8)

6.16. The Cost Audit Documentation must be assembled as the audit goes on and the final assembly required of audited documentation must be limited. Assembly the final audit file should be completed within a reasonable time after the completion of the audit. After the assembly of the final audit file has completed, the auditor should not delete or discard audit documentation of any nature before the end of its retention period. (Refer 5.9)

6.17. The audit documentation is the property of the Cost Auditor. Unless otherwise specified by law or regulation, he may at his discretion, make portions of, or extracts from audit documentation available to clients

6.18. The Cost Audit Documentation should be retained for at least ten years from the date of the Cost Audit Report.

7. Effective Date

This Standard is effective for audits on or after September 11, 2015.

Cost Auditing Standard Overall Objectives of the Independent Cost Auditor and the Conduct of an Audit in Accordance with Cost Auditing Standards - 103

The following is the **Cost Auditing Standard** (Cost Auditing Standard - 103) on **"Overall Objectives of the Independent Cost Auditor and the Conduct of an Audit in Accordance with Cost Auditing Standards".** In this Standard, the standard portions have been set in ***bold italic*** type. This Standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

This Standard on Auditing deals with the overall objectives of the independent cost auditor, the nature and scope of a Cost audit the independent auditor's overall responsibilities when conducting an audit of cost statements in accordance with Cost Auditing Standards. It also explains the requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the Cost Auditing Standards.

The independent Cost Auditor is referred to as "Cost auditor" hereafter.

2. Objectives

The objective of this Standard is to lay down the overall objectives of the Cost Auditor and ensuring **the Conduct of** ***the Audit of Cost Statements in accordance with the Cost Auditing Standards.***

The Cost auditor's overall objectives are:

2.1. to obtain reasonable assurance about whether the cost statements as a whole are free from material misstatement, whether due to fraud or error, and to enable the auditor to express an opinion whether the Cost Statements are prepared, in all material respects, in accordance with the applicable Cost reporting framework, Cost Accounting Standards(CAS) and Generally Accepted Cost Accounting Principles (GACAP) as issued by the Institute, and give a true and fair view of the Cost of a product, activity or service. In the case of a Cost Audit under the Companies Act and Rules prescribed thereunder, the objective is to express an opinion on whether the Cost Statements subject to audit represent a true and fair view of the cost of production, cost of sales and margin of products covered by the Cost Audit.

2.2. to report on the cost statements in the form required by law or by the Cost Auditing Standards in accordance with the auditor's findings.

Where reasonable assurance cannot be obtained, the cost auditor should qualify the opinion and in extreme cases disclaim an opinion.

The Cost Auditors objective may extend to making observations and suggestions where required by applicable regulations.

3. Scope

The scope of this standard is to establish overall objectives of the cost auditor while conducting an audit of cost statements, in accordance with the cost auditing standards.

It also describes management responsibility for the preparation and presentation of the Cost Statement, to identify the Cost Reporting framework and to lay down Cost Accounting policies.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1. Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

4.2. Audit Partner: Audit partner means the partner in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the audit and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

4.3. Audit Risk: Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.

(a) The risk of material misstatement has two components viz. Inherent Risk and Control risk.

(1) Inherent risk: the susceptibility of an assertion about the measurement, assignment or disclosure of cost to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(2) Control risk: the risk that a misstatement that could occur in an assertion about the measurement, assignment or disclosure of cost and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal, operational and management control.

(b) Detection risk: the risk that the procedures followed by the cost auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

4.4. Audit Team: Audit team means all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

4.5. Auditee: Auditee means a company or any other entity for which cost audit is being carried out.

4.6. Auditor: Auditor is used to refer to the person or persons conducting the audit, usually the audit partner or other members of the audit team, or, as applicable the firm. Auditor includes Cost Auditor

4.7. Cost Audit: Cost audit is an independent examination of cost statements, cost records and other related information of an entity including a non-profit entity, when such an examination is conducted with a view to expressing an opinion thereon.

4.8. Cost Auditor: "Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under subsection (1) of section 6 and who is deemed to be in practice under subsection (2) of section 2 of that Act and includes a firm of cost accountants.

4.9. Firm: Firm means a sole practitioner, partnership including LLP (Limited Liability Partnership) or any other entity of professional cost accountants as may be permitted by law and constituted under The Cost and Works Accountants Act & Regulations.

4.10. Management: The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance.

4.11. Misstatement: A difference between the amounts, classification, presentation or disclosure of a reported cost statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable cost reporting framework. Misstatements can arise from error or fraud.

Where the cost auditor expresses an opinion on whether the cost statements give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the cost auditor's judgment, are necessary for the cost statements to be presented fairly, in all material respects, or to give a true and fair view.

4.12. Non-compliance: Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations governing Cost Accounting, Cost Records and Cost Audit. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

4.13. ***Overall Audit Strategy: Overall Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.***

4.14. Professional Judgment: The application of relevant training, knowledge and experience, within the context provided by cost auditing standards, cost accounting standards and ethical requirements, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

4.15. Professional Skepticism: An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatements due to error or fraud, and a critical assessment of audit evidence.

4.16. ***Risk Assessment: The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the overall cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof.***

4.17. Those charged with governance: The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

5. Requirements

5.1. The cost auditor shall comply with the relevant ethical requirements including those pertaining to independence in respect of cost audit engagements. (refer 6.1)

5.2. While conducting an audit, the cost auditor shall comply with each of the Cost Auditing Standards relevant to the audit. A Cost Auditing Standard is relevant to the audit when the Cost Auditing Standard is in effect and the circumstances addressed by the Cost Auditing Standard exist. (refer 6.2)

5.3. The cost auditor shall have an understanding of the entire text of the Cost Auditing Standard, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

5.4. The cost auditor shall not represent compliance with the cost auditing standards in the cost auditor's report unless the auditor has complied fully with all of the Cost Auditing Standards relevant to the audit.

5.5. In exceptional circumstances, the cost auditor may judge it necessary to depart from a relevant requirement in a Cost Auditing Standard. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement.{Refer 6.2(c)}

5.6. The cost auditor shall plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the Cost Statements to be materially misstated. (refer 6.3)

5.7. The auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.(refer 6.4)

5.8. The cost auditor shall exercise professional judgment in planning and performing the audit.

5.9. The cost auditor shall determine whether the Cost Reporting Framework followed by management in preparing cost statements is in line with the Companies Act and the Rules prescribed thereunder. (refer 6.5)

5.10. The cost auditor shall not be required to perform audit procedures regarding the entity's compliance with laws and regulations governing cost audit in the absence of identified or suspected non-compliance. (refer 6.6)

5.11. If an objective in a relevant Cost Auditing Standard cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the Cost Auditing Standards, to modify the auditor's opinion.

6. Application Guidance:

6.1 Audit and Ethics: The cost auditor should comply with relevant ethical requirements as per Code of Ethics issued by the Institute of Cost Accountants of India. This code establishes fundamental principles of professional ethics relevant to the auditor while conducting an audit and provides a conceptual framework for applying these principles. The fundamental principles with which the auditor is required to comply are Independence, Integrity, Objectivity, Professional competence and due care, Confidentiality and Professional conduct. In case of an audit engagement, it is in the public interest that the auditor should be independent of the entity subject to the audit. The cost auditor's independence from the entity safeguards the cost auditor's ability to form an opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity to be objective and to maintain an attitude of professional skepticism. (Refer 5.1)

For Example: The provision of services for maintenance of cost records, design and implementation of Cost Systems and internal audit are considered to erode the independence.

6.2 Conduct of audit: (Refer 5.2)

(a) The Cost Auditing Standards provide the standards for the cost auditor's work in fulfilling the overall objectives of the cost auditor. The Cost Auditing Standards deal with general responsibilities of the cost auditor, as well as cost auditor's further considerations relevant to the application of those responsibilities to specific topics.

(b) In performing an audit, the cost auditor may be required to comply with legal or regulatory requirements in addition to Cost Auditing Standards. In such cases in addition to complying with each of the Cost Auditing Standard relevant to the cost audit, it may be necessary for the cost auditor to perform additional audit procedures in order to comply with the legislative and regulatory requirements. The Cost Auditing Standards do not override law or regulations that govern audit process.

The form of the cost auditor's opinion will depend upon the applicable cost reporting framework and any applicable laws or regulations such as Companies Act and Rules prescribed thereunder.

(c) The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Refer 5.5)

6.3 Professional skepticism: An attitude of professional skepticism means the cost auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and be alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. An attitude of professional skepticism is necessary throughout the cost audit process for the auditor to reduce the risk of overlooking unusual circumstances, of over generalizing when drawing conclusions from cost audit observations, and of using faulty assumptions in determining the nature, timing and extent of the cost audit procedures and evaluating the results thereof. When making inquiries and performing other cost audit procedures, the cost auditor should not be satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the cost auditor's opinion. (Refer 5.6)

(a) A cost auditor conducting an audit in accordance with Cost Auditing Standards obtains reasonable assurance that the Cost Statements taken as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the Cost Statements taken as a whole. Reasonable assurance relates to the whole audit process.

A cost auditor cannot obtain absolute assurance because there are inherent limitations in an audit that affect the cost auditor's ability to detect material misstatements. These limitations result from factors such as the following:

(1) The use of sample testing.

(2) The inherent limitations of internal control (for example, the possibility of management override or collusion).

(3) The fact that most audit evidence is persuasive rather than conclusive.

Also, the work undertaken by the cost auditor to form an audit opinion is permeated by judgment, in particular regarding:

(1) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and

(2) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the Cost Statements.

(b) Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions. (For example, transactions between related parties). In these cases certain Cost Auditing Standard identify specified audit procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:

(1) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or

(2) Any indication that a material misstatement has occurred.

Accordingly, because of the factors described above, an audit is not a guarantee that the Cost Statements are free from material misstatement, because absolute assurance is not attainable. Further, an audit opinion does not assure the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

6.4 Audit Risk and Materiality: Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and industry, the regulatory environment in which they operate, and their size and complexity, they face a variety of business risks. Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the Cost Statements. The auditor is ultimately concerned only with risks that may affect the cost statements. (Refer 5.7)

(a) The cost auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the Cost Statements give a true and fair view or in accordance with the applicable cost reporting framework. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is inappropriate. The risk that the cost auditor expresses an inappropriate audit opinion when the Cost Statements are materially misstated is known as "audit risk."The cost auditor reduces audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

(b) Audit risk is a function of the risk of material misstatement in the cost statements (or simply, the "risk of material misstatement") (i.e., the risk that the Cost Statements are materially misstated prior to audit) and the risk that the auditor will not detect such misstatement ("detection risk"). The cost auditor performs audit procedures to assess the risk of material misstatement and seeks to limit detection risk by performing further audit procedures based on that assessment. The audit process involves the exercise of professional judgment in designing the audit approach, through focusing on what can go wrong (i.e., what are the potential misstatements that may arise) at the assertion level and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence.

(c) The cost auditor is concerned with material misstatements, and is not responsible for the detection of misstatements that are not material to the Cost Statements taken as a whole. The cost auditor considers whether the effect of identified uncorrected misstatements, both individually and in the aggregate, is material to the Cost Statements taken as a whole. Materiality and audit risk are related.

In order to design audit procedures to determine whether there are misstatements that are material to the cost statements taken as a whole, the cost auditor considers the risk of material misstatement at two levels:

(1) the overall cost statement level and

(2) In relation to cost heads, items of cost and disclosures and the related assertions.

(d) The cost auditor considers the risk of material misstatement at the overall cost statement level, which refers to risks of material misstatement that relate pervasively to the Cost Statements as a whole and potentially affect many assertions. Risks of this nature often relate to the entity's control environment (although these risks may also relate to other factors, such as declining economic conditions), and are not necessarily risks identifiable with specific assertions at the cost heads, items of cost or disclosure level. Rather, this overall risk represents circumstances that increase the risk that there could be material misstatements in any number of different assertions, for example, through management override of internal control. Such risks may be especially relevant to the cost auditor's consideration of the risk of material misstatement arising from fraud. The auditor's response to the assessed risk of material misstatement at the overall cost statement level includes consideration of the knowledge, skill, and ability of personnel assigned significant engagement responsibilities, including whether to involve experts; the appropriate levels of supervision;

(e) The cost auditor also considers the risk of material misstatement at the cost heads, items of cost and disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level. The cost auditor seeks to obtain sufficient appropriate audit evidence at the cost heads, items of cost, and disclosure level in such a way that enables the auditor, at the completion of the audit, to express opinion on the Cost Statements taken as a whole at an acceptably low level of cost audit risk. Auditors use various approaches to accomplish that objective. The discussion in the following paragraphs provides an explanation of the components of audit risk.

(f) The risk of material misstatement at the assertion level consists of two components as follows:

(1) "Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related cost heads, items of cost and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cost heads consisting of amounts derived from cost estimates that are subject to significant measurement uncertainty pose greater risks than do cost heads consisting of relatively routine, factual data.

External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a cause changes to a manufacturing process rendering the existing classification of variable and fixed costs inappropriate and cause product contribution to be misstated. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of cost heads, items of cost, or disclosures may influence the inherent risk related to a specific assertion. These latter factors include, for example, external market constraints may cause normal capacity as an unreliable basis for determining unit costs.

(2) "Control risk" is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's Cost Statements. Some control risk will always exist because of the inherent limitations of internal control.

Inherent risk and control risk are the entity's risks; they exist independently of the audit of the Cost Statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. When the auditor's assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the auditor performs tests of controls to support the risk assessment. The Cost Auditing Standard do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risk of material misstatement." Although the Cost Auditing Standard ordinarily describe a combined assessment of the risk of material misstatement, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

(g) "Detection risk" is the risk that the cost auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor usually does not examine all of cost heads, items of cost, or disclosure and because of other factors. Such other factors include the possibility that a cost auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed through adequate planning, proper assignment of personnel to the audit team, the application of professional skepticism, and supervision and review of the audit work performed.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level.

For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.

6.5 Responsibility for the Cost Statements: The cost auditor is responsible for forming and expressing an opinion on the Cost Statements. (Refer 5.9)

The term "Cost Statements" refers to a structured representation of the cost information, which ordinarily includes accompanying notes, derived from cost accounting records and intended to communicate an entity's use of economic resources and the output obtained in accordance with a Cost reporting framework. The term can refer to for example, a cost statement, reconciliation with financial accounts and related explanatory notes.

(a) The requirements of the Cost reporting framework determine the form and content of the Cost Statements and what constitutes a complete set of Cost Statements. For certain Cost reporting frameworks, a single cost statement as such and the related explanatory notes constitute a complete set of Cost Statements. For example: a Cost Statement under Cost Accounting Standard 4.

(b) The Cost auditor is not responsible for preparing and presenting the cost statements in accordance with the applicable Cost reporting framework including inter-alia:

(1) Designing, implementing and maintaining internal control relevant to the preparation and presentation of Cost Statements that are free from material misstatement, whether due to fraud or error;

(2) Selecting and applying appropriate Cost accounting policies; and

(3) Making cost estimates that are reasonable in the circumstances.

6.6 Non-compliance: The cost auditor shall request management to provide written representation that all known instances of non-compliance or suspected non - compliance with laws and regulations governing Cost Accounting, Cost Records and Cost Audit have been disclosed to the cost auditor. The representations provide necessary audit evidence about management knowledge of identified or suspected non-compliance with laws and regulations whose effects may have a material effect on the cost statement however, written representation do not provide sufficient audit evidence on their own, and accordingly do not affect the nature and extent of other audit evidence that is to be obtained by the cost auditor. (Refer 5.10)

7. Effective Date

This Standard is effective for audits on or after September 11, 2015.

Cost Auditing Standard on Knowledge of Business, its Processes and the Business Environment - 104

The following is the ***Cost Auditing Standard*** **(Cost Auditing Standard - 104)** on "**Knowledge of Business, its Processes and the Business Environment**". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

In performing an audit of cost statement, records and other related documents, the cost auditor should have the knowledge of the client's business to enable him to understand the processes and express his opinion on the cost statements.

The cost auditor's level of knowledge for a cost audit engagement should include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates.

2. Objective

The objective of this standard is to enable the cost auditor to have knowledge of the client's business which is sufficient to identify and understand the events, transactions and practices that, in the cost auditor's judgment may have a significant effect on the examination of cost statements or on the preparation of the cost audit report.

3. Scope

This standard deals with obtaining the knowledge of the client's business, its processes and business environment as it is important for the cost auditor and members of the audit team working on an audit engagement.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

4.2 Audit Plan: A record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risk.

4.3 Audit Risk: Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.

(a) The risk of material misstatement has two components viz. Inherent Risk and Control risk.

(1) Inherent risk: the susceptibility of an assertion about the measurement, assignment or disclosure of cost to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(2) Control risk: the risk that a misstatement that could occur in an assertion about the measurement, assignment or disclosure of cost and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal, operational and management control.

(b) Detection risk: the risk that the procedures followed by the cost auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

4.4 Auditee: Auditee means a company or any other entity for which cost audit is being carried out.

4.5 Cost Auditor: "Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under subsection (1) of section 6 and who is deemed to be in practice under subsection (2) of section 2 of that Act and includes a firm of cost accountants.

4.6 Overall Audit Strategy: Overall Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

4.7 Risk Assessment : The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the overall cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof.

5. Requirements

5.1 The Cost Auditor shall have adequate level of understanding of the knowledge of Business, its Processes and the Business Environment to develop a reasonable assurance in order to express an opinion on the cost statements on which he is expressing an opinion.(refer 6.1)

5.2 The Entity and Its Environment: The cost auditor should obtain an understanding of the following:

(a) The nature of the entity, (including its operations covering Business processes, major inputs, Joint & By-Products and Wastages and major outputs etc) and the entity's ownership and governance structure.

(b) Relevant industry, regulatory, and other external factors including the applicable cost and financial reporting framework.(refer 6.2)

(c) The entity's selection and application of cost accounting policies.(refer 6.3)

(d) The measurement and review of the entity's performance. (refer 6.4)

5.3 The Entity's Internal Control: The cost auditor shall obtain an understanding of internal controls relevant to the audit. (refer 6.5)

(a) Control Environment: The cost auditor shall evaluate whether management has created and maintained a culture of honesty and ethical behaviour.

(b) The entity's risk assessment process: The cost auditor shall obtain an understanding of whether the entity has a process for: (refer 6.6, 6.7, 6.8)

(1) Identifying business risks relevant to cost reporting objectives;

(2) Assessing the likelihood of their occurrence;

(3) Estimating the significance of the risks; and

(4) Deciding about actions to address those risks.

(c) Cost Information System/ Management Information System: The cost auditor shall obtain an understanding of the Information System including Management Information System, relevant to cost reporting, including the following areas: (refer 6.9)

(1) The classes of transactions and their analysis, that are significant to the cost statements;

(2) The procedures, by which those transactions and their analysis are initiated, recorded, processed, and reported in the management information systems and cost statements;

(3) The related cost accounting records, supporting information that are used to initiate, record, process and report transactions; and

(4) The reporting process used to prepare the entity's cost statements, including significant estimates and disclosures.

(d) Control Activities: The auditor shall obtain an understanding of the control activities, relevant to the audit.(refer 6.10)

(e) Monitoring of controls:

(1) The auditor shall obtain an understanding of the major activities, that the entity uses to monitor internal control over reporting.(refer 6.11)

(2) The cost auditor shall evaluate the adequacy of the internal audit function in relation to cost records. (refer 6.12)

5.4 IT (Information Technology) Environment and Control: The cost auditor shall evaluate and assess: (refer 6.13)

(1) IT Architecture, Systems and programmes in use in the entity;

(2) Controls on access to data;

(3) Controls on changes to data in master files, systems or programmes; an

(4) Integrity of information and security of the data

5.5 Identifying and Assessing the Risks of Material Misstatement: The cost auditor shall identify and assess the risks of material misstatement at the cost statement level; and at the assertion level including items of cost, cost heads and disclosures thereof.

For this purpose, the cost auditor shall: (refer 6.14, 6.15, 6.16)

(1) Identify risks including relevant controls that relate to the risk of material misstatements or a risk of fraud;

(2) Assess whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;

(3) Assess whether the risk involves significant transactions with related parties;

(4) Assess the degree of subjectivity in the measurement of information related to the risk.

(5) Assess whether there arises a need for revising the assessment of risk based on additional audit evidence obtained.

5.6 Documentation: The auditor shall document:

(a) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 5.1 & 5.2 above and of each of the internal control components specified in paragraphs 5.3 above; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;

(b) The identified and assessed risks of material misstatement at the cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof as required by paragraph 5.5 above; and

(c) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 5.5 above.

6. Application Guidance

6.1 Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous and dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the cost auditor plans the audit and exercises professional judgment throughout the audit, for example, when: (Refer 5.2)

(a) Assessing risks of material misstatement of the cost statements;

(b) Considering the appropriateness of the selection and application of cost accounting policies, and the adequacy of cost statement disclosures;

(c) Identifying areas where special audit consideration may be necessary, for example, abnormal losses, lower yields, higher wastages, higher utilities consumption, related party transactions etc.

(d) Developing Models for use in performing analytical procedures;

(e) Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and

(f) Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

6.2 Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments etc. Examples of matters the cost auditor may consider include: {Refer 5.2(b)}

(a) The market and competition

(b) Cyclical or seasonal activity

(c) Changes in product technology

(d) Business risk (for example, high technology, high fashion, ease of entry for competition)

(e) Declining or expanding operations

(f) Adverse conditions (for example, declining demand, excess capacity, serious price competition)

(g) Key ratios and operating statistics

(h) Specific cost accounting practices and problems

(i) Specific or unique practices (for example, relating to labour contracts, financing methods, accounting methods).

(j) Energy supply sources and cost

(k) Environmental requirements and problems

6.3 An understanding of the entity's selection and application of cost accounting policies may encompass matters such as: {Refer 5.2(c)}

(a) The methods the entity uses to account for significant and unusual transactions (abnormal events).

(b) The effect of significant cost accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

(c) Changes in the entity's cost accounting policies.

(d) Cost reporting framework, and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

6.4 Management will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the cost or financial statements. Accordingly, an understanding of the entity's performance measures assists the cost auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the cost auditor may consider, include: {Refer 5.2(d)}

(a) Key performance indicators and key ratios (financial and non-financial).

(b) Key trends and operating statistics.

(c) Period-on-period financial performance analyses.

(d) Budgets, forecasts, variance analyses, segment information and divisional, departmental or other unit level performance reports.

(e) Employee performance measures and incentive compensation policies.

(f) Comparisons of an entity's performance with that of competitors.

6.5 While understanding controls that are relevant to the audit, cost auditor should evaluate the design of those controls and determine whether they have been implemented properly, by performing procedures in addition to discussions with the entity's personnel.(Refer 5.3)

6.6 If the entity has established risk assessment process, the cost auditor should obtain an understanding of it, and the results thereof. If the cost auditor identifies risks of material misstatement that management failed to identify, the cost auditor should evaluate whether there was an underlying risk of a kind that the cost auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the cost auditor should obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process. {Refer 5.3(b)}

6.7 As part of the risk assessment, the cost auditor should determine whether any of the risks identified are, in the cost auditor's judgment, a significant risk. In exercising this judgment, the cost auditor should exclude the effects of identified controls related to the risk. {Refer 5.3(b)}

6.8 An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the cost statements. However, the cost auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement. {Refer 5.3(b)}

6.9 The cost auditor should understand the related cost accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred primarily to the accounting system and subsequently to cost accounting statement. {Refer 5.3(c)}

6.10 The cost auditor should obtain an understanding of control activities relevant to cost/ management information system in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions and disclosure in the cost statements or to every assertion relevant to them. {Refer 5.3(d)}

6.11 The cost auditor should obtain an understanding of the major activities that the entity uses to monitor internal control relevant to cost reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. {Refer 5.3(e)(1)}

6.12 If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the cost auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the cost statement and assertion levels. If based on responses to the cost auditor's inquiries, it appears that there are findings that may be relevant to the entity's audit; the cost auditor may consider it appropriate to read related reports of the internal audit function. {Refer 5.3(e)(2)}

6.13 The cost auditor should assess the following with regard to IT environment and controls. (Refer 5.4)

(a) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

(b) Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.

(c) The possibility of IT personnel gaining access to privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(d) Unauthorized changes to data in master files.

(e) Unauthorized changes to systems or programs.

(f) Failure to make necessary changes to systems or programs.

(g) Inappropriate manual interventions.

(h) Potential loss of data or inability to access data as required.

6.14 Risks at the cost statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the cost statements and may require an overall response by the auditor. (Refer 5.5)

6.15 Risks of material misstatement at the cost statement level refer to risks that relate pervasively to the cost statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Cost statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud. (Refer 5.5)

6.16 The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion. (Refer 5.5)

7. Effective Date

This Standard is effective for audits on or after September 11, 2015.

Study Note - 6

GUIDANCE ON PEROFRAMANCE APPRAISAL

This Study Note includes

6.1 Preface
6.2 Performance Analysis
6.3 Suggested Mechanism for Performance Analysis
6.4 Steps Approach Suggested for Report on Performance Appraisal
6.5 Indicative Content of the Report on Performance Appraisal
6.6 Capacity Utilisation Analysis
6.7 Productivity and Efficiency Analysis
6.8 Utilities and Energy Efficiency Analysis
6.9 Key Costs and Contribution Analysis
6.10 Product/Service Profitabilty Analysis
6.11 Market/Customer Profitability
6.12 Working Capital and Inventory Management Analysis
6.13 Manpower Analysis
6.14 Impact of IFRS on the Cost Structure, Cash Flows and Profitability
6.15 Other Areas Suggested to be Covered in the Report on Performance Appraisal
6.16 Management Accounting Tools

6.1. PREFACE

6.1.1 Performance measures help managers to create capable and matured processes. Measures are a tool to help understand, manage, and improve the performance of the organization as a whole. Effective performance measures can let us:

- Monitor performance to judge how well the company is fairing,
- Know if company management is meeting its goals.
- If appropriate actions have been taken to affect performance or improve efficiency if improvements are necessary.

There is no set number or formula to determine how many performance measures an organization should have. Tracking too many performance measures at once may cause managers to lose sight of which ones contribute directly to strategic objectives. On the other hand, having too few measures may not tell a good story about your work. The Report on Performance Appraisal may be submitted to the Board of Directors of the Company, the performance measures which will be appraised should be discussed with the Company Management and then finalized for analysis and reporting thereof.

This guidance is not on strategic management in companies but using strategic management process in the context of performance analysis of companies. The guidance is a suggestive mode for performance analysis.

6.2 PERFORMANCE ANALYSIS

6.2.1 The basic objective to prepare a Report on Performance Appraisal is to provide an actionable insight into costs and profitability for the management in the strategic and operational context. It aims at discovering various drivers of costs and profitability and their impact on the selected performance variables. It would help the organisations:

- to improve profits and profitability
- to optimize resource allocation
- to optimize the product and services portfolio

6.2.2 The objective is to provide assessment of the performance of the organisation across various spectrums. It inter-alia aims at satisfying the goals of management audit. It is concerned with providing the Board with information that it “should know” to take suitable actions to improve business performance.

6.2.3 The following criteria may help the auditor to select and include the various performance measurement criteria in the Report on Performance Appraisal:

- Effect on profitability
- Effect on resource utilisation
- Effect on liquidity
- Effect on risks
- Effect on quality
- Effect on competitiveness
- Effect on responsiveness to the market etc.

6.2.4 An ideal Report on Performance Appraisal should possess the following characteristics:

- Objectivity
- Capability of being predictive value
- Comprehensiveness
- No information overload
- Coverage of strategic thrust
- Trend measures and current status
- Timeliness
- Segmented and enterprise-wide coverage

6.3 SUGGESTED MECHANISM FOR PERFORMANCE ANALYSIS

6.3.1 After analyzing the activities within each process, we given below the suggested mechanism for performance analysis as follows:

6.3.2 In the above paragraphs, we discussed how the strategies are formulated, how they are implemented through the processes and now we come to assess the actual performance. Performance measures tell managers something important about the company’s products, services, and the processes. Effective performance measures can let us:

- Monitor performance to judge how well the company is doing,
- Know if company is meeting its own set goals and if the customers are satisfied,
- Take action to affect performance or improve efficiency if improvements are necessary.

So we need to identify appropriate Performance measures so that the analyst is provided data and information necessary to make informed decisions. Performance measures provide a snapshot of current performance capabilities and track whether actual performance is getting better, staying the same, or getting worse over time. Machine hour rate is a performance measure which provides us inputs for various decisions. Capital expenditures tell about the investment of funds; we communicate the return on that investment through performance measures.

6.3.3 Keep the focus of the chosen performance measure on things that matter most, such as:

- Are we accomplishing our mission to analyze the performance?
- Are the processes achieving strategic goals and objectives?
- Are the customers satisfied?
- Are various processes being managed by the company properly?
- Are the output and outcomes observed result in the company being cost-efficient as the industry leader?

6.3.4 The auditor could summarize the plan in order to have clarity. A suggestive format of the plan is given in the List- A

6.4 STEPS APPROACH SUGGESTED FOR REPORT ON PERFORMANCE APPRAISAL

Suggested below steps involved in the preparation of the Performance Analysis:

Preliminary discussion with the Management of the company to apprise them of the scope with specific reference to the company.

6.4.1 Identify and understand the key strategies of the company, both prescriptive and emergent strategies included.

6.4.2 Choose strategies that have more visible expressions in costs data maintained by the company.

6.4.3 Identify the activities that were impacted by the strategies selected and also implemented during the year of cost audit.

6.4.4 Analyze the cost implications of those activities and link it with the expected results of the strategies.

6.4.5 Present the evaluation, in a table or any other easily comprehensible format like histogram, chart, graph etc.

6.4.6 Give explanatory notes for the terms used, calculations made, and assumption behind the evaluations.

6.4.7 Finalize the finding after a discussion with the concerned operating executives and then with the management of the company.

6.5 INDICATIVE CONTENTS OF THE REPORT ON PERFORMANCE APPRAISAL

6.5.1 The Report on Performance Appraisal may covers the following indicative areas:

(i) Capacity Utilization Analysis
(ii) Productivity/Efficiency Analysis
(iii) Utilities/Energy Efficiency Analysis
(iv) Key-Costs & Contribution Analysis
(v) Product/Service Profitability Analysis
(vi) Market/Customer Profitability Analysis

(vii) Working Capital & Inventory Management Analysis

(viii) Manpower Analysis

(ix) Impact of IFRS on the Cost Structure, Cash-Flows and Profitability

(x) Application of Management Accounting Tools

6.5.2 For these and any other performance measures elected for inclusion in the Report on Performance Appraisal, the auditor should also include wherever appropriate the following:

- Horizontal and vertical analysis of quantitative figures
- Trend analysis of performance parameters reflecting 3-10 years' figures
- Qualitative comments with interpretations of the cost auditor
- Comparison with external benchmarks such as industry average

6.6 CAPACITY UTILISATION ANALYSIS

6.6.1 The basic quantitative information on capacity is covered in the Annexure 1 of Part B and C of CRA 3 – Quantitative Information. However, this information is only indicative and does not provide analytical review. Capacity is usually expressed in terms of the final cost unit and where not so possible in terms of machine hours, people hours etc.

6.6.2 The concept of capacity is highly subjective. While on one hand it denotes the availability of resources, it would also mean the maximum rate at which the company can produce goods or services. Capacity does have considerable impact on the profitability. The auditor should assess this impact by analyzing and relating the impact of capacity costs on profitability.

6.6.3 The auditor should collect information of theoretical capacity, practical capacity, normal capacity and budgeted capacity for the period under review. Although the information may be available for all machinery & equipment, the auditor should identify the "constraint" that would limit the capacity of the entire organisation or product or a certain geographical area.

6.6.4 The auditor should assess various capacity limits for better analysis and reporting. All these have costs and could affect profitability. These are:

- Internal physical capacity – machinery & equipment
- External physical capacity – subcontracting and leasing
- The capacity of manpower bandwidth at all levels
- The financial capacity

6.6.5 When comparing the actual production with the capacity, the auditor should identify and analyze the reasons for variation due to controllable and uncontrollable causes. It would help to concentrate on material impact caused due to idle time, break-downs, lack of power, lack of material, lack of demand. It would be advisable to compute the cost impact of these.

6.6.6 Most of the capacity related information is available with the production and industrial engineering departments. The auditor should also refer to the CENVAT records for actual production data.

6.6.7 The auditor should comment on how the company responds to the variations in product demand by adjusting its capacity. This should be done with respect the cost impact.

6.6.8 The capacity performance measures could be:

- Capacity ratios to measure utilisation
- Identify bottlenecks & their impact on costs
- Ability to serve markets by creating short term capacity
- Analysis of throughput per hour of constraint capacity resource and return per hour at this resource (could be done decomposing the Throughput Accounting ratios)

- Committed capacity costs by process and managed capacity costs by process
- Impact of wastages on capacity utilisation

6.6.9 The auditor's checklist would include processing of information gathered from sources like:

- Technical documents pertaining to the equipment
- Production planning reports
- Interviews with managers responsible
- Wastage and down-time reports
- Benchmarking exercises done, if any
- External sources providing suggestive capacity reporting formats like CAM-I publications (Consortium for Advanced Manufacturing – International)

6.6.10 Suggested additional references

- Cost Accounting Standard (CAS- 2) – Capacity Determination issued by the Institute of Cost Accountants of India
- CAM-I capacity model developed by Consortium for Advanced Manufacturing – International, Texas
- Capacity Utilisation Bottleneck Efficiency System (CUBES) model
- SEMATECH's approach to Overall Equipment Effectiveness (OEE)
- Theory of constraints model (TOC)
- Balanced Score Card – by Robert Kaplan
- AA1000APS (Principles)
- AA1000AS (Assurance)
- AA1000SES (Stakeholder Engagement)

6.7 PRODUCTIVITY AND EFFICIENCY ANALYSIS

6.7.1 Productivity involves variables of input resources and the output. Measuring, identifying and isolating the different input resources and analyzing their contribution to produce goods and services and their effect on costs and profitability is imperative for improving business performance. It should be noted carefully that productivity is a measure of efficiency per unit of output, whereas efficiency is generally measured in totality.

6.7.2 The auditor could understand and analyse the whole chain of input-processing-output. This analysis, while traditional and very basic, would help auditor to comment upon the performance of the organisation across products or product groups. It is necessary for the auditor to understand the input ingredients for each product, product group, customer etc.

6.7.3 Annexure 3 & 4 of Part of CRA-3 to the cost audit report provide some basic information about the input costs and their relation with the output. The auditor should further analyse these areas to identify causes of good performance and areas that need improvements.

6.7.4 The considerations in measuring productivity and efficiency performance could be:

- Performance of input factors such as material, people, tools, equipment, processes, management, capital funds etc.
- The output factors could be units produced and sold, number of customers served, reduced costs, improved responsiveness etc.
- It's not just the productivity, but the improvement (or lack of it) in it that must be measured.

This could be done by identifying whether the company is able to

- ✓ Achieve more output with same input
- ✓ Achieve same output with less input
- ✓ Achieve much more output with relatively less increased input
- ✓ Achieve slightly less output with much less input

- For each selected area, the auditor should identify whether the improvement is permanent or temporary and report on the same. The recommended approach for the organisation should be focusing on the sustainable improvements. Care should be taken to identify and report potential manipulations.
- Alongside the productivity or efficiency ratios, the cost auditor should also analyse and report on the effect of the same on quality. The auditor should isolate quality of various inputs and their effect of the output.
- The performance measures in respect of this area could be:
  - ✓ Inputs ustilised (material, man, machine, capital etc) per unit of output or output obtained per unit of an input variable
  - ✓ Wastages as percentage of input
  - ✓ Indices could be developed for Single Factor Productivity (SFP), Multi-Factor Productivity (MFP), Total Factor Productivity (TFT)
  - ✓ Inter-relationships in various productivity measures e.g. output per man-hour may have increase, but if it is accompanied by higher wastage per man hour, then there is no real benefit

6.7.5 The cost auditors checklist would include, inter alia, the following:

- The Bill of Material (BOM) for each product
- The standard cost card, if any
- Internal reports on consumption, wastages per unit of input to capture actual data
- Production scheduling and plans to measure labour& machine time productivity
- External benchmarking such as industry norms, best practices data etc. used by the company or generated by auditor for analysis

6.7.6 Suggested additional references:

- Publications by the Indian Productivity Council
- Industry association reports like Indian Machine tool manufacturers, Society for Indian Automobile Manufacturers, etc. to get the data on Industry averages for benchmarking.

6.8 UTILITIES AND ENERGY EFFICIENCY ANALYSIS

6.8.1 This is an extended analysis of single factor productivity in respect of the utilities and energy inputs acquired and consumed by the company. The importance of conservation of non-renewable energy needs no emphasis.

6.8.2 The utilities are resources that are used in the process of conversion of material and other components into a finished product, but these resources do not form part of the physical unit of the product. In manufacturing industries, utilities and energy form a substantial part of the conversion cost.

6.8.3 The broad headings under which the utilities and energy performance could be categorized are Power, steam, electricity, compressed air, water, etc. These utilities are consumed in the production process or in environment protection initiatives. The use of utilities for administrative functions may be found in terms of lighting, cooling, ventilation, heating refrigeration etc. The auditor should evaluate the impact from cost angle as well as from the viewpoint of conservation of energy. It is essential to check if there are any statutory norms prescribed for the company.

6.8.4 The auditor should gather information on whether the company falls under the energy intensive industries as per the schedule attached to the Energy Conservation Act 2001. These industries include Aluminum, fertilizers, steel, cement, paper and pulp, sugar, textile, chemicals, petrochemicals, gas crackers, etc.

6.8.5 For external benchmarking, it may be useful to refer to the practices followed by companies which are accredited by the Bureau of Energy Efficiency formed under the Energy Conservation Act 2001.

6.8.6 The performance appraisal parameters for energy and utilities would include the consumption of fuel for generating energy and then the use of the energy thus produced per unit of final product. The performance parameters could include the following:

- Energy generated per unit of fuel consumed or fuel consumed per unit of energy generated. This could be applied for power, steam, electricity, water etc.
- Measurement of improvement in power factor (denoting reduction in the KVA demand charges)
- The cost of generating energy per unit and the cost of consuming the energy per unit of the finished product would be the critical part of the analysis.
- Trend analysis of energy costs as percentage of total production costs is a good indicator of performance

6.9 KEY COSTS AND CONTRIBUTION ANALYSIS

6.9.1 The thrust here should not be only on computation of numbers or percentages for various product groups under consideration. The auditor should check the reasonableness of the contribution by benchmarking with the industry average wherever applicable.

6.9.2 Financial performance is the major element of the performance management. This analysis involves assessment of major items of cost, their relationship with the volume of production and impact on the profitability. Annexure 4 of Part D of CRA-3 of the cost audit report provides information (for each product group) on operating ratios for the current and previous years. These ratios are computed as proportion of individual cost elements to the cost of sales.

6.9.3 The auditor could provide analysis of the cost information by highlighting any significant variation therein during the reporting period. These variations are caused by non-recurring, onetime costs that may vitiate the ratios. Suggestions to avoid such variations may be provided in the report. This could be having long term rate contracts, supplier agreements, consumption controls etc.

6.9.4 The cost information should include comparison of actual cost performance with the standards or budgets as the case may be. If the company is using target costs, the auditor could identify the cost gap and recommend the ways to reduce the same. The report should provide a commentary on variance analysis. The process followed by the organisation for investigation and correction of variances should be commented upon.

6.9.5 In addition to these, it would be necessary to enlighten the company management with an in depth analysis of contribution earned by each product group. The contribution analysis may be given an absolute amount per unit of the finished product or in terms of percentage of sales i.e. the PV ratio. The auditor can add value by pointing out contribution earned per unit of the key constraint resource.

6.9.6 The contribution analysis should also be extended to include the break-even analysis and the margin of safety at the current volumes. It may be necessary for the auditor to scientifically split the costs into fixed and variable elements. This split should be validated every year to find out structural changes if any. It will help to include inter-firm comparison for the same.

6.9.7 The auditor should report on evaluation of use of the contribution analysis data by the management for decisions like pricing, accepting or rejecting an order, make or buy etc.

6.9.8 The checklist for the auditor could include reference to

- Sales and production records
- Reconciliation with CENVAT records
- Price lists and discount structure policy
- Product cost statements
- Operational budgets

6.10 PRODUCT/SERVICE PROFITABILITY ANALYSIS

6.10.1 The unit product or service profits are driven by two major components viz. cost per unit and selling price per unit. The auditor should analyse if the business belongs to the sellers' market or buyers' market. This would facilitate the assessment of impact of changes in selling prices and changes in costs on the profitability or otherwise of the products or services. While the selling price is a single number, the cost is the sum total of different elements. The auditor must ensure that the basis use to allocate indirect costs is consistently adopted by the company.

6.10.2 In case of services, the unit of measurement is very important and hence carefully selected. Further, due to the diverse nature of services, it is essential to exercise care in analyzing the profitability thereof especially when the services provided are not standard. Many times, there is a combined contract for sale of product along with the service & maintenance contract. In such cases, the auditor should bifurcate the sales and costs for each portion and then compute and comment on their respective profitability.

6.10.3 Care should be taken in splitting the joint costs in case of joint products and by products. The method adopted for separation of costs should be checked to ensure correctness and consistency.

6.10.4 It would help to separately identify the costs of production, selling & marketing and handling customer services.

6.10.5 The auditor is expected to provide a thorough evaluation to bring out the products and/or services that are contributing more or less to the overall company performance. For convenience purpose, the products and/or services could be classified in groups with similar risk-return profiles. This classification may be different from the 'product groups' in the cost audit report annexures.

6.10.6 The analysis should separately appraise profitability of newly introduced products or services and also their proportion to the total profits of the organisation. The auditor should incorporate the profitability analysis of products discontinued during the period.

6.10.7 The term "profitability" should be taken with an extended meaning to include, apart from the concept of accounting profit, the ROI analysis as well. It would be useful to analyse profitability of products/services in domestic and export market. Care should be taken to isolate reasons for the changes in the profitability percentages. Similarly, if significant, profitability on sales to the related parties may be separately highlighted.

6.10.8 The report should specifically highlight the top five and the bottom five products. This will help the company to understand which products or services are contributing to the performance and which are ones that are non-performing. Based on this the suitable corrective actions may be suggested.

6.10.9 The checklist for the auditor could include reference to

- Sales and production records
- Reconciliation with CENVAT records
- Price lists and discount structure policy
- Product cost statements
- Operational budgets

6.11 MARKET / CUSTOMER PROFITABILITY

6.11.1 Certain industries focus on limited markets and customer types, while the others are broad based. The management may choose to understand its position in the different markets and different customers it serves.

6.11.2 The auditor should observe the segmentation method adopted by the company for analysing its profitability. The objective is to take suitable action for the segments that are not performing as per desired targets by introducing campaigns or to pull out of those segments that are no longer attractive.

6.11.3 The markets could be segmented on the basis of geographical locations such as domestic & international, zones or regions. They can also be segmented based on customers, e.g. OEMs, institutional, dealers, aftermarket, retail etc. These are normally termed as channels of distribution. Sales and supplies to Government, related parties could also be used for analysis.

6.11.4 The challenge in all the above named method of segmentation lies in the computation of costs for each of them. The auditor should carefully evaluate the allocation of costs to the different channels, especially marketing & campaigning costs.

6.11.5 While analysing the profitability, the amount of turnover should not be ignored. There could cases of improved profitability and dropping turnover levels for the different segments. The auditor should perform trend analysis to judge the performance in such cases and recommend suitable measures.

6.11.6 A life cycle approach would provide better insight into the market or customer profitability analysis. Hence, the auditor could analyse the costs of acquiring the market or customer, costs involved in servicing and maintaining them and also costs involved in evaluating the potential thereof through market research. Example of how to look at “Cost per unit” when there are multiple customers and orders vary from quantities to deliveries. A Customer places the PO for X quantity to be delivered in four batches. Another customer places PO for Y quantity which is higher than Customer X, but delivery in equal number every month, which incidentally falls short of the minimum batch size. Here customer X, eventhough the quantity is lesser than customer Y, is economical to produce the required quantity as it costs less per item compared to Y.

6.11.7 This aspect of the report should specifically highlight the top five and the bottom five markets and/ or customer/customer categories. This will help the company to understand the most profitable markets and customers/customer categories and also the ones that are consuming resources but not yielding profits.

6.11.8 In addition to the study of profitability, the auditor could comment on the risks associated with the markets and customers. This risk could be “concentration risk”, e.g. overdependence on a few customers or selling in one market only. The other risk may be related to defaults by customers. The analysis of bad debt history would help the analysis.

6.11.9 The checklist for evaluation of performance in this area could be based on the study of

- Market and customer-wise sales and cost reports
- The marketing campaigns undertaken by the company
- Date on new markets or new customers added during the year

6.12 WORKING CAPITAL AND INVENTORY MANAGEMENT ANALYSIS

6.12.1 This part of the report should point out the efficiencies in operations through management of different components of working capital. The auditor should identify all the elements of working capital for each product group and evaluate the adequacy or otherwise thereof.

6.12.2 In case of multi-unit operations, the working capital and inventory management is centralized, with sub limits fixed for each manufacturing locations. While the working capital assessment is done for the Company as a whole, the key factor which influences the working capital requirement of each unit have to be kept in mind and evaluated.

6.12.3 On the whole, the auditor should critically examine the working capital policy of the company. The total working capital could be analysed into permanent and fluctuating components. It is necessary to check whether the funding of these components is consistent with the period of requirement.

6.12.4 Working capital decision is handling of the conflict between liquidity and profitability. The auditor could provide an independent assessment of how it is being currently handled and how it can be improved.

6.12.5 The analysis of working capital can be done using the traditional measures of ratios like current ratio, quick ratio, turnover ratios, number of days in operating cycle etc. These ratios could be computed for each product group separately. Analysis of the operating cycle of the company would be immensely useful.

6.12.6 For manufacturing industries, inventory is the major portion of the current assets. The auditor should evaluate the inventory management policy which would include, inter alia, procurement policy, stocking policy, inventory valuation method, inventory records and physical verification procedures. Benchmarking of the policy pursued by the company with the industry averages will enhance the value of performance report.

6.12.7 It will be appropriate to analyse the inventory into its components such as raw material and stores, work in progress and finished goods. For each of these categories, system of inventory control should be evaluated using tools like ABC or VAT or FSND analysis, EOQ technique, JIT system etc. The auditor should comment upon the quality of inventory asset using the inventory aging reports.

6.12.8 Another important component of working capital is receivables. Analysis of receivables is important for internal perspective (working capital management) and external perspective (customer management) as well. The auditor should peruse through the policy of the company regarding credit evaluation of customers, setting up of credit terms and credit limits, discount policy, collection & delinquency procedures etc.

6.12.9 Trade credit from suppliers is the most crucial spontaneous source of working capital funding. The performance in respect of this could be critical for operational efficiencies and liquidity of the company. The auditor could analyse the supplier-wise performance in respect of on time supply, quality issues, pricing, etc.

6.12.10 Observations about other components of working capital and trends therein could be noteworthy. These components may be loans and advances, other receivables and payables etc. the criteria for analysis here should be to find whether excessive amount is blocked in these areas. Cash management can be included in the analysis.

6.12.11 It will be helpful to include the observations on cost of working capital funding. These costs may include the interest paid on cash credit and loans, cost of using factoring services, cost of collection efforts, costs involved in cash management, cost of inventory carrying etc. These costs may be explicit or implicit. Reasonable assumptions could be made for computing the implicit costs. The total cost of managing working capital as a percentage of total working capital invested may be a very useful performance indicator.

6.12.12 The auditor's checklist could include the reference to the following:

- Records related to inventory of RM, WIP and FG, stock discrepancy reports
- Inventory aging reports, reports on treatment of non-moving items
- Reports on receivables – aging, timely collection, bad debt etc.
- Terms and conditions of working capital funds such as bank credit, loans etc.

6.13 MANPOWER ANALYSIS

6.13.1 The depth of analysis of manpower could depend upon the proportion of manpower cost to the total cost of product or service. The performance criteria for this area will mainly be related to the costs and efficiency or productivity. Again, benchmarking with the similar organisations would be helpful.

6.13.2 The costs may be categorized into the cost of recruitment, cost of maintaining the manpower and the cost of separations. Recruitments costs may include position advertisements, commission paid to recruitment agencies, participation in job fairs or campus recruitment etc. The maintenance costs may be the training & development costs, facilities provided over & above the monetary benefits etc. The separation costs would mostly be implicit costs. These costs as a percentage of the total salaries and wages would provide an insight into the quality of manpower management. These costs could be further broken up as per the hierarchies of people. The time taken to recruit important positions may affect the performance adversely.

6.13.3 The factor returns from the manpower is in terms of growth in production and productivity, enhancement of skills and knowledge of the organisation. The auditor should analyse the figures of manpower productivity, idle time, overtime worked, absenteeism etc. These factors could be compared with the respective outputs such as increased production, increased sales etc. The criteria such as sales per person achieved, production per man hour etc. will add value to the Report on Performance Appraisal.

6.13.4 The Report on Performance Appraisal may include comments and observations about the employee learning and growth opportunities and their linkage with the improvement in overall performance of the organisation.

6.13.5 The auditor's checklist for this content area may be:

- Details of number of recruitments done, number of people left, the labour turnover ratios
- The data on idle time, absenteeism
- Manpower productivity reports
- Use of temporary or casual labour
- Turnover at the higher level of management
- Training and developmental programmes and the feedback thereon

6.14 IMPACT OF IFRS ON THE COST STRUCTURE, CASH FLOWS AND PROFITABILITY

6.14.1 The new era of accounting standards has started in India after Introduction of IND AS. The Ministry of Corporate Affairs had notified 39 new Ind AS in 2015. The timeline for the adoption of these new standards is not yet given. The date has been postponed in view of pending the suitable amendments required to be done in the other enactments.

6.14.2 However, it will be useful for the auditor to run through the effects that the new standards may have on the organisations in the new era. The auditor should get acquainted with the requirements of the new standards and the differences as compared to the existing standards.

6.14.3 In the Report on Performance Appraisal, the auditor may point out the impact of IFRS on the existing cost structure, cash flows, and profitability. It may be noted that the new standards provide a principle based framework in place of rule based standards, and as such the companies may need to assess the effect of their actions and choices made for accounting.

6.14.4 The five main elements of financial statements are assets, liabilities, equity, income and expenses. The IFRS provide for recognition, measurement and disclosure criteria for these elements. In cases, where the measurement criteria change, there will be an impact on the costs. The changed recognition criteria may impact the profitability and cash flows of the company.

6.14.5 The most important effect on valuation will happen through the adoption of "fair value" concept in measuring various assets and liabilities. The auditor must enumerate the cases where use of fair value is mandatory or permitted as management's choice. It should be noted that any change in the fair value as on the reporting date has to be taken to the profit and loss a/c.

6.14.6 It may not be possible to split the effect of new standards on individual product or product group costs and profitability. It could be assessed for the organisation as a whole.

6.14.7 These effects arise due to the balance sheet orientation of IFRS rather than the P & L smoothing practices followed by companies. Given below is an illustrative list of areas where major impact would be arising out of the IFRS provisions related to:

- **Revenue recognition –** companies may have to defer part or whole of their revenues
- **Inventory valuation –** explicit rejection of LIFO method could change the inventory costs and thus profitability
- **Property, plant and equipment –** recognition of assets and depreciation may change, provisions on revaluation of assets are noteworthy
- **Financial instruments –** accounting for hedges and FOREX may result in profits or losses to be recognised or derecognized
- **Construction contracts –** there could be changes in contract revenues and profit measurement thereon
- **Impairment of assets –** recognition of provisions may impact profitability
- **Intangible assets –** certain existing assets may have to be derecognized
- **Business combinations –** some costs of M & A cannot be capitalized

6.14.8 The impact of changeover has been explained in the Ind AS 101 – First Time Adoption. It may be noted that the impact based on this standard would be in the first year in which the new standards are applied. In the first financial statements, the adjustments will have to be made in the retained earnings, subject to some exceptions and exemptions. This standard may require an entity to

(a) Recognise all assets and liabilities whose recognition is required by Ind AS

(b) Not to recognise items as assets or liabilities if Ind AS do not permit such recognition;

(c) Reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under Ind AS and

(d) Apply Ind ASs in measuring all recognised assets and liabilities

6.14.9 The Report on Performance Appraisal should include comments of the potential changes for the understanding of the Board and Audit Committee members. The auditor could provide them an insight to the likely changes in the cost structure. This content area is an important aspect to be covered till the new standards are not adopted. In subsequent years, it may lose its relevance.

6.15 OTHER AREAS SUGGESTED TO BE COVERED IN THE REPORT ON PERFORMANCE APPRAISAL

6.15.1 It should, be noted that these are very comprehensive and could cover most of the aspects of enterprise performance.

6.15.2 The auditor should make use of the non-financial measures of performance that signal the direction in which the future performance is being driven. The various non-financial measures are listed in the List-B.

6.15.3 The companies may track performance using parameters such as EVA and therefore the assessment will have to be done to meet the specific requirement.

6.15.4 The listed companies clearly bring out business specific factors that may affect their performance going forward. This is usually given in the "management discussion and analysis" in the annual reports. The auditor should benchmark these with companies in the same industry and provide observation thereon.

6.15.5 Risk Analysis: That may affect the future performance. The auditor should

- Identify the sources of various risks
- Assess the potential downside or upside effect thereof
- Comment whether the risks are worth taking or suggest the acceptable range
- Recommend risk mitigation tools and techniques to be used
- Evaluate the effect of the existing risk mitigation tools used by the company

6.15.6 Environment and Sustainability: To provide insight into how effectively the company is following policies on CSR, environment and sustainability.

6.15.7 Quality Performance: Could be assessed by relating the quality costs incurred versus the benefits achieved by reduction in customer complaints or increase in customer satisfaction index.

6.15.8 R & D Performance: The future performance of companies would depend upon their success of the R & D initiatives. The auditor could provide a useful lead in this respect by including analysis of the R & D costs.

6.15.9 Business Process Performance: The auditor could evaluate various processes followed by the company and incorporate valuable assessment in the Report on Performance Appraisal. The processes could be evaluated on the criteria like speed, accuracy, empowerment, hurdles, facilitation etc.

6.15.10 Human Resource Accounting: This is an extended analysis of total human resource costs, both explicit and implicit, which are capitalised at an appropriate discount rate. The auditor could observe the value of human asset and link it to the returns. This is an upcoming performance measurement criterion.

6.15.11 Value Added Analysis: The value added is measured as an absolute value created by the business and the distribution thereof to the employees and other providers of capital. The growth in the value added over a period of time could be observed and commented upon.

6.15.12 Performance of Intangible Assets: The business may have internally developed intangible assets.

In financial accounting these are generally not capitalised. The value created by the intangibles could be computed as excess returns earned by the company over the industry average. This excess is supposed to be earned due to the presence of intangible assets like brand.

6.15.13 Stakeholder Performance Analysis: The performance for shareholders could be denoted by EPS growth, the stock price performance, market capitalization, dividend growth, EVA etc. The lenders' parameters would be interest coverage and debt-service cover ratios. The suppliers would look for business growth, and on time payments. Customers expect on time delivery, proper pre and post sales service, and reasonable prices. These are performance metrics could be included in the Report on Performance Appraisal.

6.16 MANAEMENT ACCOUNTING TOOLS

6.16.1 The performance measurement involves collection of information, analysing the same by establishing the inter-relations between them, interpreting the results and then arriving at meaningful conclusion. The collection of information depends upon various sources of data and other reports for various systems used by the organisation.

6.16.2 The data input is generally made in the accounting system used by the company e.g. the ERP systems. Most of the ERP systems facilitate input and capturing of even the non-financial data which can be then processed to produce desired reports. There is a lot of information to be accessed from outside of the ERP system. The auditor should identify such sources within and outside of the organisation and use information drawn from the same.

6.16.3 The management accounting tools could be used to analyse the performance with different purposes. The auditor should verify the tools and techniques used by the company and comment on appropriateness and adequacy thereof. The auditor could recommend more appropriate management accounting tool.

6.16.4 The following table shows various management accounting tools that are used to serve different objectives:

Purpose	Management Accounting tool
Control	Budgetary control, standard costing, variance analysis
Cost computation	Full(absorption) Costing, Job, batch, process or contract costing Activity based costing, Time Driven ABC
Cost reduction	Total Quality management, Quality costing, Kaizen costing, Lean manufacturing, Value Analysis and Value Engineering, Six Sigma
Pricing and decision making	Target costing, Life cycle costing, Throughput accounting, Variable or marginal costing
Total performance management	Balanced Scorecard, Performance Prism, Performance pyramid, Business Objects, Business Intelligence

6.16.5 The auditor should be acquainted with the intricacies of these and such other tools and what it takes to successfully implement and use them. The success of Report on Performance Appraisal would depend upon not how many performance measure are considered, but upon how they are evaluated and assessed with the help of various management accounting tools.

Planning for the Report on Performance Appraisal

Key Performance Indicators (KPIs) are simply the variables, independent or interdependent, in respect of which the goals can be set and performance measured to assess whether it is in furtherance of the enterprise objectives. Hence, for evaluation of performance the selection of KPIs must be chosen correctly in tune with the objectives. The KPI measurement should not be a static computation, but always needs to be compared with a benchmark set. The KPIs could be:

a) **Quantitative –** these can be financial or non-financial

b) **Qualitative –** these are often lead indicators i.e. they influence future performance

c) **Actionable –** those which can be influenced by enterprise actions or controllable

d) **Trending –** those which need to be assessed over a period of time to observe whether they are improving or not

At the outset, based on the initial discussion with the management, a proper checklist may be drawn in the following format for planning the Report on Performance Appraisal:

KPI (performance measure) Also indicate if strategic or operational	Type of KPI (whether quantitative or qualitative)	Functional areas affected by KPI	Persons/ departments responsible	Measurement criteria	Comparison with (budget, standard, external benchmark etc)

Depending upon merit of each case, the auditor could factor in other things such as source of the information, measurement frequency, time periods to be covered, etc. This will facilitate clarity of understanding and once the auditor gets the management's nod on these basic elements, the Report on Performance Appraisal can certainly be a value adding proposition for the company.

List - B

Suggestive list of KPIs

Performance area	KPI	Measurement
Financial performance	**Turnover**	Segmental revenue to total revenue % Segmental turnover growth % Total turnover growth % Growth % in new product sales New product sales as % of total sales Customer-wise sales Top 5 customers, bottom 5 customers' sales
	Margins	Gross margin % on total sales Gross margin % on segmental sales Gross margin % on new products Customer-wise Gross margin %
	Costs	Element-wise cost % to total turnover and segmental turnover Cost composition – nature-wise, variability structure, functional split
	Returns	ROI on product groups ROI on geographical segments ROI on new products ROI on new markets ROCE Value added to total income Earnings per share (EPS) Dividend per share (DPS) Retention ratio Price-Earnings (PE) ratio Market price per share
	Balance sheet	Current ratio, quick ratio Asset turnover (current and fixed assets) Growth in assets Capital expenditure % to total assets Debt-equity ratio Debt to total capital employed
Productivity & Efficiency	**Material**	Material cost % to total cost Material wastage as % to total input Contribution per unit of material used

Performance area	KPI	Measurement
	Labour	Production per man hour Production per employee Employee cost % to sales Idle hours % to total available hours
	Machine	Production per machine hour Growth in machine capacity utilisation Machine downtime ratio Break-down hours
Manufacturing performance	**Operating cycles**	Material turnover WIP turnover Finished goods turnover
Customer performance	**Complaints**	% of customer complaints to total orders Response time to resolve a complaint Customer-wise number of complaints Number of complaints repeated
	Development	Business growth % over 3 years
	Risks	Payment defaults Delinquencies Payment delays
	Retention and satisfaction	Customer retained over 3 years Customer satisfaction index On time order execution % Correct documentation % Customer orders delivered in full % Average time spent on customer relation
	Overall	Order-to-cash cycle days
Supplier performance	**Delivery**	On time supplies Supply of full quantity
	Quality	% of rejections
	Cost	Price reductions agreed – cost effect Price escalations given – cost effect
	Overall	Supplier satisfaction index Accuracy of forecasts shared

List - C

Additional references for cost auditor

1. Annual reports of the companies for current year and past years
2. Guidance given by companies to stock markets
3. Written Policy documents of the company
4. Company web-sites
5. Web-sites of industry associations
6. Macro-economic data from RBI, Ministry of finance and commerce & industry etc.
7. Management accounting tools and techniques – reference books and hand books
8. Cost accounting standards issued by the ICAI
9. Accounting standards and Ind AS issued by the Institute of Chartered Accountants of India
10. Generally accepted cost accounting principles (CAGAP) published by ICAI
11. Stock market information on prices, market capitalisation, market returns
12. Minutes of board meeting to the extent relevant
13. Personal meetings with the CEO/MD of the organisation and members of the audit committee and the Board
14. The cost accounting policy of the company
15. The cost accounting system of the company – costing methods
16. The CENVAT and VAT records maintained by the company
17. The monthly MIS reports – concentrate only on exceptional reports

Study Note - 7

EXPOSURE DRAFT TRAINING & GUIDANCE MANUAL FOR COST AUDIT REPORT & COMPLIANCE REPORT IN XBRL FORMAT (as per TAXONOMY)

This Study Note includes

7.1 Introduction

7.2 Preface

7.3 Steps for Filing Cost Audit Report and Companiance Report in XBRL format on MCA Portal

7.1 INTRODUCTION

The Ministry of Corporate Affairs (MCA) has released the Validation Tool and Costing Taxonomy for filing cost audit reports under Companies (Cost Records and Audit) Rules, 2014 ("the Rules"). MCA has now informed that XBRL validation tool version 2.0 (beta) - Validation Tool (for costing taxonomy 2015) has been released to cater filing as per both costing taxonomy 2012 and 2015. MCA is yet to release Form CRA-4 for filing cost audit reports.

In this connection attention is drawn to sub-rule 6 of Rule 6 of the Rules.

> Every company covered under these rules shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in form CRA-4 alongwith fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

The MCA has further notified, vide General Circular No. 08/2015 dated 12th June, 2015, that additional fees on delayed filing of form CRA-4 beyond the prescribed period of 30 days from the date of receipt of a copy of Cost Audit Report from the Cost Auditor for the Financial Year starting on or after 1st April, 2014 is also waived for all such filings till 31st August, 2015.

In view of the above provisions, companies that have already approved and adopted the Cost Audit Report for financial year commencing on 1st April, 2014 at its Board Meeting and were required to file the cost audit report on any date prior to 31st August, 2015 can file the same till 31st August, 2015 without any additional filing fees and such filing would be deemed to be due compliance of Rule 6(6) of the Rules.

The last date of filing of cost audit report by 31st August 2015 will not be applicable for those companies who received the cost audit report on or after after 2nd August 2015. Such companies can file the cost audit report with MCA within 30 days from the date of receipt of Cost Audit Report by the company.

7.2 PREFACE

This document aims to facilitate the preparation and filing of Cost Audit Report and Compliance Report in XBRL format. It provides guidance on the preparation, filing, and validation of Cost audit report and compliance report prepared in eXtensible Business Reporting Language (XBRL) format on the MCA portal.

Purpose of this Document

This document describes the various specifications and guidelines to be followed for preparation of XBRL documents. It also includes the various steps required to be followed for submission of the XBRL documents on the MCA portal.

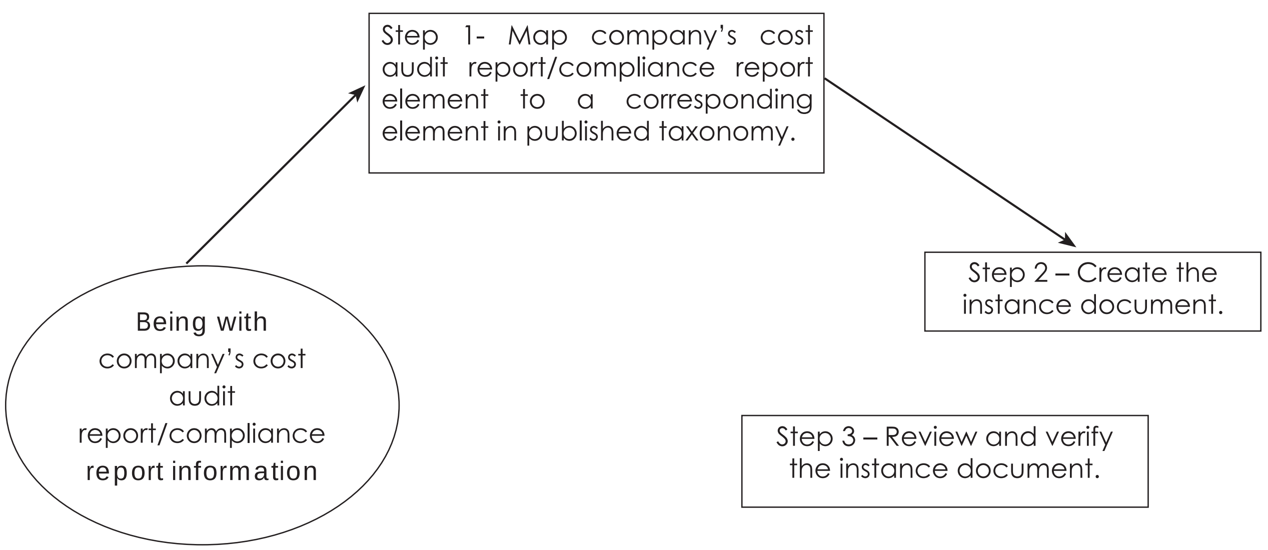
Intended Audience

This document is intended for use by the companies and the XBRL vendors involved in preparation of XBRL documents and for the public users.

7.3 STEPS FOR FILING COST AUDIT REPORT AND COMPLIANCE REPORT IN XBRL FORMAT ON MCA PORTAL

1. Creation of XBRL instance document
2. Download XBRL validation tool
3. Load the instance document
4. Validate the instance document
5. Pre-scrutiny of the instance document
6. Convert to PDF and verify the contents of the instance document. (This step is essential to ensure that the textual information entered in the instance document is clearly viewable)
7. Attach instance document to the Form I and Form A or Form CRA-4 respectively
8. Submitting the Form I and Form A or Form CRA-4 on the MCA portal.

1. Creation of XBRL instance document



1.1 Map Company's Cost audit report / Compliance report elements to corresponding elements in published taxonomy

Companies have the option to create their own XBRL documents in house or to engage a third party to convert their Cost audit report/ compliance report into XBRL form.

The first step in creation of an instance document is to do tagging of the XBRL taxonomy elements with the various information in the Cost audit report/ compliance report of the company. This would create the mapping of the taxonomy elements with the Cost audit report/ compliance report so that the Cost audit report/ compliance report can be converted into XBRL form.

Mapping is the process of comparing the concepts in the Cost audit report/ compliance report to the elements in the published taxonomy, assigning a taxonomy element to each costing concept published by the company.

Those persons in the company who are most familiar with the Cost audit report/ compliance report should be associated with mapping of costing concepts to taxonomy elements. **The mapping should be reviewed before proceeding further as the complete reporting would be dependent on the mapping.**

The complete information as contained in the Cost audit report/ compliance report and related documents, should be reported in the XBRL instance documents to be submitted with MCA.

1.2 Create instance document for Cost Audit and compliance report.

Once the tagging of Cost audit report/ compliance report elements with the published taxonomy elements is done, the next step is to create the instance document. An instance document is a XML file that contains business reporting information and represents a collection of costing information and report-specific information using tags from the XBRL taxonomy.

It is to be noted that no extensions to the core Taxonomy will be allowed.

Separate instance documents need to be created for the following depending on the applicability to the company:

(i) Cost Audit report

(ii) Compliance report (For costing period beginning prior to 1.04.2014)

Once the instance document has been prepared, it needs to be ensured that the instance document is a valid instance document and all the information has been correctly captured in the instance document. MCA Validation Tool provides for 'human readable' PDF printable form as well as a view of the instance document.

1.3 Specifications to be followed for creation of instance document

The following are the specifications to be followed while preparing the instance document:

1.3.1 Technical Specifications

(1) The value of the xlink:href attribute in the schemaRef element of the instance document must be according to table shown below:

Taxonomy	xlink:href value
Cost Audit Report (2012)	http://www.mca.gov.in/XBRL/2012/08/02/Taxonomy/CAR/in-cost-aud-2012-09-07.xsd
Cost Audit Report (2015)	http://www.mca.gov.in/XBRL/2015/04/01/Taxonomy/CAR/in-cost-aud-2015-04-01.xsd
Compliance Report	http://www.mca.gov.in/XBRL/2012/08/02/Taxonomy/CAR/in-cost-com-2012-09-07.xsd

(2) The value of the scheme attribute of the identity element in the context must be http://www.mca.gov.in/CIN for indian companies and http://www.mca.gov.in/FCRN for foreign companies.

(3) An XBRL instance document must be schema valid according to all schemas in the DTS (Discoverable Taxonomy Set)

(4) The value of identity element in the context must all be x-equal and must be the CIN/FCRN of the company.

(5) An instance must not contain duplicate xbrli:context elements. Duplicate contexts are those which have the same scenario and period elements.

(6) Every xbrli:context element must appear in at least one contextRef attribute in the same instance.

7) An instance must not have more than one fact having the same element name and equal contextRef attributes

(8) All monetary facts must have the same unitRef attribute.

(9) The facts corresponding to a single concept must not have contextRef attributes pointing to contexts with overlapping time period. In case of periodType=”instant”, it means to have same date, and in case of periodType=”duration”, it means to have a duration that overlaps. For example: The following contexts have overlapping duration, this would not be allowed.

```
<xbrli:context id=”D2010″>
<xbrli:entity>
<xbrli:identifier
scheme=”http://www.mca.gov.in/CIN”>L24223MH1946PLC005434</xbrli:identifier>
</xbrli:entity>
<xbrli:period>
<xbrli:startDate>2009-04-01</xbrli:startDate>
<xbrli:endDate>2010-03-31</xbrli:endDate>
</xbrli:period>
</xbrli:context>
<xbrli:context id=”I2010″>
<xbrli:entity>
<xbrli:identifier
scheme=”http://www.mca.gov.in/CIN”>L24223MH1946PLC005434</xbrli:identifier>
</xbrli:entity>
<xbrli:period>
<xbrli:startDate>2009-08-01</xbrli:startDate>
<xbrli:endDate>2010-07-31</xbrli:endDate>
</xbrli:period>
</xbrli:context>
</xbrli:period>
</xbrli:context>
```

(10) A link:footnoteLink element must have no children other than link:loc, link:footnote, and link:footnoteArc.

(11) A link:footnoteLink link:loc xlink:href attribute must start with the sharp sign “#”.

(12) Every nonempty link:footnote element must be linked to at least one fact

(13) Non significant digits for values for numeric facts MUST be equal to “0″.

(14) An instance document must not contain unused units

(15) If the unescaped content of a fact with base type nonnum:escapedItemType contains the “” or “>”, then the un-escaped content must contain only a sequence of text and XML nodes.

(16) A fact is defined to have a footnote if it has an id attribute and a link:footnoteArc to a nonempty link:footnote in the same instance.

(17) The filing is required to reference certain recognized schemas and linkbase. Filings must always refer to recognized files at the specified URI locations. A reference to a local copy will not be allowed.

(18) The xsi:nil=”true” attribute must be used only to convey a value that is different from both “zero” and different from not reporting the fact at all, or to identify a fact detailed only by a link:footnote.

(19) The value of the decimals attribute of a fact must correspond to the accuracy of the corresponding amount as reported in the financial statements.

(20) The content of a numeric fact never has a scale factor

(21) Do not define or use units that imply a scale factor on a currency.

(22) Text that is shown in cost audit/compliance report at the bottom of a page or at the bottom of a table preceded by a superscript must appear in the instance as the text of a link:footnote element.

(23) Each unit should appear with only one scale factor in a given instance.

(24) Every numeric fact must also have an associated unit, and the unit must be declared.

(25) Filers must use one of the taxonomies as specified in the disclosure system as their standard taxonomy.

(26) Encoding of all XBRL documents must be “UTF8“

(27) The xbrli:xbrl element must not have any facts with the precision attribute.

(28) The textual information in the instance document should have the language attribute as ‘en’

(29) Instance document generated should be as per the valid taxonomy schema otherwise the XML generated will not be properly formed and you might get errors which start with ‘cvc’. This is a basic level error and the software vendor needs to be contacted for these errors i.e. cvccomplextype.2.2. The schema validator used is Xerces from Apache (http://xerces.apache.org/) which is Industry Standard Schema Validator.

(30) Default member of any axis should never come in instance document

(31) Any context in the instance document must not contain segment element in the entity

(32) Namespace of axis, member(If explicit dimension), and item should be same as defined in the taxonomy

(33) All the dimensional contexts should be valid with respect to all the hypercubes of at-least one base Set.

(34) Non-Dimensional element must not contain scenario or segment element in context referred by contextRef

(35) If no value is entered for any Axis having dimension-default, the default value shall be inferred and the same shall be rendered 36) HTML Guidelines:

These guidelines need to be adhered to by the companies to provide the textual information in the instance document. Please note that all textual information would be displayed in the viewer tool / converted human readable document as per the format given by the company in the instance document. Please note that the XBRL content will be rendered in multiple media types (including HTML viewer, print medium, small screen devices, pdf etc). It is required that the embedded HTML for providing textual information is properly rendered in each of the media types. Hence, it is prescribed that the HTML contents follow the below guidelines.

a. All tags must be properly closed and must be in lower case.

b. The following predefined css classes can be used for displaying.

header1 - top level header header2 -

next level header header3 - even next

level header header4 - even next

level header header5 - bottom level

header bordered - tag with visible

borders unbordered - tag with

invisible borders tableHeader -

headers of the table tableRow - row in

the table tableRowLabel - the label for

a row tableRowValue - A value inside

a table normalText - Normal text

noteText1 - For writing a note level 1 (top level) [notes are text that are important to mention, but does not match exactly with the context of the text (not to be confused with

XBRL context). The top level will be shown as most important] noteText2 - For writing a note level 2

noteText3 - For writing a note level 3 noteText4 -

For writing a note level 4 (bottom level)

numericValue - Used for specifying numeric values

nonNumericValue - Used for non-numeric text

highlightedText1 - Highlighted text level 1 (top

level) highlightedText2 - Highlighted text level 2

highlightedText3 - Highlighted text level 3

highlightedText4 - Highlighted text level 4 (bottom level)

c. Specifying style attribute for html tags is not allowed.

d. <div> and <span> tag may be used for organizing content.

e. Multiple classes for the same element can be specified by separating them by space.

f. Only allowed tags are <div>, <span>, <p>,
, <table>, <td>, <tr>, <thead>,<tfoot>, <tbody>, <th>, <col>, <colgroup>. HTML formatting tags like <b>, <i> etc. arenot allowed.

g. Please avoid more than one level of table nesting.

h. Processing instructions are not allowed.

i. The following entities are allowed -   & < >. No other entities are allowed.

1.3.2 Business Specifications

1. The instance document prepared should conform to the business rules framed by MCA for preparation and filing of the cost audit report and compliance report in XBRL mode. The business rules are available on the XBRL website of the Ministry (www.mca.gov.in/XBRL).
2. It is to be noted that these Business Rules are the minimum set of rules which are required to be reported. The complete information as contained in the cost audit report and compliance report; should be reported in the respective XBRL instance documents to be submitted with MCA. It is to be noted that even if any element is optional or exempted in the business rules, but the same is available in the cost audit report/ compliance report, then the same should be reported in the instance documents.
3. It is to be noted here that validation of the instance document on the MCA XBRL validation tool (for costing taxonomy) is with respect to the taxonomy and the MCA business rules. The validation tool is not verifying the quality of tagging, completeness and correctness thereof. The quality of tagging, completeness and correctness of the instance document is the responsibility of the company and the cost auditor/ cost accountant.
4. Since the standard taxonomy as published by MCA is to be used and no extensions are allowed, hence in such cases, companies are required to strictly follow the calculation relationships of taxonomy and derive the totals and sub-totals accordingly. Following the calculation link base will ensure there are no calculation inconsistencies, except for the unavoidable errors which are due to mutually exclusive extended links.
5. It is suggested that whenever any value or information are adjusted or clubbed to match the calculation relationships (and thus are different from the actual cost audit report/ compliance report of the company), a footnote describing the adjustments made should be provided.
6. While specifying members in case of a typed dimension, the member names should be uniform and in sequential order. For eg: While providing product or activity group details in Product or activity group [table] the member may be specified as Product or activity group 1, Product or activity group 2, Product or activity group 3…., Similarly while providing cost auditor details in Details of cost auditor [table] the member names may be specified as Cost Auditor 1, Cost Auditor 2, Cost Auditor 3…..

2. Download MCA XBRL validation tool (for costing taxonomy) from MCA portal

A separate tool has been provided on the MCA XBRL portal for validating the generated XBRL instance document. Validating the instance document with the MCA XBRL validation tool (for costing taxonomy) is a pre requisite before filing the Cost Audit Report and Compliance Report on MCA portal. You are required to download the tool from the portal and validate the instance document before uploading the same. The MCA XBRL validation tool (for costing taxonomy) can be downloaded from the XBRL website of the Ministry (www.mca.gov.in/XBRL). Before Validating an Instance document, the applicable taxonomy is to be selected by the user from the drop down option "taxonomy".

In case the user is under LAN network, then he/she is required to click the link 'Proxy Settings' under 'Taxonomy' menu in the tool to enter the Proxy Host and Port along with user name and password. This is to setup the Internet connection, required to download the taxonomy through the XBRL Validation Tool.

3. Load the Instance Document in the validation tool

To load the instance document, you need to click the open button, select the instance document and open it. You need not exit the tool to load another instance document just click on 'open' again in the menu bar to open the next document. The detail of the company is available under the General Information tag in the XBRL viewer.

4. Use the tool to validate the instance document

The next step is to validate the instance document. The following validations shall be performed by the tool-

- Validating that the instance document is as per the latest and correct version of taxonomy prescribed by MCA
- All mandatory elements have been entered
- Business Rules as specified by MCA
- Validations relating to XBRL technical Specifications as per taxonomy

See the Business Rules provided on the MCA XBRL portal for further details.

To know about 'How to interpret validation errors' please refer Annexure – I

For 'List of common errors' please refer Annexure – II.

5. Perform pre-scrutiny of the validated instance document through the tool

Once the instance document is successfully validated from the tool, the next step is to pre-scrutinise the validated instance document with the help of the same tool. For pre-scrutinizing the instance document, a working internet connection shall be required. In the Pre-scrutiny, the server side validations (i.e. validations which are to be validated from the MCA21 system) shall be performed.

6. Final verification post pre-scrutiny of the document

Once the instance document has been successfully pre-scrutinized, the next step is to generate PDF by using 'Export to PDF' functionality in the tool to verify the final instance document. It is imperative that the company and the cost auditor/ cost accountant should use this feature to verify the accuracy of the instance document.

In case there is PDF conversion error or the size of the converted PDF is zero kilobytes, then check the textual information entered in the instance document and follow the html guidelines provided under the technical specifications to correct the instance document and validate and pre-scrutinize again.

Important Note:

Verification of PDF document is essential to ensure that the textual information entered in the instance document is clearly viewable. It shall be ensured that disclosures in this PDF file are as per the Cost audit report/ Compliance report of the company in all material aspects. It may however be noted that due to XBRL taxonomy, HTML guidelines, etc, the display/presentation of these disclosures may not exactly match with those in Cost audit report/ Compliance report of the company. Such variations in human-readable' PDF version of the XBRL document and Cost audit report/ Compliance report of the company are unavoidable, and thus permitted. In case of validation errors (other than warnings) with respect to non-adherence to the HTML guidelines, PDF document will not be created. For such cases, the HTML guidelines needs to be followed and the instance document needs to be corrected, validated and pre-scrutinized again.

7. Attach instance document to the Form I XBRL and Form A-XBRL or CRA-4 based upon the Costing period for which report is filed

Form I-XBRL and Form A-XBRL or CRA-4 are available on the MCA portal for filing in XBRL instance documents by the Company.

First fill up the relevant Form. Thereafter, attach the validated and pre-scrutinised instance document for Cost Audit Report to Form I-XBRL and instance document for Compliance Report to Form AXBRL.

8. Submitting the Form I-XBRL and Form A-XBRL or CRA-4 on the MCA portal

After the forms are filled, you are required to perform pre-scrutiny of the form, sign the form and then upload the same as per the normal eForm filing process. It shall be validated that the attached instance documents are validated and pre-scrutinised from the XBRL validation tool.

Annexure – I: How to interpret validation errors

Once the validation has been performed you will see a list of errors which have occurred. Please follow the instructions given below to interpret those errors -

- All the Element Names will be shown within single quotes i.e. 'QuantityOfMaterialConsumed'
- All the values will be shown within square brackets i.e. [In Employment]
- All the explicit members must come within curly brackets i.e. {MaterialConsumed1Member}
- All the axis names will be shown within parenthesis i.e. (Identification of Product Or Activity Group Axis)
- Errors which start with "cvc" are those which have occurred for the reason that the instance document generated is not as per valid taxonomy schema and the XML is not properly formed. This is a basic level error and the software vendor needs to be contacted for these errors i.e. cvc-complex-type.2.2. The schema validator used is Xerces from Apache (http://xerces.apache.org/) which is Industry Standard Schema Validator.
- In case of Costing Taxonomy 2012, in some of the errors you might see terms like "table", "axis", "explicit-members" and "typed-members".

  The same has been explained below for your understanding –

  Table (Hypercube) : is a collection of axes (dimensions) when grouped together define an entity.

  Axis (Dimension): is a category used to analyze the information about the items having relationship with a table.

  Explicit-members: are domains that are used to express an explicit dimension. It is an element defined in the taxonomy.

  Typed-members: are domains that are used to express a typed dimension. The dimension value for simple type domain is decided by the user creating instance document.

  For example,

  1) The item 'QuantityOfMaterialConsumed' has a table

  'DetailsOfMaterialConsumedOfProductGroupTable' which is described by an axis

  'DetailsOfMaterialConsumedOfProductGroupAxis'. This axis is further expressed by explicit-members such as 'MaterialConsumed1Member','MaterialConsumed2Member' etc.

  2) The item 'UnitOfMeasurementForProductOrActivityGroup' has a table

  'ProductOrActivityGroupTable' which is described by an axis

  'IdentificationOfProductOrActivityGroupAxis'. This axis is further expressed by a typeddomain 'ProductOrActivityGroupDomain' which is a simple type domain whose value is decided by the user preparing the instance document.
- In case warning messages are displayed, these are in respect of non- compliance to HTML guidelines. You should convert the instance documents into PDF through the validation tool and verify the contents of the same. However the warning messages will not disallow the pre-scrutiny through validation tool.

Annexure – II: List of common errors

1. **Issue in net connectivity. Please check your connection.**

   In case the user is under LAN network, then he/she is required to click the link 'Proxy Settings' under 'Taxonomy' menu in the tool to enter the Proxy Host and Port along with user name and password. This is to setup the Internet connection, required to download the taxonomy through the XBRL Validation Tool.

2. **The PDF is not getting generated or PDF generated is of zero kilobytes in size.**

   For example: Error creating PDF. Resolution: Please check the textual information entered in the instance document and follow the html guidelines provided in section 1.1.3.1 point no. 38 technical specifications to correct the instance document and validate and pre-scrutinize again.

3. **The format of the date entered is not as per the valid format.**

   For example: cvc-datatype-valid.1.2.1: '01-04-2011' is not a valid value for 'date'. Resolution: It should be in 'yyyy-mm-dd'.

4. **For Boolean data types 'Yes' or 'No' has been entered.**

   For example: cvc-datatype-valid.1.2.1: 'yes' is not a valid value for 'boolean'. Resolution: Only 'True' or 'False' can be entered for Boolean DataType.

5. **0-100 entered for Percentage Data Type fields**

   For example: RatioOfOperatingExpenses should be less than equal to 100%. Resolution: Only value between 0-1 needs to be entered. For example to report 60 % as value you need to enter 0.6 in the field.

6. **Wrong Currency code like Rs. entered.**

   For example: cvc-id.1: There is no ID/IDREF binding for IDREF 'Rs'.

   - No valid unit specified for monetary item {http://www.icwai.org/in/xbrl/2012-09-07/in-cost} NetOperationalRevenueOfProductOrActivityGroup
   - No unit defined for unit id Rs
   - Invalid unit specified for monetary item {http://www.icwai.org/in/xbrl/2012-09-07/in-cost} NetOperationalRevenueOfProductOrActivityGroup
   - Reporting currency should be in INR for 'NetOperationalRevenueOfProductOrActivityGroup

Resolution: For Indian Currency 'INR' needs to be entered.

7. **Mandatory fields have not been entered.**

   For example: Element 'NetRevenueFromOperationsOfCompanyForValueAddition' is required - Not present for date: 31/03/2012 Resolution: Please refer Taxonomy and Business Rules for the list of mandatory elements.

8. **For Cost accounting taxonomy for F.Y. 2011-12, if the following error appears – "Element 'DateOfStartOfFirstPreviousFinancialYear' is not present - Required, since element 'DateOfEndOfFirstPreviousFinancialYear' is present for date: 31/03/2012".**

   Resolution: In extended link role [100100] General information, in case the element ''DateOfEndOfFirstPreviousFinancialYear' is provided, then you are required to provide the value of 'DateOfStartOfFirstPreviousFinancialYear' and vice-a-versa.

9. **In case the mandatory line-items of a table are not entered in the instance document.**

   For example: For DetailsOfCostAuditorTable {http://www.icwai.org/in/xbrl/2012-09-07/incostaud/role/CostAuditReportFormII} mandatory items

[‘DisclosureRelatingToAvailabilityOfCostRecordsOfBranchesNotVisitedExplanatory’ ,

‘CostAuditorsObservationsOrSuggestionsExplanatory’] should be present for typedmember:{Detailsofcostauditor1} for date : 31/03/2012

Resolution: The element(s) mentioned in square bracket should be present for all the mentioned typed members(explicit members incase the error is for explicit member).

10. The elements are not entered for any abstract.

For example: All the elements of ‘CostAccountingPolicyAbstract’ are mandatory - Required for date: 31/03/2012. Resolution: The elements which come under this abstract should be provided. Please refer Taxonomy and Business Rules for the list of elements under this abstract.

11. The elements are not entered for ordered explicit members.

For example: Explicit members on axis (DetailsOfMaterialConsumedOfProductGroupAxis) of table DetailsOfMaterialConsumedOfProductGroupTable should be present in sequential order , item(s) for the members { MaterialConsumed3Member } should be present for date: 201103- 31. Resolution: The element should be present for the mentioned explicit member(s). For ordering please refer the presentation linkbase.

12. In case of mandatory table, there is no element present.

For example: Item(s) for TypesOfIndirectTaxesOfCompanyTable {http://www.icwai.org/in/xbrl/2012-09-07/in-cost-aud/role/ReconciliationOfIndirectTaxes} should be present For Period 2011-04-01 to 2012-03-31 Resolution: At least one of the elements of the table should be present for one of the explicit members.

13. The value of element should be provided in at least one of the dimensional member.

For example: Value of element ‘WhetherProductOrActivityGroupCoveredUnderCostAudit’ should be ‘true’ for at least one dimensional member. Resolution: The value for given element should be selected “true” in at least one of all dimensional members in which it is present .Please refer taxonomy and business specifications for such elements and corresponding values.

14. All details for given product or activity group code should be provided.

For example: All details of applicable ProductOrActivityGroupCode [1009] are required for previous year on role ‘[100340] Abridged cost statement of product or activity group’. Resolution: In this case provide the details of product or activity group code which is specified for corresponding ELR’s which are specified in the error statement.

15. An element having dimensional relationship is invalid with respect to scenario element in the referenced context.

For example: item {http://www.icwai.org/in/xbrl/2012-09- 07/incost} DisclosureRelatingToAdequacyOfInternalAuditOfCostRecordsExplanatory in context D2012 does not have any valid hypercube set in any role.

Resolution: The scenario element must be dimensionally valid for at least one definition base set for that element.

All the references to dimensions and dimensional values in scenario element should be as per taxonomy including namespaces. It should not contain any combination of dimension values which are excluded by notAll relationship defined for that element.

It should not contain reference to default dimension value. It should not contain reference to dimension values whose usable attribute is set as false in taxonomy (Freezed).

Study Note - 8

BASICS OF INTERNAL CONTROL AND INTERNAL AUDIT

This Study Note includes

8.1 Internal Control - Concept
8.2 Scope of Internal Control
8.3 Structure of Internal Control
8.4 Limitations of Internal Control
8.5 Evaluation of Internal Control
8.6 Internal Control Questionnaire
8.7 Internal Control and Internal Auditor
8.8 Origin of Internal Audit
8.9 Internal Check and Internal Audit
8.10 Internal Audit and its Scope
8.11 Statutory Auditors and Internal Auditors
8.12 Assessment of Adequacy of Internal Audit Function
8.13 Auditing Government Agencies
8.14 Standards on Internal Audits (SIA)
8.15 Internal Audit Programme – Industires Specific

8.1 INTERNAL CONTROL - CONCEPT

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.

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.

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 now days 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 organisation, 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.

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".

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.

8.2 SCOPE OF INTERNAL CONTROL

It is clear from above that internal control is an essential pre-requisite for efficient and effective management of any organisation 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.

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.

8.3 STRUCTURE OF INTERNAL CONTROL

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. Other wise 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.

8.4 LIMITATIONS OF INTERNAL CONTROL

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?).

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.

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.

It may be added here that most of the internal controls are aimed at anticipated risks or transactions of usual nature. Therefore, un-anticipated event or the transactions of un-usual 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.

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 organisation may become an industrial spy.

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.

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.

8.5 EVALUATION OF INTERNAL CONTROL

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, 2015 (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 system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. It will also include whether there is a continuing failure to correct major weaknesses in internal control system.

The Board of directors of every listed company and the following classes of companies, as prescribed under Rule 6 of Companies (Meetings of Board and its powers) Rules, 2014 shall constitute an Audit Committee:

(i) all public companies with a paid up capital of ₹10 Crores or more;

(ii) all public companies having turnover of ₹100 Crores or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding ₹50 Crores or more.

The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Sub-section (5) of section 177 of the Companies Act, 2013 provides that the Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

The Audit Committee shall have powers to investigate any activity within its terms of reference, to seek information from any employee, to obtain outside legal or other professional advice, to secure attendance of outsiders with relevant expertise, if it considers necessary.

The role of the Audit Committee to (i) evaluation of internal financial controls and risk management systems; (ii) reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems; (iii) 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; (iv) discussion with internal auditors of any significant findings and follow up there on; (v) 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; (vi) 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.

The Audit Committee shall mandatorily review the Internal audit reports relating to internal control weaknesses; and the appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

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 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.

8.6 INTERNAL CONTROL QUESTIONNAIRE

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; (d) Terms of delivery; (e) Terms of transport; (f) Terms of payment; (g) 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 w.r.t. 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 w.r.t. 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 maybe 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 Note 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 cheques 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?			

8.7 INTERNAL CONTROL AND INTERNAL AUDITOR

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

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;

(e) monitoring.

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.

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.

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 organisation 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.

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.

   (v) the accomplishment of established objectives and goals of operation or programmes.

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 is managing the business in the desired direction. Then, the question arises as to the scope of appraisal by the internal auditor to aid management is 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.

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.

8.8 ORIGIN OF INTERNAL AUDIT

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.

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.

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.

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.

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 labourers, 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.

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.

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.

10.2.8 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, 2013.

8.9 INTERNAL CHECK AND INTERNAL AUDIT

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.

Internal auditing, on the other hand is "an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. The objective of internal auditing is to assist members of the organisation 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 organisation 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 organisation.

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.

8.10 INTERNAL AUDIT AND ITS SCOPE

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.

It comprises a complete intra-company financial and operational review, which is undertaken within an organisation 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 organisation 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 organisation to ensure correctness in accounting data and to detect fraud by way of periodical review of organizational systems and procedures.

This definition is also quite clear in explaining the term and has laid emphasis upon "independent appraisal" of the related individuals in the organisation 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.

Internal audit is in fact a control system that functions through examination and appraisal of other control mechanisms operating within the organisation. 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.

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 organisation 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.

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 favour

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

A proper organisation 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 be the Board highlighting significant audit findings.

8.11 STATUTORY AUDITORS AND INTERNAL AUDITORS

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 organisation. 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.

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.

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 very from company to company, whereas the ultimate objective of statutory audit is same in all the companies.

The qualifications of the statutory auditors are prescribed under the provisions of section 148 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 143 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.

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.

8.12 ASSESSMENT OF ADEQUACY OF INTERNAL AUDIT FUNCTION

Sometimes it is required to assess the adequacy of internal audit function of an organisation. 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?

8.13 AUDITING GOVERNMENT AGENCIES

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 Functions* (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.*

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.

The typical definition of a financial audit would not include elements 2 and 3. These are operational auditing techniques.

8.14 STANDARDS ON INTERNAL AUDITS (SIA)

Internal Audit – India

i. Clause 49 of Listing Agreement - Responsibility of audit committee to review adequacy of internal audit function and internal audit reports.

ii. The Board of directors of every listed company and the following classes of companies, as prescribed under Rule 6 of Companies (Meetings of Board and its powers) Rules, 2014 shall constitute an Audit Committee:

   (a) all public companies with a paid up capital of ₹10 Crores or more;

   (b) all public companies having turnover of ₹100 Crores or more;

   (c) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding ₹50 Crores or more.

   The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

iii. Companies (Auditor's Report) Order, 2015 - The Central Government, in terms of the power vested under Section 143(11) of the Companies Act, 2013 had notified the Companies (Auditor's Report) Order, 2015. Clause (iv) of CARO, 2015 requires the auditor to report as follows: is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a continuing failure to correct major weaknesses in internal control system.

iv. Section 581 ZF of the Companies Act, 1956 requires that every Producer Company shall have internal audit of its accounts carried out by a chartered accountant, at such interval and in such manner as may be specified in articles.

v. The Securities and Exchange Board of India has mandated complete internal audit on a half-yearly basis for stock brokers/trading members/clearing members.

vi. IRDA (Investment) (Fourth Amendment) Regulations, 2008 has introduced requirements o quarterly internal audit for insurers.

vii. Companies going in for tapping the international capital market, especially, those seeking listing in US stock exchanges, NASDAQ, NYSE, etc., also need a strong internal audit function to meet the stringent corporate governance and internal control requirements of those stock exchanges. In this context, the US companies, having US public as investor also needs to comply with the requirements of Sections 302 and 404 of the Sarbanes Oxley Act of 2002.

Framework of SIA

The Framework for Standards on Internal Audit comprises four components viz., the Code of Conduct, the Competence Framework, the Body of Standards and the Technical Guidance.

Internal audit is conducted in variant economic, legal, cultural and business environments. The organisations in which internal audit is performed differ widely in size, structure, nature of business, scale, purpose, objectives and geographical spread. Further, the internal audit activity may be performed by an entity's employees or by some external agency. Thus, the Framework for Standards on Internal Audit applies to all the persons performing internal audit activity, irrespective of whether the function is performed in-house or by an external agency.

Purpose of SIA

- To provide standards for quality of services during an internal audit
- To codify the best practices in internal audit services

Scope of SIA

The SIA shall apply whenever an internal audit is carried out. The SIA(s) are mandatory from the respective date(s) mentioned in the SIA(s). However, any limitation in the applicability of a specific Standard shall be made clear in the Standard. The mandatory status of a Standard on Internal Audit implies that while carrying out an internal audit, it shall be the duty of the members of the Institute to ensure that the SIAs are followed. If, for any reason, a member has not been able to perform all or any of such activities, as mentioned in accordance with the SIAs, his report should draw attention to the material departures therefrom.

Summary of Standards on Internal Audit ('SIA') Issued By ICAI

SIA 1: Planning an Internal Audit

i. Planning involves developing an overall plan for the expected scope and conduct of audit and developing an audit programme showing the nature, timing and extent of audit procedures.

ii. Develop and document a plan in consultation with those charged with governance, including the audit committee for each internal audit engagement.

iii. Objectives of internal audit engagement as well as time and resources required for conducting the engagement be considered. Internal audit plan should also reflect risk management strategy of the entity.

iv. Internal audit plan should cover areas such as obtaining knowledge of legal and regulatory framework within which the entity operates, obtaining knowledge of the entity's accounting and internal control systems and policies, determining the effectiveness of internal control procedures adopted by the entity, determining the nature, timing and extent of procedures to be performed, identifying activities warranting special focus based on materiality and criticality of such activities, and their overall effect on operations of the entity, identifying and allocating staff to different activities to be undertaken.

v. Planning process includes obtaining knowledge of business, establishing the audit universe, establishing the objectives of engagement, establishing scope of the engagement, deciding resource allocation, preparation of audit programme.

vi. Plan to be finalised in consultation with the appropriate authority before commencement of the work

SIA 2: Basic Principles Governing Internal audit

i. Internal auditor should adhere to the basic principles governing an internal audit.

ii. These principles are integrity, objectivity and independence, confidentiality, skills and competence, work performed by others, documentation, planning, internal audit evidence, accounting system and internal control, and internal audit conclusions and reporting.

SIA 3: Internal Audit Documentation

i. Internal audit documentation should be designed and properly organized to meet the requirements and circumstances of each audit. To formulate policies for standardization of internal audit documentation.

ii. It should be sufficiently complete and detailed for an internal auditor to obtain an overall understanding of the audit.

iii. All significant matters which require exercise of judgment, together with internal auditor's conclusion thereon should be included in the internal audit documentation. Documentation prepared by internal auditor should enable reviewer to understand:

  - the nature, timing and extent of audit procedures performed to comply with SIAs and applicable legal and regulatory requirements;
  - the results of audit procedures and audit evidence obtained;
  - significant matters arising during the audit and conclusions reached thereon; and
  - terms and conditions of an internal audit engagement/requirements of internal audit charter, scope of work, reporting requirements, any other special conditions, affecting the internal audit.

iv. It should cover all the important aspects of an engagement viz., engagement acceptance, engagement planning, risk assessment and assessment of internal controls, evidence obtained and examination/evaluation carried out, review of the findings, communication and reporting and follow up.

v. The internal audit file should be assembled within sixty days after the signing of the internal audit report.

vi. To formulate policies as to the custody and retention of the internal audit documentation within the framework of the overall policy of the entity in relation to the retention of documents.

SIA 4: Reporting

i. To review and assess the analysis drawn from internal audit evidence obtained as the basis for his conclusion on the efficiency and effectiveness of systems, processes and controls including items of financial statements.

ii. Report clearly expressing significant observations, suggestions/recommendations based on the policies, processes, risks, controls and transaction processing taken as a whole and managements' responses.

iii. Report includes basic elements such as title, addressee, report distribution list, period of coverage of the report, opening or introductory paragraph, objectives paragraph, scope paragraph (describing the nature of an internal audit), executive summary (highlighting key material issues, observations, control weaknesses and exceptions), observations, findings and recommendations made by the internal auditor, comments from the local management, action taken report – action taken/not taken pursuant to the observations made in the previous internal audit reports, date of the report, place of signature and Internal auditor's signature with membership number.

iv. To facilitate communication and ensure that recommendations presented in final report are practical from the point of view of implementation, the internal auditor should discuss the draft with the entity's management prior to issuing the final report. The different stages of communication and discussion should be discussion of draft, Exit meeting, formal draft, submission of final report.

v. When there is a limitation on the scope of internal auditor's work, the internal auditor's report should describe the limitation.

vi. To state in the report that the same is to be used for the intended purpose only as agreed upon and the circulation of the report should be limited to the recipients mentioned in the report distribution list.

SIA 5: Sampling

i. Design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence to meet the objectives of internal audit engagement unless otherwise specified by the client.

ii. When designing an audit sample, internal auditor should consider specific audit objectives, the population from which internal auditor wishes to sample, and the sample size.

iii. When determining the sample size, internal auditor should consider sampling risk, tolerable error and the expected error.

iv. To select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items or sampling units in the population have an opportunity of being selected.

v. Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the internal auditor should:

- analyse the nature and cause of any errors detected in the sample;
- project the errors found in the sample to the population;
- reassess the sampling risk; and
- consider their possible effect on the particular internal audit objective and on other areas of internal audit engagement

vi. To evaluate the sample results to determine whether the assessment of relevant characteristics of the population is confirmed or whether it needs to be revised.

SIA 6: Analytical Procedure

i. To apply analytical procedures as the risk assessment procedures at the planning and overall review stages of internal audit.

ii. Analytical procedures are analysis of significant ratios and trends including resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

iii. Factors to be considered for analytical procedures are significance of the area being examined, adequacy of the system of internal control, availability and reliability of financial and non–financial information, the precision with which results of analytical procedures can be predicted, availability and comparability of information regarding the industry in which the organization operates, the extent to which other auditing procedures provide support for audit results. After evaluating the aforementioned factors, internal auditor should consider and use additional auditing procedures, as necessary, to achieve the audit objective.

iv. To apply analytical procedures at or near the end of internal audit when forming an overall conclusion as to whether the systems, processes and controls as a whole are robust, operating effectively and are consistent with the internal auditor's knowledge of the business.

v. When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

SIA 7: Quality Assurance in Internal Audit

i. A system for assuring quality in internal audit should provide reasonable assurance that the internal auditors comply with professional Standards, regulatory and legal requirements, so that the reports issued by them are appropriate in the circumstance. In order to ensure compliance with the professional standards, regulatory and legal requirements, and to achieve the desired objective of internal audit, a person within the organization should be entrusted with the responsibility for the quality in the internal audit, whether done in–house or by an external agency.

ii. In case of in–house internal audit or a firm carrying out internal audit, the person entrusted with the responsibility for the quality in internal audit should ensure that the system of quality assurance includes policies and procedures addressing leadership responsibilities for quality in internal audit, ethical requirements, acceptance and continuance of client relationship and specific engagement, as may be applicable, human resources, engagement performance, monitoring The quality assurance framework should cover all the elements of internal audit activity.

iii. The internal quality review framework should be designed with a view to provide reasonable assurance that the internal audit is able to efficiently and effectively achieve its objectives of adding value and strengthening the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system.

iv. The internal quality reviews should be undertaken on an ongoing basis. The person entrusted with the responsibility for quality in internal audit should ensure that recommendations resulting from the quality reviews for improvements in the internal audit activity are promptly implemented.

v. Internal quality reviews are also communicated to appropriate levels of management and those charged with governance on a timely basis along with the proposed plan of action to address issues and concerns raised in the review report.

External quality review is a critical factor in ensuring and enhancing the quality of internal audit

SIA 8: Terms of Internal Audit Engagement

i. Internal auditor and the auditee should agree on the terms of engagement before commencement. Terms should be approved by the Board of Directors or a relevant Committee thereof such as the Audit Committee or such other person(s) as may be authorised by the Board in this regard.

ii. It should contain a statement in respect of the scope of internal audit engagement.

iii. It should clearly mention that internal auditor would not be involved in the preparation of auditee's financial statements. It should also be made clear that the internal audit would not result in the expression of an opinion or any other form of assurance on the auditee's financial statements or any part thereof.

iv. The terms of engagement should clearly mention the responsibility of the auditee vis-a-vis the internal auditor.

v. It should provide the internal auditor with requisite authority, including unrestricted access to all departments, records, property and personnel and authority to call for information from concerned personnel in the organization.

vi. The internal auditor should have full authority on his technologies and other properties like hardware and audit tools he may use in course of performing internal audit.

vii. It should be clear that the ownership of working papers rests with internal auditor and not the auditee.

viii. The engagement letter should contain a condition that the report of internal auditor should not be distributed or circulated by the auditee or the internal auditor to any party other than that mutually agreed between the internal auditor and auditee unless there is a statutory or a regulatory requirement to do so.

ix. There should be a clear understanding among internal auditor and auditee as to the basis on which the internal auditor would be compensated, including any out of pocket expense, taxes etc, for the services performed by him.

x. It should contain a statement that the internal audit engagement would be carried out in accordance with the professional Standards applicable to such engagement as on the date of audit.

SIA 9: Communication with Management

i. Internal auditor while performing audit should communicate clearly the responsibilities of internal auditor and an overview of the planned scope and timing of audit with the management.

ii. Communication regarding the planned scope and timing of internal audit may assist the management to understand better the objectives of internal auditor's work, to discuss issues of risk and materiality with internal auditor and to identify any areas in which they may request the internal auditor to undertake additional procedures, assist the internal auditor to understand the entity and its environment better.

iii. Different stages of communication and discussion should be: discussion of draft; exit meeting; formal draft; and final report.

iv. Clear communication of internal auditor's responsibilities, planned scope and timing of internal audit and expected general content of communications helps establishing the basis for effective two–way communication.

v. Appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include significance and nature of the matter, and the action expected to be taken by management.

vi. Where matters required by this SIA to be communicated, are orally communicated, internal auditor shall document them and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of internal audit documentation.

SIA 10: Internal Audit Evidence

i. To obtain sufficient appropriate evidence to enable him to draw reasonable conclusions therefrom on which to base his opinion or findings.

ii. Scope of an internal audit is much broader in comparison to that of statutory audit. The depth of coverage of internal audit, being a management function, would also be much wider. An internal audit function normally is spread beyond checking of financial transactions and is expected to cover comments on internal control systems, risk management, propriety aspect of transactions.

iii. To evaluate sufficiency of appropriate audit evidence before conclusions therefrom. The internal audit evidence should enable internal auditor to form a opinion on the scope of the terms of engagement.

iv. The reliability of internal audit evidence depends on its source – internal or external and on its type.

v. When internal audit evidence obtained from one source is inconsistent with that obtained from another, or the internal auditor has doubts over the reliability of information to be used as internal audit evidence, the internal auditor shall determine what modifications to or additional audit procedures are necessary to resolve the matter.

vi. Various methods for obtaining audit evidence include inspection, observation, inquiry and confirmation, computation and analytical review.

SIA 11: Consideration of Fraud in an Internal Audit

i. An internal auditor is not expected to possess skills and knowledge of a person expert in detecting and investigating frauds, he should, however, have reasonable knowledge of factors that might increase the risk of opportunities for frauds in an entity and exercise reasonable care and professional skepticism while carrying out internal audit.

ii. A system of internal control comprise of following five elements namely control environment, entity's risk assessment process, information system and communication, control activities and monitoring of controls. It is essential for internal auditor to gain an understanding of the components of system of internal control.

iii. The primary responsibility for prevention and detection of frauds is that of the management of the entity. The internal auditor should, however, help the management fulfill its responsibilities relating to fraud prevention and detection.

iv. To obtain an understanding of the various aspects of control environment and evaluate the same as to the operating effectiveness.

v. To evaluate the mechanism in place for supervision and assessment of internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.

vi. To carefully review and assess conclusions drawn from audit evidence obtained. Actual or suspected fraud or any other misappropriation of assets should be immediately reported to management.

vii. To document fraud risk factors identified as being present during internal auditor's assessment process and document internal auditor's response to any other factors.

SIA 12: Internal Control Evaluation

i. The system of internal control must be under continuous supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in environment. Internal control system extends beyond those matters which relate directly to the functions of accounting system and comprises of control environment and control activities.

ii. To examine the continued effectiveness of internal control system through evaluation and make recommendations, if any, for improving that effectiveness. To focus towards improving internal control structure and promoting better corporate governance.

iii. To obtain an understanding of significant processes and internal control systems sufficient to plan the internal audit engagement and develop an effective audit approach, assess and evaluate the maturity of entity's internal control, assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.

iv. To evaluate internal control system in an entity, based on various criteria x To ensure segregation of duties between various functions.

v. Tests of control are performed to obtain audit evidence about the effectiveness of design of internal control systems.

vi. Based on the results of tests of control, internal auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. To consider whether internal controls were in use throughout the period.

vii. To identify internal control weaknesses that has not been corrected and make recommendations to correct those weaknesses.

viii. When internal controls are found to contain continuing weaknesses, internal auditor should consider whether management has increased supervision and monitoring, additional or compensating controls have been instituted and/or management accepts the risk inherent with control weakness

ix. To evaluate identified control deficiencies and then determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses

x. Report to the management should provide a description of significant deficiency or material weakness in internal control. His opinion on possible effect of such weakness on entity's control environment

SIA 13: Enterprise Risk Management

i. Risk is an event which can prevent, hinder, fail to further or otherwise obstruct the enterprise in achieving its objectives. Risk may be broadly classified into Strategic, Operational, Financial and Knowledge.

ii. ERM is a structured, consistent and continuous process of measuring or assessing risk and developing strategies to manage risk within the risk appetite. It involves identification, assessment, mitigation, planning and implementation of risk and developing an appropriate risk response policy. Management is responsible for establishing and operating the risk management framework.

iii. ERM process consists of Risk identification, prioritization and reporting, Risk mitigation, Risk monitoring and assurance. The corporate risk function establishes the policies and procedures, and the assurance phase is accomplished by internal audit. The role of internal auditor is to provide assurance to management on the effectiveness of risk management.

iv. Nature of internal auditor's responsibilities should be adequately documented and approved by those charged with governance.

v. To review the maturity of an ERM structure by considering whether the framework so developed, inter alia protects the enterprise against surprises, stabilizes overall performance with less volatile earnings, operates within established risk appetite, protects ability of the enterprise to attend to its core business and creates a system to proactively manage risks.

vi. To review whether the ERM coordinators in the entity report on the results of assessment of key risks at appropriate levels, which are, inter alia risk Management Committee, Enterprise Business and Unit Heads, Audit Committee.

vii. To submit his report to the Board or its relevant Committee, delineating the following information Assurance rating (segregated into High, Medium or Low) as a result of the review, Tests conducted, Samples covered and Observations and recommendations.

SIA 14: Internal Audit in an Information Technology Environment

i. The overall objective and scope of an internal audit does not change in an IT environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and the interplay of processes, systems and control procedures. This may affect the internal control systems employed by the entity. Accordingly, an IT environment may affect the procedures followed by the internal auditor in obtaining a sufficient understanding of the processes, systems and internal control system and the auditor's review of the entity's risk management and continuity systems.

ii. To consider the effect of an IT environment on internal audit engagement, inter alia the extent to which IT environment is used to record, compile, process and analyse information and the system of internal control in existence in the entity with regard to flow of authorised, correct and complete data to the processing centre, the processing, analysis and reporting tasks undertaken in the installation and the impact of computer–based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.

iii. To have sufficient knowledge of information technology systems to plan, direct, supervise, control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of the IT environment. The internal auditor should consider whether any specialised IT skills are needed in the conduct of audit, for example, the operating knowledge of a specialised ERP system.

iv. If specialized skills are needed, the internal auditor should seek the assistance of a technical expert possessing such skills, who may either be the internal auditor's staff or an outside professional. If the use of such a professional is planned, the internal auditor should obtain sufficient appropriate evidence that the work performed by the expert is adequate for the purposes of the internal audit.

v. To obtain an understanding of the systems, processes, control environment, risk– response activities and internal control systems sufficient to plan the internal audit and to determine the nature, timing and extent of the audit procedures.

vi. When the information technology systems are significant, the internal auditor should also obtain an understanding of IT environment and whether it influences the assessment of inherent and control risks. The nature of risks and internal control characteristics in IT environments include the Lack of transaction trails, Uniform processing of transactions, Lack of segregation of functions, Potential for errors and irregularities, Initiation or execution of transactions, Dependence of other controls over computer processing, Potential for increased management supervision, Potential for the use of computer–assisted audit techniques.

vii. To review whether the information technology system in the entity considers the confidentiality, effectiveness, integrity, availability, compliance and validity of data and information processed. To review the effectiveness and safeguarding of IT resources, including – people, applications, facilities and data.

SIA 15: Knowledge of the Entity and its Environment

i. To obtain knowledge of the economy, entity's business and its operating environment, including its regulatory environment and the industry in which it operates, sufficient to enable him to review the key risks and entity–wide processes, systems, procedures and controls. To identify sufficient, appropriate, reliable and useful information to achieve the objectives of the engagement.

ii. Prior to accepting an engagement, the internal auditor should obtain a preliminary knowledge of the industry and of the nature of ownership, management, regulatory environment and operations of the entity subjected to internal audit, and should consider whether a level of knowledge of the entity's business adequate to perform the internal audit can be obtained.

iii. Following the acceptance of the engagement, further and more detailed information should be obtained. To the extent practicable, the internal auditor should obtain the required knowledge at the commencement of the engagement. As the internal audit progresses, that information should be assessed, enhanced, updated, refined and validated as the internal auditor and the engagement team obtain more knowledge about the entity's business.

iv. In case of continuing engagements, internal auditor should update and re– evaluate information gathered previously, including information in the prior year's working papers. The internal auditor should also perform procedures designed to identify significant changes that have taken place in the operations, control environment, technology and strategic processes since the last internal audit.

v. To obtain sufficient, appropriate information about the entity. An understanding of business risks facing the entity increases the likelihood of identifying risks of material misstatement in the information subject to internal audit.

vi. Knowledge of the entity's business is a frame of reference within which the internal auditor exercises professional judgment in reviewing the processes, controls and risk management procedures of the entity.

vii. To ensure that the internal audit engagement team assigned to an internal audit engagement obtains sufficient knowledge of the business to enable them to carry out internal audit work delegated to them. The internal auditor should also ensure that the audit team appreciates and understands the need tobe alert for additional information and the need to share that information with the internal auditor and other members of internal audit team.

viii. To make effective use of knowledge about the business, internal auditor should consider how this knowledge acquired, affects his review of internal controls and systems taken as a whole and whether his overall entity–wide assessment of systems, procedures, controls and risk management principles are consistent with his knowledge of the entity's business.

ix. The information and knowledge obtained by the internal auditor on the entity and its environment should be adequately documented in the engagement working papers.

SIA 16: Using the Work of an Expert

i. To obtain technical advice and assistance from competent experts if the internal audit team does not possess necessary knowledge, skills, expertise or experience needed to perform all or part of the internal audit engagement.

ii. When the internal auditor uses the work of an expert, he should satisfy himself about the competence, objectivity and independence of such expert and consider the impact of such assistance or advice on the overall result of internal audit engagement, specially in cases where the outside expert is engaged by senior management or those charged with governance.

iii. When determining whether to use the work of an expert or not, internal auditor should consider the materiality of the item being examined, the nature and complexity of the item including the risk of error therein, the other internal audit evidence available with respect to the item.

iv. When the internal auditor plans to use the expert's work, he should satisfy himself as to the expert's skills and competence. To consider the objectivity of the expert. To satisfy himself that the expert has no personal, financial or organizational interests that will prevent him from rendering unbiased and impartial judgments and opinion.

v. When the internal auditor intends to use the work of an expert, he should gain knowledge regarding the terms of the expert's engagement. To seek reasonable assurance that the expert's work constitutes appropriate evidence in support of the overall conclusions formed during the internal audit engagement. To consider whether the expert has used source data which are appropriate in the circumstances.

vi. In exceptional cases where the work of an expert does not support related representations in the overall systems, procedures and controls of the entity, the internal auditor should attempt to resolve the inconsistency by discussions with the auditee and the expert.

vii. The internal auditor should not, normally, refer to the work of an expert in the internal audit report.

SIA 17: Consideration of Laws and Regulations in an Internal Audit

i. It is the primary responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

ii. The objectives of the internal auditor are to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, to perform specified audit procedures to help identify instances of noncompliance with other laws and regulations that may have a significant impact on the functioning of the entity and to respond appropriately to non–compliance or suspected non–compliance with laws and regulations identified during the internal audit.

iii. Since the role of an internal auditor is to carry out a continuous and critical appraisal of the functioning of an entity and suggest improvements thereto, the identification of non–compliance with laws and regulations is also an inherent part of his responsibilities.

iv. Internal auditor should obtain an Understanding of the Legal and Regulatory Framework. The internal auditor shall inquire from the management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and Inspecting correspondence, if any, with the relevant licensing or regulatory authorities to help identify instances of non–compliance with other laws and regulations that may have a significant impact on the entity's functioning.

v. The internal auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non–compliance or suspected non–compliance with laws and regulations which impact the functioning of the entity, including the reporting framework, have been disclosed to the internal auditor.

vi. If the internal auditor becomes aware of information concerning an instance of non–compliance or suspected non–compliance with laws and regulations, the internal auditor shall obtain an understanding of the nature of the act and circumstances in which it has occurred and further information to evaluate the possible effect on the functioning of the entity. The internal auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence.

vii. The internal auditor shall evaluate implications of non–compliance in relation to other aspects of internal audit, including the internal auditor's risk assessment and the reliability of written representations, and take appropriate action.

viii. If the internal auditor concludes that non–compliance has a significant impact on the functioning of an entity and has not been adequately dealt with by the management, the internal auditor shall report the same in accordance with SIA 4, "Reporting". If the internal auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non–compliance that may be significant to the functioning of the entity has, or is likely to have, occurred, the internal auditor should report the same.

8.15 INTERNAL AUDIT PROGRAMME – INDUSTIRES SPECIFIC

(A) INTERNAL AUDIT PROGRAMME IN PLANTATION INDUSTRIES

INTRODUCTION

1. Importance of Plantatation Industry in Indian Economy in terms of total turnover, employment generation, etc.:

Plantation Industry plays an important role in Indian econonomy in terms of both economic value addition as well employment generation as the Indian economy is still predominenetly an agrarian economy. Further, the following three industries constitute a major share of the total plantation industry:

i) Tea plantartion;

ii) Rubber plantation;

iii) Coffee plantation.

Total size of these three industries taken together in terms of turnover is Rs……… Besides this, plantion industry, particulary, Tea and Coffee, are also the two major foreign exchange earners of the country.

Plantation Industry is the employment provider to a large mass of people, particularly, in the areas inhabited by backward classes and tribes whose level of skill is much lower in comprison to the skill of urban industrial labour.The above three industries taken together provide direct employment to 2.02 million workers and provides indirect employment to another population of size almost double the above fitgure. In some part of the country, for example, North-Eastern Region, economy mostly revolves around the plantation industry.

2. Unique features of Plantation Industry :

Plantation Industry is the only Industry where the total activities ,starting from the agricultural activities involving the production of raw-materials to the manufacturing activities for finished products are located at the same placeunder the umabrage of the single management . In case of most of the organisations engaged in plantation industry, the organisation handles all activities pertaining to production of raw-materials, production of finished products and marketing of the finished products also.

At the Estate level, the strength of the managerial staff is much less as compared to the total number of workers engaged. The ratio of the total number of managerial staff to the total number of workers is much lower than the same ratio for other industries. At the Estate level, most of the managerial staff has to handle multiple operational functions like overseeing the agricultural activities, manufacturing, labour management ,office administration etc.

Plantation Industry is highly labour intensive. Not only that, majority of the workforce directly attached with the plantation industry reside in the labour quarters situtated within the Estate. As aresult, the Management has to look after the total maintenance of the labour quarters , maintainance of law and order situation as well as general administration of labour lines and smooth provisioning of the entitlements to which workers are entitled statutorily.

The output in plantation industry is also highly dependent on the climatic condition.

3. Needs of Plantation Industry for a strong Internal Control System and consequent importance of integrated and well-organised Internal Audit System in Plantation Industry :

The basic nature of Plantation Industry and its unique features demand the existence of a strong internal control system in Plantation Industry due to the following reasons :

(i) As the field productivity of the raw materials vis-à-vis the quantum of output is highly dependent on the condition of the weather – common to any agro-based product, the input-output ratio cannot be fixed rigorously and at the same time, the total quantum of output of final product cannot also be forecast with substantial acuracy many a times;

(ii) The total operation of the Estate is controlled by a few managerial staff as compared to the vastness of the area of the estate and variety of operational functions involved;

(iii) Because of this vastness of the total area of any Estate being looked after by a small number of managerial staff usually, it becomes very difficult to exercise personal managerial supervision in all cases;

(iv) Sometimes , It becomes difficult to exercise the managerial supervision on the workers, to the fullest extent considering the low ratio of managerial staff and the number of workers and the Estate Management has to depend on the supervisory staff for most of the operations.

In view of the above factors, any plantation industry requires a strong well-structured internal control system to achieve the economic viability of the Industry as well as its smooth operation. Consequently, the existence of an integrated and well-organised Internal Audit Syustem is very important in Plantation Industry because a structured Internal Audit system will continuously assess the existence and effectiveness of the internal control system in all the operational areas. Internal Audit will point out any gap found in the Internal Control system in all the operational areas and will also facilitate the continuous improvement in the Internal Control System and procedures.

To achieve these objectives, Internal Auditors have to take a pragmatice and practical approach while framing the Internal Audit Programme and also in preparation of the Internal Audit Check List without compromising with the professional requirements. Internal Auditor shall also apprise himself of the basic features and peculiarities of the Industry and also the age-old established practices prevalent in the Estate. In any agro-based Industry, there are certain customs and practices prevalent in a particular region which have very important role to play in the operation of agriculture in that particular area and in maintaining smooth industrial relations.

MODEL INTERNAL AUDIT PROGRAMME

1. Sales :

1.1 For Tea

(i) Auction Sales & Private Sales :

a) Price recovery of each sale - Comparison with Brokers Valuation - Comparison with Sale Average of respective Auctions as well as Price realized by neighboring gardens or the Circles to which the estate belongs;

b) Comparison of Price recovery between Auction Sale & Private Sale;

c) Crop Book ;

d) Allocation of Tea among Private Sale & Out-market sale;

e) Realisation of Sale proceeds – both Private Sale & Auction Sale;

f) Payment of Brokers' Commission;

g) Review of Debtors' Ledger .

(ii) Export Sale :

(a) Fixation of price ;

(b) Approval of samples ;

(c) Shipping of Consignment ;

(d) Realisation of Sale Proceeds ;

(e) Realisation of Export Benefits.

1.2 For Rubber :

a) Review of the customer base of different grades of rubber i.e. Cenex, Crumb (Indian Standard Natural Rubber or ISNR), Skim Crepe, Sheet Rubber etc. ;

b) Process of fixation of Sales Price ;

c) Examination of customers' Purchase Orders ;

d) Process of Invoicing including compliance of Statutory requirements of the Rubber Board and Sales Tax/VAT Act of the respective States ;

e) Realisation of Sale Proceeds including review of Debtors Ledger .

2 Warehousing:

a) Examination of process of selection of warehouses and fixation of warehousing charges;

b) Scrutiny of the contracts with warehouses;

c) Examination of process of documentation at warehouses relating to receipt of material, despatch of material;

d) Physical verification of warehouse stock;

e) Examination of warehouse records.

3. Transportation Contract – for Finished Products & Stores Materials :

a) Examination of process of selection of Transporters;

b) Examination of credentials of Transporters;

c) Fixation of Rates of transportation – Full Lorry Load & Part Lorry Load;

d) Examination of terms of contract with the transporters including price variation clause;

e) Checking the system of processing the bills of the transporters;

f) Checking the system of recovery from the transporters, of the cost of damages / loss in transit/ shortages ;

g) Examination of system of maintenance of related records.

4. Insurance Matters :

a) Examination of Policy Coverages;

b) Examination of Adequacy of Policy Coverages;

c) Insurance Claims & Realisation of Insurance Claims;

d) Scrutiny of Records pertaining to Insurance Claims;

e) Review of Status of outstanding claims.

5. Purchase :

a) Review of Purchase Policy with special emphasis on procurement of agricultural inputs, machinery spares and packing materials;

b) Examination of individual Purchase transactions with reference to Company's Purchase Procedure;

c) Examination of local purchase transactions made at estates with reference to the company's purchase policy and laid down procedure, if any ;

d) System of payment to Suppliers including payment of advance, recovery of advance paid to suppliers – Scrutiny of outstanding advance to suppliers.

6. Capital Expenditure :

(i) Capital Budget;

(ii) Procedures followed for decision regarding specification, design, manufacturer, etc. for Capital assets to be procured;

(iii) Examination of the Credentials of the Vendors submitting quotations;

(iv) Authorisation & Placement of Order for procurement;

(v) Installation of Capital items.

7. Purchase of Green Leaf :

(i) Selection of suppliers;

(ii) Fixation of Price with reference to fine leaf count;

(iii) Records relating to daily receipt of consignments of purchased Greenleaf;

(iv) Records relating to leaf count of Bought Leaf;

(v) Recovery %age of Bought Leaf

8. Purchase of Field Latex :

(i) Selection of supplier;

(ii) Fixation of Price vis-à-vis Dry Rubber Content (DRC) %age;

(iii) Records relating to receipt of consignments;

(iv) Records pertaining to measurement of DRC %age – consignment-wise.

9. Slaughter Tapping :

(i) Selection of Contractors;

(ii) Fixation of price and realization of sale proceeds with reference to terms of contract;

(iii) Fixation of Price for buy-back of field latex collected through slaughter tapping;

(iv) Records relating to measurement of DRC percentage;

(v) Payment for field latex bought back.

10. Civil Construction & Other Contracts including Contracts for Repairs to Building, Machinery & Vehicles:

i) System of awarding contracts – Selection of Contractors – Fixation of rates and other Terms & conditions;

ii) Process of minor repairs to Buildings, e.g. Bungalows, Labour Quarters, Factory, etc.;

iii) Maintenance of Measurement Book;

iv) Monitoring progress of work & Bill Passing;

v) System of payment to Contractors including payment of AdvanceExamination of maintenance of records of expenditure of individual assets

vi) Checking of comparative expenditure on vehicles, machinery items & buildings for last 3 / 4 years;

vii) Control system for issue of machinery & vehicle spares for repairs within the Estate;

viii) Control system for repair of machinery & vehicles in Workshops outside the Estate;

ix) Maintenance of Accounts for materials consumed in respect of civil construction/ repairs done internally;

x) Examination of major expenditures incurred within the year, in particular the expenditure on overhauling of machinery.

11. Cultivation :

(i) Examination of Land Records, Cadastral Map, Drainage Map, etc.

(ii) Examination of Standard task fixed for each agricultural operation to measure output and procedure followed for such fixation of tasks.

(iii) Drainage : Checking of Drainage Program and its implementation;

(iv) Application of agricultural inputs :

(a) Checking of program for application of agricultural inputs, i.e. Manure, Pesticides, Weedicides;

(b) Checking of records for application of agricultural inputs;

(v) Checking of Maintenance of records for other agricultural operations

(vi) Weighing of raw-materials at field – Green Leaf, Coffee seeds & field latex - Checking of procedures followed for weighment of Green Leaf/ Coffee Seeds and Field Latex including maintenance of relevant records;

(vii) System of control for stock of Sprayers;

(viii) Maintenance of records for DRC percentage (in case of rubber) of daily collection of field latex by individual workers for payment of wages and incentives to tappers;

12. Yield Analysis vis-à-vis Examination of Vacancy Percentage :

(i) Examination of Section No./Field No. wise Yield Record;

(ii) Study of Section/Field No. wise Comparative Yield Analysis;

(iii) Study of the yield of the Sections/ fields planted/replanted in last 10 yrs;

(iv) Study of the low yielding sections/ fields;

(v) Examination of system of identification of vacancy in Sections/ Fields;

(vi) Examination of records pertaining to Vacancy;

(vii) Examination of Rehabilitation Programme for reduction Vacancy Percentage.

13. Extension Planting/ Replantation :

(i) Programme for new extension/ replantation for the year under audit and next 5 years;

(ii) Basis of selection of replantation areas;

(iii) Budget for extension planting/ re-plantation;

(iv) Implementation of Extension/ Replantation Programme;

(v) Examination of expenditure on uprooting (in case of replantation) and records pertaining to measurement of uprooted tea bush, coffee plants, shade trees and rubber trees and their subsequent utilization / sale;

(vi) Records maintained for areas under Extension planting/ Replantation;

(vii) Expenditure on Plantation and Maintenance of newly planted /re-planted area;

(viii) Analysis of Cost per Hectare for plantation / replantation and on maintenance in respect of individual section Nos./ field Nos.;

(ix) Compliance with the formalities for availing incentives from Tea Board/ Rubber Board for Extension planting & replantation;

(x) Year-wise yield analysis for the sections/ fields which have come into bearing in last 7 years.

14. Nursery :

(i) Budget for requirement of Plants for next 3 years for Planting & infilling

(ii) Plan for Nursery including type of Nursery – Clonal or Seedlings;

(iii) Examination of Nursery records;

(iv) Examination of Nursery Expenses and utilization of materials;

(v) Examination of Nursery Cost :

a) Actual cost per plant vis-à-vis budgeted cost per Plant;

b) Cost per Plant of Shade Nursery (for Tea only) vis-à-vis Budgeted Cost per Plant;

(vi) Verification of Plantation Records;

(vii) Survival/ Success percentage of Nursery;

(viii) Verification of Nursery Plant – Reconciliation Statement;

(ix) Treatment of cost of damaged plants in course of planting;

(x) Valuation of Closing Stock of plants;

15. Deployment :

(i) Examination of system of Planning & related records,

(ii) Comparison between Work Order Book and Actual Deployment,

(iii) Verification of Deployment records,

(iv) Field Productivity of Labours –

- ✓ Pluckers' Productivity (in case of Tea),
- ✓ Productivity of Labour for peakin g Coffee Seeds;
- ✓ Tappers Productivity (in Rubber plantation);
- ✓ 3 / 4 Years' comparative analysis for the above – Permanent, Casual workers separately and in totality

(v) Fixation of Task of all types of agricultural operations

(vi) Factory deployment – Deployment of Casual Workers, Overtime work, Shift working along with system of OT payment, Productivity of Factory Workers.

(vii) Deployment of Labours in non-productive areas – Comparative study in respect of the earlier years.

(viii) Study of actual pattern of deployment of labour – both permanent & Casual in Cultivation, Manufacture, Plucking/ Tapping/ Picking, Stripping & Gleaning of Coffee Seeds and other operations including establishment.

(ix) Reconciliation of wages as per final Deployment Book with Wages as per monthly Accounts.

16. Wages :

i) Checking of Master Roll, Pay Roll vis-à-vis Actuarial Valuation List prepared for the purpose of computation of Gratuity;

ii) System of recording the attendance;

iii) Scrutiny of attendance / absenteeism record – for Staff, Sub-staff & Workers;

iv) Verification of final Deployment Book with the Field (i.e. rough) Deployment Book/ Record as well as Daily Attendance Record ;

v) Checking of procedure followed for disbursement of wages, bonus etc;

vi) Checking of records for unpaid Wages & unpaid Bonus and their subsequent disbursement;

vii) Checking of computation of Wages of Casual/ Contractual Workers with reference to basic records maintained for recording their attendance;

viii) Checking of Payment Vouchers for disbursement of Wages to Casual/ Contractual workers;

ix) Checking of basic records maintained for payment of incentives, i.e. for plucking, tapping, picking of Coffee Seeds with reference to minimum task fixed;

x) Procedure followed for recovery of Cost of electricity provided to Staff/ workers' quarters and records maintained there for;

xi) Procedures followed for recovery of cost of food stuff issued to workers,

xii) Payment of Sick Allowance, Maternity Benefits, Leave with Wages, Holiday Wages, Bonus including records maintained there for;

xiii) Checking of system of payment of Overtime;

xiv) Procedure for payment of Advance to Staff/ Workers and Management Staff and their recovery including records maintained therefor;

xv) Checking of computation of Leave with Wages and their disbursement.

17. Miscellaneous Labour Welfare Expenditure :

(i) Examination of expenditure on different labour welfare items including the study of trend of expenditure for a period of consecutive 3 / 4 years;

ii) Fire wood or other form of fuel to be issued to staff and workers - Procurement process including fixation of price, records for issue of fuel and system of control exercised on issue;

iii) Procurement of other labour welfare items like Umbrella, Chappals, Blankets and other protective clothing, issue of those items and related records;

iv) System of issue of black tea to staff & workers in Tea Estates

18. Ration:

i) Procurement of Food Stuff

ii) Issue of Food Stuff – Comparison with entitlements as per Industry norms, deduction for absenteeism

iii) Comparison of Ration Issue Book with Census Records

iv) Physical verification of Stock of Food Stuff

v) Checking of percentage of handling loss on monthly & yearly basis – Comparative analysis of Handling Loss Percentage for a period of 3 / 4 years

19. Census :

i) Checking of Census Records

ii) Examination of method followed for updating the Census Records

iii) Examination of Land Labour Ratio with reference to Industry norms

20. Medical Benefit & Expenditure :

i) Purchase & consumption of Medicine at Estate's Hospital

ii) Expenditure incurred on Hospital

iii) Maintenance of records at Hospital

iv) Treatment at outside Hospital – Review of Procedure followed, Records maintained for the patients sent to such hospitals and expenditure incurred, system of payment to such hospitals

v) Recovery of cost of treating non-workers who are not dependent of the Estate workers

vi) Checking of records for payment of Sick Allowance and Maternity Benefits and cross-check same with Accounting Records – system followed for payment

21. Gratuity :

i) Verification of Gratuity Payment including checking of gratuity computation;

ii) Maintenance of Statutory records;

iii) Compliance with Payment of Gratuity Act & Rules;

iv) Examination of pending cases of unpaid Gratuity;

v) Status of nomination form;

22. Production :

i) Verification of records maintained for weighment of raw-materials at factory;

ii) Checking of Machine Log Books;

iii) Verification of maintenance of Production records i.e. raw-material register, RG-1, RT-12, Packing records, Despatch records;

iv) Excise Records;

v) Checking of system of measurement of Finished Goods including records thereof;

vi) For Tea Manufacturing – Examination of Sorting, Packing & Despatch records, assessment of accumulated stock of unsorted, unpacked stock of Tea and Stock awaiting dispatch – reasons thereof

vii) Checking of system of dispatch of Finished Goods & records pertaining to dispatch and stock of finished goods;

viii) System of issue of Tea to Labour/ Staff & Management Staff, maintenance of related records

ix) For Tea manufacturing - Analysis of Recovery percentage, Tea Waste Percentage, Percentage of Primary & Secondary grades and Comparative analysis for 3 / 4 years figures.;

x) For Rubber manufacturijg – method of computation of volume of Production, Manufacturing Loss Percentage, Productivity of different Production Centers;

xi) For Coffee – Percentage of out-turn of clean Coffee, Percentage Component of Cherry & Perched Coffee.

23 Inventory Control :

(i) Checking of system of receipt/ issue of Stores,

(ii) Verification of Stores Records,

(iii) Physical verification of Stores, Verification of utilization of Stores,

(iv) Assessment of Status of Slow Moving & Non-moving Stores Items.

(v) Checking of records including physical verification of Stores and Tea;

24 Power & Fuel :

Vehicle Log Book :

a) Comparative Study of Fuel Consumption-individual vehicle-wise;

b) Consumption of fuel – Quantitative Reconciliation between Log Book and stores record.

Power Consumption :

a) Electricity Consumption;

b) Gas consumption;

c) Coal & TD Oil Consumption;

Generator Log Book :

a) Generator Set fuel efficiency ;

b) Reconciliation with Stores Records .

25. Fixed Assets :

i) Checking of maintenance of records including recording of Addition, Deletion & Disposal

ii) Physical verification of Assets

iii) Assessment of status of unutilized assets, specially machinery & vehicles

26. Scrap :

i) Maintenance of Scrap records for both generation and disposal

ii) Physical stock of scrap – its maintenance & security

iii) Procedures followed for disposal of scrap

27 Statutory Matters :

Tax Deducted at Source (TDS) :

i) Basis of deducting TDS;

ii) Deduction and deposit of TDS

iii) Filing of TDS Return

Service Tax :

i) Deduction and deposit of Service Tax;

ii) Filing of Service Tax Return

Deposit of Statutory Dues :

i) Deduction and deposit of Provident Fund (PF);

ii) PF Annual Return;

iii) PF Annual Administrative Charges;

iv) Pending PF Settlement

Deposit Linked Insurance (DLI & DLI Administrative Charges);

Excise Records & Excise Returns ;

Green Leaf Cess ;

VAT / Sales Tax ;

Profession Tax (P Tax)

Status of Licenses & Returns

Land Revenue

28 Accounts :

i) Verification of Bank Book;

ii) Verification of Cash Book;

iii) Bank Reconciliation Statement (BRS);

iv) Cash Vouching;

v) Physical Verification of Cash;

vi) Review of Creditors' Ledger and List of other Liabilities;

vii) Scrutiny of Advance given to Staff/ employees :

   a) PF Advance;

   b) Medical Advance;

viii) Status of Recovery of Labour Line Electricity Bills (where bills are paid by the employer)

ix) Scrutiny of Advance A/c in respect of Advances paid to Suppliers, Service providers , Contractors and Miscellaneous purposes ;

x) Security Deposit ;

xi) Maintenance of Cost Records.

(B) Gist of Internal Audit Programme in Steel Industries

Direct Reduced Iron (DRI)

Sponge – iron is a metallic product produced through direct reduction of iron ore and iron – ore pellets in the solid state. It is also known as Direct Reduced Iron (DRI) or Hematite iron ore which is used for reduction. After reduction of iron ore the product resembles sponge because of pores left behind after removal of oxides. As such it is called sponge Iron. Sponge iron is a substitute of scrap in steel melting.

There are mainly two routes of iron making:

(a) Blast furnace

(b) Direct reduction

Direct reductions is further divided in two routes:

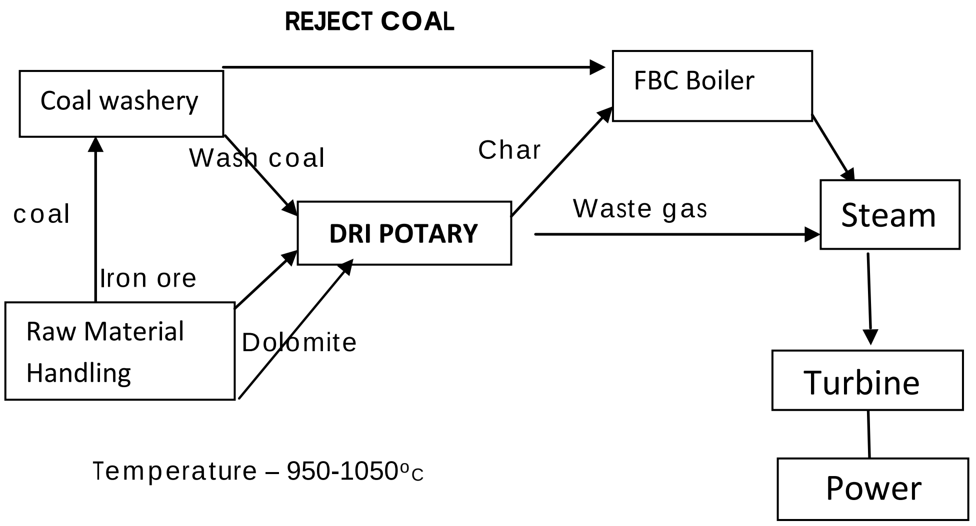
(a) Gas based

(b) Coal based

The gas-based route is less preferred due to project cost, use of imported coke and relatively longer gestation period. Coal based DRI process is mainly preferred on account of comparatively lower project cost, better R.O.I crisis of scrap for steel making, international/ national demand of solid metrellic and availability of large reserves of high grade iron ore & non- coking coal in India . Although the reduction inside kiln is not direct as Co formation inside kiln takes place but because the reduction its taking place in solid state without meetings as such this process is called direct reduction process.

1) Process:

Iron-ore, wash coal & dolomite are fed in different proportions from the feed end. Injection cola lumps & injection coal fines are injected from out late , about 40-45% of the total coal is charged from the feed end & remaining 55-60% of the coal is pneumatically injected into the kiln from the discharge end, dolomite is feed in proportion of 2- 4% of iron ore.



2) Raw materials required to manutaetme sponge iron

For making one – tone sponge iron following raw materials required (standard) as below

- Iron ore = 1.70 to 1.80 tonnes
- Pellets = 1.50 to 1.55 tonnes
- Coal = 1.35 to 1.45 tonnes
- Dolomites = 50kg

3) Standards Quality raw material required for iron making

(a) Iron – ore

i) Fe (T) = 65% min

ii) Al 203+ Si02 = 5% max

iii) Pumbles Index = 88%

iv) Abrasion Index = 5% min

v) Thermal degradation index = 5 max

vi) Size = 5-20mm

(b) Chemical Composition

i) Gangue content of ore feed should not exceed 5%

ii) Silica (Si02) = 2%

iii) Alumina (Al203) content does not appear to be of significance from reduction point of view

iv) Phosphorous (P) = below 0.03% (normal in India 0.03 to 0.08%)

v) Sulphur (s) = below 0.02%

(c) Non – cocking Coal

i) F.C. = 46% min

ii) V.M. = 30% Max

iii) Ash = 24% Max

iv) Moisture = 10% max

v) Ash fusion temperature =128^{0}c min

vi) Reactivity (Min) = 1.8 cc of co/Gm of/c/sec

vii) Size (Feed Coal) = 5-20 MM

viii) Size (inj/coal Lumps) = 3-20MM

ix) Size (inj/coal Lumps) = 0- 3MM

x) Caking/ swelling induce = 1% max

(d) Dolomite

i) CaO = 28% Min

ii) MgO = 18% Min

iii) SiO2 = 04% Max

iv) Size = 2-6 MM

Wastage: - In DRI plant nothing is wastage. Coal fines transfer to sinter plant.

SINTER PLANT

Sintering is a process of agglomeration of Iron ore fines into a porous hand mass by INCIPIENT FUSION due to the heat generated within the mass itself.

Or

Sintering may be defined as the process agglomeration, where heat is produced by combustion of solid fuels within moving beds of loosely parked particles i.e. iron ore and other raw materials into a compact porous mass.

Quality of Input material

i) Ore fines (90% - 10mm)

ii) Lime stone (90% - 03 mm)

iii) Dolomite (90% - 03mm)

iv) Coke fines (90% - 03mm)

v) Sand/Quartzite (90% - 03mm)

vi) Plant wastes like fine dust, Mill seals, bag Fitter, Dust etc.

Output

Sinter (5- 40mm)

Need of Sintering

The porous mass, which is called sinter, is used in blast furnace as an iron bearing, preponed charge material for production of Hot Metal for the following reasons:-

i) To utilize the times generated during the mining operations or in plant generation

ii) To utilize different additives like mill scale, flue dust, Bag fitter dust, rejected lime fines etc. chemical demand of the blast furnace.

iii) To produce hot metal with better consistency.

iv) To reduce cost of hot metal by reduction of coke rate

v) To increase Blast furnace performance & productivity.

Types of Sinter

i) Non Fluxed or Acid sinters :- Those where no flux is present or is added in the ore.

ii) Basic sinter or self fluxing sinter:- Those where sufficient flux has been added in the sinter mix to provide a basicity that is desired in the final slag, taking into consideration only the burden acids, An extra flux is added to the burden while charging to coke ash acids.

iii) Super basic or super fluxed sinter: - In these types of sinters an additional flux is added to the mix to provide for the desired final slag basicity, taking into account the acids content of both ore as well as the coke ash.

Input material

Sinter plant is made to utilized the waste generated during mining operation or in plant question as follows

i) Iron ore fines

ii) Blast Furnace fines

iii) Sinter return fines

iv) ESP Dust (Electro Static Precipitation)

v) Dolomite fines

vi) Lime stone fines

vii) Coke fines

viii) All other metal lurgical waste like mill scale, flue dust, Bag fitter dust & river sand are collected. Temperature required = 800^0 - 1200^0C

Blast Furnace

The purpose of Blast furnace is to chemically reduce and physically convert iron oxide into liquid iron called "hot metal"! The blast furnace is a huge, steel lined with refractory brick where iron ore, coke and limestone are charged into the top and pretreated air is blown into the bottom. The raw materials require 6 – 8 hours to descend to the bottom of the furnace where they become the final product of liquid slag and liquid iron. These liquid products are drained from the furnace at regular interval. The hot air that was blown into the bottom of the surface as cends to the top in 6 to 8 seconds after going through numerous chemical reactions' once the blast furnace is started it continuously runs for four to ten years with only short stops to perform planned maintenance.

Iron oxide is charged into the blast furnace plant in the form of raw ores, ballets or sinter. The raw ore is extracted from the earth and sized into piece that range from 0.5 to 1.5 inches. This ore is mainly Hematite (Fe 203) with or without small amount of magnetite (Fe 304) and the iron contents ranges from 50% to 70%. This iron rich ore can be changed directly into blast furnace without any further processing iron that contains a lower iron contents must be processed or beneficiated to increase its iron contents pallet are produced from this lower iron content ore. This ore is crushed and ground into a powder so the walte material called gangue can be removed. The remaining iron rich powder is volled into balls and fired in a furnace to produce strong, marble sized pellets that conteinte 60.5 to 65% iron. One more agglomeration process is called sintering. Sinter is produced from fine raw ore, small coke, sand sized lime stone and nemerous other steel plant waste material that contain some iron. These time materials are proportioned to obtain a desired product chemistry then mixed together. This raw material mixed is then placed on a sinteins stand, which is similar to conveyor belt, where. It is ignited by gas fived furnace and fused by the heat from the coke fines into larger size pieces that are from 0.5 to 2.0 inch. The iron ore, pellets and sinter then are charged into blast furnace to produce liquid iron, with any of their remaining impurities going to the liquid slag.

The another raw materials in the iron making process is lime stone, dolomite and quartz together with coke. The one removed from the earth by blasting with explosives. It is then crushed and screened to a size that ranges from 0.5 inch to 1.5 inch to charge into the blast furnace to act as flay. These fluxes help to remove out gangue from blast furnace in the from of slag.

The iron ore, pellets and sinter are reduced which simply means the Oxygen in the iron. Oxide is removed by a series of chemical reaction. While, going through these purifying readions, the iron oxide gets soften and finally converts into motter from that trickles as liquid iron throuly the coke to the bottom of the furnace. The coke descends to the bottom of the furnace to the level where the preheated air or hot blast enters the blast and immediately reacts to generate heat.

Finished products

i) The metal

ii) The slag

iii) The gas

The metallic product from a blast furnace is variously known as hot metal and pig iron. It contains carbon, silicon, phosphorus, manganese and surplus as the chief impurities totaling anything upto 6% by weight or so. Since the liquid iron trickles through coke lumps in the bosh region it gets saturated with carbon may very around 3.5 – 4.2% slag granules are produced in a granulation plant where motter slag is poured in turbulent water. These slag granules are sent to cement plants.

The blast furnace would produce an effluent gas containing a significant proportion of carbon monoxide, which cannot be used for iron oxide reduction. The quantity of gas produced depends upon amount of fuel burnt. The actual Co content varies around 20 – 30% by volume. The gas is therefore cleaned before its use and in so doing the sensible heat of the gas is invariably lost.

STEEL MELTING SHOP

The Hot Metal that comes from Blast furnace through ladle after purifying and rending the percentage of carbon, sulpher and phosphorous, the not metal is convented into steel.

Weight%

Input -- Hot metal = 46 - 50

DRI = 40.45

Scrap = 1.54 – 2.0

Burn Lime = 5.3 – 5.5

Burn Dolo = 4.5 – 5.0

Furnace operations

The electric are furnace operates as a batches melting process producing batches of molten steel know "heats". The electric are furnace operating cycle is called the tap – to – tap cycle and is made up the following

Operations:

i) Furnace charging

ii) Melting

iii) Refining

iv) De – Slagging

v) Tapping

vi) Furnace turn- around.

Modern operations aim for a tap – to – tap time of less than us minutes.

Output

Combi Caster = Beam blank or Round.

Billet caster = Round, 130 X 130mm, 150X150mm, 200X200mm

Slab caster = Width 1300mm to 2600mm thickness 215mm, 250mm and 280mm.

Rail & universal Beam Mill

At Rubna a mixture of blast furnace gas, furnace oil and produce gas is used to five the furnace walking beam furnace has been commissioned for reheating. The moveable grid moves 75 mm upward, 500mm forward, 150mm downward and finally 500mm backward.

Blooms remain in the furnace for about 4 hours. For beam blanks the temperature setting are 1130, 1250, 1270 degree Celsius for preheating, heating and soaking zone respectively.

Hot Saw

Two parallel lines, each with one Hot saw, provide alternate routes for the hot rolled products exiting from the finishing stand. The hot saws are fitted with lambaton stoppers, which move in version to temperature and profit length to ensme exacting finish lengths post cooling

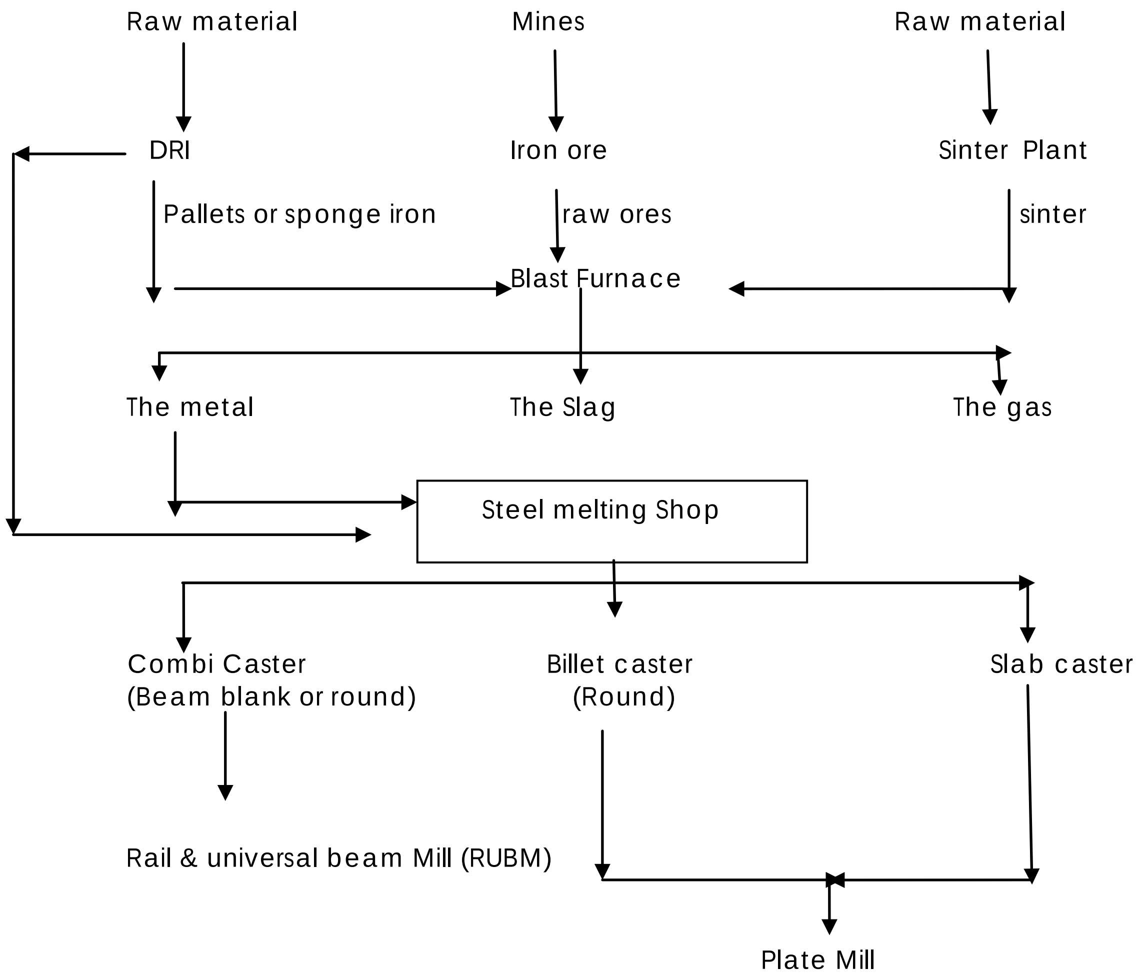
Cooling Bed

Walking beam type cooling bed capable of 120m long rolled products in installed in RUBM. Cooling bed is preceded by Hot saws and automatic rail stamping machine and is especially designed to finish 120m long rail road rails to be produced for the tirst time in. It in the iron ore, iron contents ranges from 50% to 70% then this iron rich ore can be changed directly into blast furnace without any further processing.

Further, iron ore that contains a lower iron contents must be processed or beneficiated to increase its iron contents so pallet are produced from this lower iron content ore.

This ore is crushed and ground into a power so that waste material called gangue can be removed.

SMS: - By purification and reducing the percentage of carbon, sulpher and phosphorous, the hot metal is converted into steel.



Study Note - 9

BASICS OF OPERATIONAL AUDIT

This Study Note includes

9.1 Operational Audit
9.2 Budgetary Control System
9.3 Capacity Utilization
9.4 Inventory Control
9.5 Management Information System
9.6 Nature and Scope of Management Audit
9.7 Audit of Management Process and Functions
9.8 Specimen Questions with Answers

9.1 OPERATIONAL AUDIT

The internal audit function in any organisation 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.

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.

An operational audit can lead to better management of all aspects of business organisation 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. Methodology : Focus on policies, transactions and compliance	Methodology : Focus on goals, strategies and risk management processes

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

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.

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 analyses or the critical analyses. These analyses or reports could indicate potential critical areas such as over- or under-staffing, noncompliance 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.

9.2 BUDGETARY CONTROL SYSTEM

9.2.1 Budget and Budgetary Control – Nature and Scope

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.

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.

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.

In order that a budgetary control is operated effectively, there must be an efficient ogranisation for budgetary control. The budgetary control organisation 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.

The different types of budgets are – (1) Functional budgets and (2) Master budget. The master budget summarises 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 organisation as its main objective.

9.2.2 ADEQUACY OF BUDGETARY CONTROL SYSTEM

While determining the adequacy or otherwise of the budgetary control system of an organisation, 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 organisation 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.

9.3 CAPACITY UTILISATION

9.3.1 Need for Capacity Determination

The need for determining "production capacity" in respect of industrial organisation in India arises from the following reasons :-

(i) To meet the requirement under Section 129 of the Companies Act, 2013, that prescribes the form and contents of the balance sheet as well as profit and loss account (Schedule III of the Companies Act).

(ii) For purpose of Cost Audit Report under section 148 of the Companies Act, 2013 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.

11.3.2 Adequacy of Capacity Determination and Utilisation Mechanism

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, labour 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.

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

$$\text{Capacity utilization} = \frac{\text{Real fixed capital}}{\text{Minimum Capital Output Ratio}} \times 100$$

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 Companies (Cost Records and Audit) Rules, 2014 the Cost Auditor is required to undertake the capacity determination under these rules as per this standard.

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.

11.3.3 Suggestions to Rectify Imbalance in Production Facilities

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.

9.4 INVENTORY CONTROL

9.4.1 Introduction

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.

The cost auditor can get an idea about the internal control relating to inventory from the following questionnaire.

9.4.2 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, labour 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?

9.5 MANAGEMENT INFORMATION SYSTEM

9.5.1 Introduction

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.

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 behavioural impacts on organizational decision-making.

The introduction of computers as a means of processing data to produce management information has made it possible to consider sophisticated management information system.

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 organisation 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, to day it is possible to obtain data through computers from one place although the manufacturing units are situated at different parts of the country.

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.

11.5.2 Management Information System and Cost Auditor

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.

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.

Flow of information : A cost auditor has to proceed on the following lines :

(i) System organisation :

- (a) system is centralized or decentralized,
- (a) flow of information from various units to the control section,
- (b) estimating the volume of data, transmission time and cost,
- (c) cost-benefit analysis of centralized v. decentralized information.

(iii) 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.

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?

9.6 NATURE AND SCOPE OF MANAGEMENT AUDIT

9.6.1 Introduction

An organisation 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.

Management Audit is the total examination of transaction of an organisation, 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 organisation 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 frame work. 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 organisation 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.

In this context management audit undertakes examination of the effectiveness of management in controlling the total activities of the organisation in the accomplishment of the organisation 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.

Management audit deals with –

(i) the objectives of an organisation;

(ii) the policies and procedures in terms of the objective of the organisation; and

(iii) adequate performance of an organisation in terms of objectives, policies, and procedures.

9.6.2 Definition and Objects of Management Audit

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. T is normally presumed to be a non-routine investigation into a performance of a manage or group of managers. But in a umber of organizations management audit is now a regular feature to examine and improve managerial effectiveness.

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 organisation.

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 organisation 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 organisation 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

H. Washbrook in the book "The Board and Management Audit" has defined "Management Audit" as –

"the total examination of an organisation 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 organisation and to recommend ways to rectify these weaknesses".

- CIMA Terminology.

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 organisation 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 organisation. 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.

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.

9.6.3 Need for Management Audit

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.

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.

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.

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.

Management audit is now becoming more popular everywhere. Almost all progressive organizations undertake voluntary management audit due to its benefits as under :-

(ii) It helps management in framing basic policies for the organisation and to define objectives.

(iii) In pursuance of the objectives of the organizations, management audit helps in preparing a viable and achievable plan for the organisation.

(iv) It helps in setting up an organizational framework to implement the plans.

(v) It assists in designing systems and procedures for smooth operation of the organisation.

(vi) It helps in designing and reviewing management information system (MIS) for decision making to help in coordination, motivation and control of the operations.

(vii) It assists in analyzing SWOT (strengths, weaknesses, opportunities and threats) of the organisation and assists in marketing the organisation stronger.

(viii) 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.

(ix) 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.

(x) 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.

(xi) It can help in analyzing social-cost benefit analyses for public projects like dams, power houses, national highways etc.

(xii) It is essential whenever a unit is planned to be taken-over or an amalgamation or merger with other unit is proposed.

(xiii) 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.

9.6.4 Scope and Usefulness of Management Audit

The scope of management audit is decided by each organisation on its own needs. It has no limitations. It generally extends over all the resources deployed and commercial activities of the organisation 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.

The scope of management audit extends over all the functions of an organisation viz. management, personnel, administration, material administration, marketing, finance, etc. wherever the effectiveness of management needs to be examined.

Accordingly, the scope of management audit may include –

(i) The suitability, practicability and present compliance or otherwise of the organisation with its desired objectives and aims.

(ii) The current image of the organisation among customers, general public within its own particular industrial or commercial field.

(iii) Efficient utilization of resources of the organisation.

(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.

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.

The implications of separation of ownership and control were first analysed in depth by Berie & 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 & 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.

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 organisation 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.

The value of auditing can be only judged by its ability to promote accountability of an organisation through their participants. The process of accountability is concerned with the needs of the participants of an organisation 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 behaviour of the organization.

9.6.5 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.

9.6.6 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 organisation, personnel, administration, manufacturing, marketing, finance, research and development and other areas. The audit is expected to cover every activity of the organisation 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 organisation.

The areas covered are discussed in detail in the following sections.

9.7 AUDIT OF MANAGEMENT PROCESS AND FUNCTIONS

9.7.1 Concept of Management Audit

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 –

(i) Planning.

(ii) Organising.

(iii) Staffing.

(iv) Coordinating.

(v) Communicating.

(vi) Directing.

(vii) Motivating.

(viii) Controlling.

(ix) Communicating.

(x) Directing.

(xi) Motivating.

(xii) Controlling.

(xiii) Innovating.

As such management audit covers the above functions of management in various areas of operations as detailed in he Table below :-

	Function of an organization	Marketing	Manufact-ring	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 organisation.

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 organisation could broadly be identified into the following functional areas –

(ii) Marketing, including selling and distribution.

(iii) Manufacturing/servicing, including maintenance of supply chain, machinery and equipment, etc.

(iv) Human resource management from selection to recruitment, training, motivating, retaining, advancement, etc.

(v) Personnel policies and industrial relations.

(vi) Finance including maintenance of accounts and providing accounting information to guide the management of its performance and position.

(vii) Research & development including application research and basic research, if any.

An understanding of the objectives of each functional area at every level of the organisation 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.

9.7.2 Features of Different Types of Audits

The Table below brings out succinctly the distinguishing features of different types of audit carried out in an organisation :-

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

Financial audit is statutory requirement for most of the businesses or public organisations/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 behaviour of the organisation conforms to the expectations within a definite frame work. 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.

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 organisation and can be developed into management audit by interaction of cost auditor with Board of Directors and by widening its scope.

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 Companies (Auditors' Report) Order, 2015 under the Companies Act, 2013 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.

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.

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.

9.7.3 Management Audit – Techniques and Procedures

(1) **Steps of management audit :**

The steps of management audit are :-

2. Select an area of operation of management
3. Establish what should be the objective, standard or target of the operation.
4. 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 organisation?
5. 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. sue of up-to-date technology.
   (iii) Measurement of performance and controls?
6. Carryout a detailed investigation, collective evidence as well as document for audit findings
7. 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 though 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 organisation, 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 organisation'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 organisation's operations from initiation to final disposition. This kind of testing will provide the auditor with valuable information on the organisation'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 organisation'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 organisation 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 organisation'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 organisation 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 organisation'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 organisation's transport fleet, the best mix of products to obtain, to maximize profits and optimum use of labour, 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 organisation.

(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 organisation, the survey and review of various reports of the organisation, 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 organisational 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 organisation'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 organisation 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 organisation 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 fertilisation 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 organisation.

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 organisation e.g. nationalized or government controlled organisation etc.

(iii) Ability to determine or assist the progress of the organisation

(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 organisation 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 organisation, ranging from manufacture, to marketing and finance, the management audit team should be multi-disciplinary to make multidimensional approach to audit function.

A competent management audit team, internal to an organisation, 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 organisational 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 organisational 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 organisation. 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.

9.7.4 Management Audit Report (MAR)

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.

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

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 organisation.

The report must allow management to study comparisons, to review organisation, 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 organisation come alive. It is vary 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 form 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.

9.7.5 Special Reports for Banks, Shareholders, Employees & Small Business

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 re 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 organisation'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 an 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.

9.8 SPECIMEN QUESTIONS WITH ANSWERS

Question No. 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 check list 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, labour 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. 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 organisation 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) Organisation 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. 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 indicated 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. 4

Enumerate the points to be considered for assessing the requirements of working capital requirements and borrowing limits on behalf of the lending bank:

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 umber 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. 5

Given below are the abridged balance sheets and profit & loss accounts of AB Spinning Mills Ltd. :

	20XX-XX	20XX-XX	20XX-XX
		(₹ 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
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
	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	20XX-XX	20XX-XX	20XX-XX
Sales – quantity kgs.	43,50,890	34,36,921	37,25,405
Sales Value in ₹ Lakhs	5,091	3,938	4,215
Average sales realization per Kg.- ₹	117	115	113
Raw Materials, stores & spares consumed (₹- 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:

	20XX-XX	20XX-XX	20XX-XX
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 ₹ 197 lakhs whereas the increase in loss as compared to the previous year is only ₹ 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 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.

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 is 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 different from management audit?
9. Distinguish between administrative audit and management audit.
10. Distinguish between management audit, propriety audit land 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 check list? What considerations are required by a management auditor in preparing a such check lists?
21. Suggest a suitable checklist for appraisal of organisation?
22. As a management auditor for a 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 the 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. To day'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 organisation? 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 one can 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.

Study Note - 10

MANAGEMENT AUDIT IN DIFFERENT FUNCTIONS

This Study Note includes

10.1 Corporate Culture and Objectives
10.2 Corporate Services Audit
10.3 Corporate Development Audit
10.4 Evaluation of Personnel Development
10.5 Consumer Services Audit
10.6 Audit of Social Responsibility of Management — Environmental Pollution Control
10.7 Audit Checks of Different Functions
10.8 Corporate Divisions/Departments/Functions
10.9 Corporate Governance and Audit Committee
10.10 Audit Committees and Corporate Governance
10.11 Confederation of Indian Industries (CII) Code for Desirable Corporate Governance

10.1 CORPORATE CULTURE AND OBJECTIVES

10.1.1 Evaluation of Corporate Objectives

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.

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."

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."

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.

10.1.2 Evaluation of Corporate Strategies

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.

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.

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.

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.

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.

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.

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.

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.

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.

10.1.3 Corporate Culture - Concept

"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.

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.

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.

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..

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.

10.1.4 Evaluation of Corporate Culture

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.

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?

10.2 CORPORATE SERVICES AUDIT

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.

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.

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.

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.

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.

10.3 CORPORATE DEVELOPMENT AUDIT

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.

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.

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.

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.

Checklists in Areas of Corporate Development

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*

(b) Whether the corporate objectives are clear and explicit?

(c) Whether the different elements of the enterprise have separate objectives?

(d) How are these objectives defined?

(e) Are the objectives in writing?

(f) 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?

10.4 EVALUATION OF PERSONNEL DEVELOPMENT

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.

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.

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.

10.5 CONSUMER SERVICES AUDIT

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.

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?

10.6 AUDIT OF SOCIAL RESPONSIBILITY OF MANAGEMENT — ENVIRONMENTAL POLLUTION CONTROL

10.6.1 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.

10.6.2 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 iscaused 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.

10.7 AUDIT CHECKS OF DIFFERENT FUNCTIONS

10.7.1 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.

10.7.2 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?

10.7.3 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?

10.7.4 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?

10.7.5 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?

10.7.6 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?

10.7.7 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?

10.7.8 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?

10.7.9 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?

10.7.10 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?

10.7.11 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?

10.7.12 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?

10.7.13 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?

10.7.14 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?

10.7.15 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?

10.7.16 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?

10.7.17 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?

10.7.18 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?

10.7.19 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?

10.8 CORPORATE DIVISIONS/DEPARTMENTS/FUNCTIONS

10.8.1 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?

10.8.2 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?

10.8.3 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?

10.8.4 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?

10.8.5 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.

10.8.6 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?

10.8.7 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?

10.9 CORPORATE GOVERNANCE AND AUDIT COMMITTEE

10.9.1 Introduction to Corporate Governance

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.

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.

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."

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.

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.

12.9.2 Evolution Of Corporate Governance

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.

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.

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 (Presently known as Companies Act, 2013) 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.

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.

The Companies Amendment Act 2000 had introduced a new Section 292A (Section 177 under Companies Act, 2013) regarding constitution of Audit Committees. Under Companies Act, 2013, the Board of directors of every listed company and the following classes of companies, as prescribed under Rule

6 of Companies (Meetings of Board and its powers) Rules, 2014 shall constitute an Audit Committee:

(i) all public companies with a paid up capital of ₹10 Crores or more;

(ii) all public companies having turnover of ₹100 Crores or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding ₹50 Crores or more.

The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Sub-section (5) of section 177 of the Companies Act, 2013 provides that the Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

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:

- See 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.

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.

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.

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.

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.

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.

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.

10.10 AUDIT COMMITTEES AND CORPORATE GOVERNANCE

12.10.1 Introduction

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.

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.

12.10.2 Audit Committee under Companies Act, 2013 [Section 177]

(1) The Board of Directors of every listed company and such other class or classes of companies, as may be prescribed, shall constitute an Audit Committee.

(2) The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority.

Provided that majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement.

(3) Every Audit Committee of a company existing immediately before the commencement of this Act shall, within one year of such commencement, be reconstituted in accordance with sub-section (2).

(4) Every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include,—

- (i) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;
- (ii) review and monitor the auditor's independence and performance, and effectiveness of audit process;

(iii) examination of the financial statement and the auditors' report thereon;

(iv) approval or any subsequent modification of transactions of the company with related parties;

(v) scrutiny of inter-corporate loans and investments;

(vi) valuation of undertakings or assets of the company, wherever it is necessary;

(vii) evaluation of internal financial controls and risk management systems;

(viii) monitoring the end use of funds raised through public offers and related matters.

(5) The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

(6) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in sub-section (4) or referred to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.

(7) The auditors of a company and the key managerial personnel shall have a right to be heard in the meetings of the Audit Committee when it considers the auditor's report but shall not have the right to vote.

(8) The Board's report under sub-section (3) of section 134 shall disclose the composition of an Audit Committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed in such report along with the reasons therefore.

(9) Every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed.

(10) The vigil mechanism under sub-section (9) shall provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases.

Provided that the details of establishment of such mechanism shall be disclosed by the company on its website, if any, and in the Board's report.

Audit Committee under Clause 49

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:

1. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

2. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

   Explanation (i): 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 (ii): 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.

3. The Chairman of the Audit Committee shall be an independent director;
4. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
5. 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;
6. 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. Recommendation for appointment, remuneration and terms of appointment of auditors of the company;
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 and auditor's report thereon 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 (c) of sub-section 3 of section 134 of the Companies Act, 2013
    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, the statement of uses / application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and the report submitted by the monitoring agency monitoring the utilisation of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter;
7. Review and monitor the auditor's independence and performance, and effectiveness of audit process;
8. Approval or any subsequent modification of transactions of the company with related parties;
9. Scrutiny of inter-corporate loans and investments;
10. Valuation of undertakings or assets of the company, wherever it is necessary;
11. Evaluation of internal financial controls and risk management systems;
12. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;
13. 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;
14. Discussion with internal auditors of any significant findings and follow up there on;
15. 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;
16. 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;
17. 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;
18. To review the functioning of the Whistle Blower mechanism;
19. Approval of appointment of CFO (i.e., the whole-time Finance Director or any other person heading the finance function or discharging that function) after assessing the qualifications, experience and background, etc. of the candidate;
20. 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 provided in Clause 49(VII) of the Listing Agreement.

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.

10.11 CONFEDERATION OF INDIAN INDUSTRIES (CII) CODE FOR DESIRABLE CORPORATE GOVERNANCE

10.11.1 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.

10.11.2 CORPORATE GOVERNANCE OF LISTING AGREEMENT (CLAUSE 49)

Applicability of Clause 49

The Clause 49 of the Listing Agreement shall be applicable to all companies whose equity shares are listed on a recognized stock exchange. However, compliance with the provisions of Clause 49 shall not be mandatory, for the time being, in respect of the following class of companies:

a. Companies having paid up equity share capital not exceeding ₹10 crore and Net Worth not exceeding ₹25 crore, as on the last day of the previous financial year;

   Provided that where the provisions of Clause 49 becomes applicable to a company at a later date, such company shall comply with the requirements of Clause 49 within six months from the date on which the provisions became applicable to the company.

b. Companies whose equity share capital is listed exclusively on the SME and SME-ITP Platforms.

Corporate Governance (Clause 49)

I. The company agrees to comply with the provisions of Clause 49 which shall be implemented in a manner so as to achieve the objectives of the principles as mentioned below. In case of any ambiguity, the said provisions shall be interpreted and applied in alignment with the principles.

A. The Rights of Shareholders

1. The company should seek to protect and facilitate the exercise of shareholders' rights.
   a. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes.
   b. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings.
   c. Shareholders should be informed of the rules, including voting procedures that govern general shareholder meetings.
   d. Shareholders should have the opportunity to ask questions to the board, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.
   e. Effective shareholder participation in key Corporate Governance decisions, such as the nomination and election of board members, should be facilitated.
   f. The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.
   g. The Company should have an adequate mechanism to address the grievances of the shareholders.
   h. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.
2. The company should provide adequate and timely information to shareholders.
   a. 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 discussed at the meeting.
   b. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.
   c. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase.

3. The company should ensure equitable treatment of all shareholders, including minority and foreign shareholders.
    a. All shareholders of the same series of a class should be treated equally.
    b. Effective shareholder participation in key Corporate Governance decisions, such as the nomination and election of board members, should be facilitated.
    c. Exercise of voting rights by foreign shareholders should be facilitated.
    d. The company should devise a framework to avoid Insider trading and abusive self-dealing.
    e. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders.
    f. Company procedures should not make it unduly difficult or expensive tocast votes.

B. Role of stakeholders in Corporate Governance

1. The company should recognise the rights of stakeholders and encourage cooperation between company and the stakeholders.
    a. The rights of stakeholders that are established by law or through mutual agreements are to be respected.
    b. Stakeholders should have the opportunity to obtain effective redress for violation of their rights.
    c. Company should encourage mechanisms for employee participation.
    d. Stakeholders should have access to relevant, sufficient and reliable information on a timely and regular basis to enable them to participate in Corporate Governance process.
    e. The company should devise an effective whistle blower mechanism enabling stakeholders, including individual employees and their representative bodies, to freely communicate their concerns about illegal or unethical practices.

C. Disclosure and transparency

1. The company should ensure timely and accurate disclosure on all material matters including the financial situation, performance, ownership, and governance of the company.
    a. Information should be prepared and disclosed in accordance with the prescribed standards of accounting, financial and non-financial disclosure.
    b. Channels for disseminating information should provide for equal, timely and cost efficient access to relevant information by users.
    c. The company should maintain minutes of the meeting explicitly recording dissenting opinions, if any.
    d. The company should implement the prescribed accounting standards in letter and spirit in the preparation of financial statements taking into consideration the interest of all stakeholders and should also ensure that the annual audit is conducted by an independent, competent and qualified auditor.

D. Responsibilities of the Board

1. Disclosure of Information
    a. Members of the Board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the company.
    b. The Board and top management should conduct themselves so as to meet the expectations of operational transparency to stakeholders while at the same time

maintaining confidentiality of information in order to foster a culture for good decision-making.

2. Key functions of the Board

The board should fulfill certain key functions, including:

a. 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 divestments.

b. Monitoring the effectiveness of the company's governance practices and making changes as needed.

c. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

d. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

e. Ensuring a transparent board nomination process with the diversity of thought, experience, knowledge, perspective and gender in the Board.

f. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

g. Ensuring the integrity of the company's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

h. Overseeing the process of disclosure and communications.

i. Monitoring and reviewing Board Evaluation framework.

3. Other responsibilities

a. The Board should provide the strategic guidance to the company, ensure effective monitoring of the management and should be accountable to the company and the shareholders.

b. The Board should set a corporate culture and the values by which executives throughout a group will behave.

c. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

d. The Board should encourage continuing directors training to ensure that the Board members are kept up to date.

e. Where Board decisions may affect different shareholder groups differently, the Board should treat all shareholders fairly.

f. The Board should apply high ethical standards. It should take into account the interests of stakeholders.

g. The Board should be able to exercise objective independent judgement on corporate affairs.

h. 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.

i. The Board should ensure that, while rightly encouraging positive thinking, these do not result in over-optimism that either leads to significant risks not being recognised or exposes the company to excessive risk.

j. The Board should have ability to 'step back' to assist executive management by challenging the assumptions underlying: strategy, strategic initiatives (such as acquisitions), risk appetite, exposures and the key areas of the company's focus.

k. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

l. Board members should be able to commit themselves effectively to their responsibilities.

m. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

n. The Board and senior management should facilitate the Independent Directors to perform their role effectively as a Board member and also a member of a committee.

II. <u>Board of Directors</u>

A. Composition of Board

1. The Board of Directors of the company shall have an optimum combination of executive and non-executive directors with at least one woman director and not less than fifty percent of the Board of Directors comprising non-executive directors.

   The provisions regarding appointment of woman director shall be applicable with effect from April 01, 2015.

2. Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise independent directors and in case the company does not have a regular non-executive Chairman, at least half of the Board should comprise independent directors.

   Provided that where the regular non-executive Chairman is a promoter of the company or is related to any promoter or person occupying management positions at the Board level or at one level below the Board, at least one-half of the Board of the company shall consist of independent directors.

   <u>Explanation</u>: For the purpose of the expression "related to any promoter" referred to in sub-clause (2):

   i. If the promoter is a listed entity, its directors other than the independent directors, its employees or its nominees shall be deemed to be related to it;

   ii. If the promoter is an unlisted entity, its directors, its employees or its nominees shall be deemed to be related to it.

B. Independent Directors

1. For the purpose of the clause A, the expression 'independent director' shall mean a non-executive director, other than a nominee director of the company:

   a. who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;

   b. (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;

      (ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

   c. apart from receiving director's remuneration, has or had no material pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;

   d. none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

e. who, neither himself nor any of his relatives —

(i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

(ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of —

(A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

(B) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;

(iii) holds together with his relatives two per cent or more of the total voting power of the company; or

(iv) is a Chief Executive or director, by whatever name called, of any non-profit organisation that receives twenty-five per cent or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent or more of the total voting power of the company;

(v) is a material supplier, service provider or customer or a lessor or lessee of the company;

f. who is not less than 21 years of age.

Explanation

For the purposes of the sub-clause (1):

i. “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.

ii. “Key Managerial Personnel” shall mean “Key Managerial Personnel” as defined in section 2(51) of the Companies Act, 2013.

iii. “Relative” shall mean “relative” as defined in section 2(77) of the Companies Act, 2013 and rules prescribed there under.

2. Limit on number of directorships

a. A person shall not serve as an independent director in more than seven listed companies.

b. Further, any person who is serving as a whole time director in any listed company shall serve as an independent director in not more than three listed companies.

3. Maximum tenure of Independent Directors

a. The maximum tenure of Independent Directors shall be in accordance with the Companies Act, 2013 and clarifications/circulars issued by the Ministry of Corporate Affairs, in this regard, from time to time.

4. Formal letter of appointment to Independent Directors

a. The company shall issue a formal letter of appointment to independent directors in the manner as provided in the Companies Act, 2013.

b. The terms and conditions of appointment shall be disclosed on the website of the company.

5. Performance evaluation of Independent Directors

a. The Nomination Committee shall lay down the evaluation criteria for performance evaluation of independent directors.

b. The company shall disclose the criteria for performance evaluation, as laid down by the Nomination Committee, in its Annual Report.

c. The performance evaluation of independent directors shall be done by the entire Board of Directors (excluding the director being evaluated).

d. On the basis of the report of performance evaluation, it shall be determined whether to extend or continue the term of appointment of the independent director.

6. Separate meetings of the Independent Directors

a. The independent directors of the company shall hold at least one meeting in a year, without the attendance of non-independent directors and members of management. All the independent directors of the company shall strive to be present at such meeting.

b. The independent directors in the meeting shall, *inter-alia:*

i. review the performance of non-independent directors and the Board as a whole;

ii. review the performance of the Chairperson of the company, taking into account the views of executive directors and non-executive directors;

iii. assess the quality, quantity and timeliness of flow of information between the company management and the Board that is necessary for the Board to effectively and reasonably perform their duties.

7. Familiarisation programme for Independent Directors

a. The company shall familiarise the independent directors with the company, their roles, rights, responsibilities in the company, nature of the industry in which the company operates, business model of the company, etc., through various programmes.

b. The details of such familiarisation programmes shall be disclosed on the company's website and a web link thereto shall also be given in the Annual Report.

C. 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, in any financial year and in aggregate.

Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 2013 for payment of sitting fees without approval of the Central Government.

Provided further that independent directors shall not be entitled to any stock option.

D. Other provisions as to Board and Committees

1. The Board shall meet at least four times a year, with a maximum time gap of one hundred and twenty days between any two meetings. The minimum information to be made available to the Board is given in **Annexure - X to the Listing Agreement.**

2. A director shall not be a member in more than ten committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore, every director shall inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

Explanation:

i. 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 8 of the Companies Act, 2013 shall be excluded.

ii. For the purpose of reckoning the limit under this sub-clause, Chairmanship/ membership of the Audit Committee and the Stakeholders' Relationship Committee alone shall be considered.

3. 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.
4. An independent director who resigns or is removed from the Board of the Company shall be replaced by a new independent director at the earliest but not later than the immediate next Board meeting or three months from the date of such vacancy, whichever is later.
5. Provided that where the company fulfils the requirement of independent directors in its Board even without filling the vacancy created by such resignation or removal, as the case may be, the requirement of replacement by a new independent director shall not apply.
6. The Board of the company shall satisfy itself that plans are in place for orderly succession for appointments to the Board and to senior management.

E. Code of Conduct

1. 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.
2. 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.
3. The Code of Conduct shall suitably incorporate the duties of Independent Directors as laid down in the Companies Act, 2013.
4. An independent director shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the Listing Agreement.

   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.

F. Whistle Blower Policy

1. The company shall establish a vigil mechanism for directors and employees to report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy.
2. This mechanism should also provide for adequate safeguards against victimization of director(s) / employee(s) who avail of the mechanism and also provide for direct access to the Chairman of the Audit Committee in exceptional cases.
3. The details of establishment of such mechanism shall be disclosed by the company on its website and in the Board's report.

III. 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:

1. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

2. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Explanation (i): 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 (ii): 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.

3. The Chairman of the Audit Committee shall be an independent director;
3. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
4. 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;
4. 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. Recommendation for appointment, remuneration and terms of appointment of auditors of the company;
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 and auditor's report thereon 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 (c) of sub-section 3 of section 134 of the Companies Act, 2013
   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, the statement of uses / application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and the report submitted by the monitoring agency monitoring the utilisation of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter;
7. Review and monitor the auditor's independence and performance, and effectiveness of audit process;
8. Approval or any subsequent modification of transactions of the company with related parties;
9. Scrutiny of inter-corporate loans and investments;
10. Valuation of undertakings or assets of the company, wherever it is necessary;
11. Evaluation of internal financial controls and risk management systems;
12. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;
13. 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;
14. Discussion with internal auditors of any significant findings and follow up there on;
15. 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;
16. 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;
17. 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;
18. To review the functioning of the Whistle Blower mechanism;
19. Approval of appointment of CFO (i.e., the whole-time Finance Director or any other person heading the finance function or discharging that function) after assessing the qualifications, experience and background, etc. of the candidate;
20. 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 provided in Clause 49(VII) of the Listing Agreement.

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.

IV. Nomination and Remuneration Committee

A. The company through its Board of Directors shall constitute the nomination and remuneration committee which shall comprise at least three directors, all of whom shall be non-executive directors and at least half shall be independent. Chairman of the committee shall be an independent director.

Provided that the chairperson of the company (whether executive or nonexecutive) may be appointed as a member of the Nomination and Remuneration Committee but shall not chair such Committee.

B. The role of the committee shall, *inter-alia*, include the following:

1. Formulation of the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board a policy, relating to the remuneration of the directors, key managerial personnel and other employees;
2. Formulation of criteria for evaluation of Independent Directors and the Board;
3. Devising a policy on Board diversity;
4. Identifying persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, and recommend to the Board their appointment and removal. The company shall disclose the remuneration policy and the evaluation criteria in its Annual Report.

C. The Chairman of the nomination and remuneration committee could be present at the Annual General Meeting, to answer the shareholders' queries. However, it would be up to the Chairman to decide who should answer the queries.

V. Subsidiary Companies

A. 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.

B. The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

C. 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.

D. The company shall formulate a policy for determining 'material' subsidiaries and such policy shall be disclosed on the company's website and a web link thereto shall be provided in the Annual Report.

E. For the purpose of this clause, a subsidiary shall be considered as material if the investment of the company in the subsidiary exceeds twenty per cent of its consolidated net worth as per the audited balance sheet of the previous financial year or if the subsidiary has generated twenty per cent of the consolidated income of the company during the previous financial year.

F. No company shall dispose of shares in its material subsidiary which would reduce its shareholding (either on its own or together with other subsidiaries) to less than 50% or cease the exercise of control over the subsidiary without passing a special resolution in its General Meeting except in cases where such divestment is made under a scheme of arrangement duly approved by a Court/Tribunal.

G. Selling, disposing and leasing of assets amounting to more than twenty percent of the assets of the material subsidiary on an aggregate basis during a financial year shall require prior approval of shareholders by way of special resolution, unless the sale/disposal/lease is made under a scheme of arrangement duly approved by a Court/Tribunal."

Explanation (i): For the purpos^ of sub-clause (V)(A), the term "material non-listed Indian subsidiary" shall mean an unlisted subsidiary, incorporated in India, whose income or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated income or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

Explanation (ii): For the purpose of sub-clause (V)(C), 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 (iii): For the purpose of sub-clause (V), 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.

VI. Risk Management

A The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures.

B The Board shall be responsible for framing, implementing and monitoring the risk management plan for the company.

C The company through its Board of Directors shall constitute a Risk Management Committee. The Board shall define the roles and responsibilities of the Risk Management Committee and may delegate monitoring and reviewing of the risk management plan to the committee and such other functions as it may deem fit.

D The majority of Committee shall consist of members of the Board of Directors.

E Senior executives of the company may be members of the said Committee but the Chairman of the Committee shall be a member of the Board of Directors.

VII. Related Party Transactions

A. A related party transaction is a transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged.

Explanation.- A "transaction" with a related party shall be construed to include single transaction or a group of transactions in a contract.

B. For the purpose of Clause 49 (VII), an entity shall be considered as related to the company if:

(i) such entity is a related party under Section 2(76) of the Companies Act, 2013; or

(ii) such entity is a related party under the applicable accounting standards.

C. The company shall formulate a policy on materiality of Related Party Transactions and also on dealing with Related Party Transactions.

Provided that a transaction with a related party shall be considered material if the transaction / transactions to be entered into individually or taken together with previous transactions during a financial year, exceeds ten percent of the annual consolidated turnover of the company as per the last audited financial statements of the company.

D. All Related Party Transactions shall require prior approval of the Audit Committee. However, the Audit Committee may grant omnibus approval for Related Party Transactions proposed to be entered into by the company subject to the following conditions:

a. The Audit Committee shall lay down the criteria for granting the omnibus approval in line with the policy on Related Party Transactions of the company and such approval shall be applicable in respect of transactions which are repetitive in nature.

b. The Audit Committee shall satisfy itself the need for such omnibus approval and that such approval is in the interest of the company;

c. Such omnibus approval shall specify (i) the name/s of the related party, nature of transaction, period of transaction, maximum amount of transaction that can be entered into, (ii) the indicative base price / current contracted price and the formula for variation in the price if any and (iii) such other conditions as the Audit committee may deem fit- Provided that where the need for Related Party Transaction cannot be foreseen and aforesaid details are not available, Audit Committee may grant omnibus approval for such transactions subject to their value not exceeding ₹ 1 crore per transaction.

d. Audit Committee shall review, at least on a quarterly basis, the details of RPTs entered into by the company pursuant to each of the omnibus approval given.

e. Such omnibus approvals shall be valid for a period not exceeding one year and shall require fresh approvals after the expiry of one year

E. All material Related Party Transactions shall require approval of the shareholders through special resolution and the related parties shall abstain from voting on such resolutions.

Provided that sub-clause 49 (VII) (D) and (E) shall not be applicable in the following cases:

(i) transactions entered into between two government companies;

(ii) transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.

Explanation(i): For the purpose of Clause 49(VII), "Government company" shall have the same meaning as defined in Section 2(45) of the Companies Act, 2013.

Explanation(ii): For the purpose of Clause 49(VII), all entities falling under the definition of related parties shall abstain from voting irrespective of whether the entity is a party to the particular transaction or not.

VIII. Disclosures

A. Related Party Transactions

1. Details of all material transactions with related parties shall be disclosed quarterly along with the compliance report on corporate governance.
2. The company shall disclose the policy on dealing with Related Party Transactions on its website and a web link thereto shall be provided in the Annual Report.

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. Remuneration of Directors

1. All pecuniary relationship or transactions of the non-executive directors vis-àvis the company shall be disclosed in the Annual Report.
2. In addition to the disclosures required under the Companies Act, 2013, 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.

3. 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.
4. The company shall disclose the number of shares and convertible instruments held by non-executive directors in the annual report.
5. 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.

D. Management

1. 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.
2. 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.
3. The Code of Conduct for the Board of Directors and the senior management shall be disclosed on the website of the company.

E. Shareholders

1. 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

2. Disclosure of relationships between directors inter-se shall be made in the Annual Report, notice of appointment of a director, prospectus and letter of offer for issuances and any related filings made to the stock exchanges where the company is listed.

3. 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.

4. A committee under the Chairmanship of a non-executive director and such other members as may be decided by the Board of the company shall be formed to specifically look into the redressal of grievances of shareholders, debenture holders and other security holders. This Committee shall be designated as 'Stakeholders Relationship Committee' and shall consider and resolve the grievances of the security holders of the company including complaints related to transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends.

5. 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.

I. Proceeds from public issues, rights issue, preferential issues, etc.

When money is raised through an issue (public issues, rights issues, preferential issues etc.), the company shall disclose 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 to the Audit Committee. 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. Furthermore, where the company has appointed a monitoring agency to monitor the utilisation of proceeds of a public or rights issue, it shall place before the Audit Committee the monitoring report of such agency, upon receipt, without any delay. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

IX. CEO/CFO certification

The CEO or the Managing Director or manager or in their absence, a Whole Time Director appointed in terms of Companies Act, 2013 and the CFO 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 :

1. these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

2. 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 for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such 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:

   1. significant changes in internal control over financial reporting during the year;
   2. significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
   3. 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 over financial reporting.

X. Report on Corporate Governance

A. 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 - XII to the Listing Agreement** and list of non-mandatory requirements is given in **Annexure - XIII to the Listing Agreement.**

B. 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 – XI to the Listing Agreement**. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

XI. Compliance

A. 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.

B. The non-mandatory requirements given in **Annexure - XIII to the Listing Agreement** may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

Annexure - X to the Listing Agreement

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 on recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and the 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 nonpayment for goods sold by the company.
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgement 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. Non-compliance of any regulatory, statutory or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.

Annexure - XI to the Listing Agreement

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
II. Board of Directors	49 (II)		
(A) Composition of Board	49 (IIA)		
(B) Independent Directors	49 (IIB)		
(C) Non-executive Directors' compensation & disclosures	49 (IIC)		
(D) Other provisions as to Board and Committees	49 (IID)		
(E) Code of Conduct	49 (IIE)		
(F) Whistle Blower Policy	49 (IIF)		
III. Audit Committee	49 (III)		
(A) Qualified & Independent Audit Committee	49 (IIIA)		
(B) Meeting of Audit Committee	49 (IIIB)		
(C) Powers of Audit Committee	49 (IIIC)		
(D) Role of Audit Committee	49 (IIID)		
(E) Review of Information by Audit Committee	49 (IIIE)		
IV. Nomination and Remuneration Committee	49 (IV)		
V. Subsidiary Companies	49 (V)		
VI. Risk Management	49 (VI)		
VII. Related Party Transactions	49 (VII)		
VIII. Disclosures	49 (VIII)		
(A) Related party transactions	49 (VIIIA)		
(B) Disclosure of Accounting Treatment	49 (VIIIB)		
(C) Remuneration of Directors	49 (VIII C)		
(D) Management	49 (VIII D)		
(E) Shareholders	49 (VIII E)		

(F) Disclosure of resignation of directors	49 (VIII F)		
(G)Disclosure of formal letter of appointment	49 (VIII G)		
(H) Disclosures in the Annual report	49 (VIII H)		
(I) Proceeds from public issues, rights issue, preferential issues, etc	49 (VIII I)		
IX. CEO/CFO Certification	49 (IX)		
X. Report on Corporate Governance	49 (X)		
XI. Compliance	49 (XI)		

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(VII).
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 - XII to the Listing Agreement

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:
   a. Composition and category of directors, for example, promoter, executive, nonexecutive, independent non-executive, nominee director, which institution represented as lender or as equity investor.
   b. Attendance of each director at the Board meetings and the last AGM.
   c. Number of other Boards or Board Committees in which he/she is a member or Chairperson.
   d. 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. Nomination and 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. Stakeholders' Grievance 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 - XIII to the Listing Agreement

Non-Mandatory Requirements

1. The Board

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.

2. 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.

3. Audit qualifications

Company may move towards a regime of unqualified financial statements.

4. Separate posts of Chairman and CEO

The company may appoint separate persons to the post of Chairman and Managing Director/ CEO.

5. Reporting of Internal Auditor

The Internal auditor may report directly to the Audit Committee.

Notes

Notes