PAPER 19

GROUP IV ■ FINAL COURSE

COST AND MANAGEMENT AUDIT (CMAD)

The Institute of Cost Accountants of India
(Statutory body under an Act of Parliament)
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FINAL : PAPER - 19

COST AND MANAGEMENT AUDIT

FINAL

STUDY NOTES

The Institute of Cost Accountants of India

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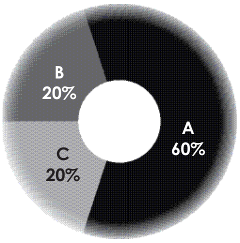
Syllabus

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. Cost Accounting Record Rules	
2. Cost Audit Report Rules	
3. Cost Accounting Standards	
4. Cost Audit & Assurance Standards	
5. Cost Auditor – appointment and related issues	
6. Management Reporting under Cost Audit	
Section B: Internal Audit and Operational Audit	**20%**
7. Internal Audit and Operational Audit	
Section C: Case Study on Performance Analysis	**20%**

SECTION A: COST AND MANAGEMENT AUDIT [60 MARKS]

1. Cost Accounting Record Rules, 2011

(a) Procedure for prescription of cost accounting record rules

(b) Cost accounting record rules and its applicability

(c) Provisions of cost accounting record rules for various industries

2. Cost Audit Report Rules, 2011

(a) Provisions of Cost Audit Report Rules, 2011

(b) Form of cost audit report

(c) Annexures to the cost audit report

(d) Pro-forma to the cost audit report

(e) Usefulness of Cost Audit

3. Cost Accounting Standards

4. Cost Audit & Assurance Standards

5. 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

6. Management Reporting under Cost Audit

(a) Management Reporting issues under Cost Audit

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

7. 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 [20 marks]

Case Study on the basis of Form III of the Companies (Cost Audit Report) Rules, 2011 [To be substituted by relevant Rules of 2014]

FORM OF THE PERFORMANCE APPRAISAL REPORT

Content

Study Note 1 : Cost Audit

Study Note 2 : Companies (Cost Accounting Records) Rules , 2011 & Guidance Note on Cost Accounting Record Rules, 2011

Section – A

Section – B

Study Note 3 : Guidance Note on Maintenance of Cost Accounting Records

Study Note 6 : Companies (Cost Audit Report) Rules, 2011, Cost Auditor and Cost Audit Programme

Study Note 7 : Cost Audit and Assurance Standards (CAAS)

Study Note 8 : Guidance Note on Peroframance Appraisal Report

Study Note 9 : Exposure Draft Training & Guidance Manual for Cost Audit Report & Compliance Report in XBRL Format

Study Note 10 : Basics of Internal Control and Internal Audit

Study Note 11 : Basics of Operational Audit

Study Note 12 : Management Audit in Different Functions

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

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.

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

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 Companies Act, 2013 was to meet the Government requirements for regulating the price mechanism in core industries like Cement, Sugar, Textiles and consumer industries like Vanaspati, Formulations and Automobiles. The objective was to provide an authentic data to the Government to regulate the demand and supply in the country through a price control mechanism.

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 PROVISIONS UNDER COMPANIES ACT RELATING TO MAINTENANCE OF COST RECORDS AND COST AUDIT

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 FEATURES OF COST AUDIT

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

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

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

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

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

Since cost audit is carried out under the provisions of the Companies Act, 2013, a thorough and comprehensive knowledge of the Indian Companies Act including various rules prescribed thereunder and the circulars issued by the Ministry of Corporate Affairs is essential for conducting an effective Cost Audit.

Study Note - 2

COMPANIES (COST ACCOUNTING RECORDS) RULES , 2011 & GUIDANCE NOTE ON COST ACCOUNTING RECORD RULES, 2011

This Study Note includes

SECTION - A

The Cost Accounting Record Rules, 2011, is applicable to every company including a foreign company engaged in production, processing, manufacturing or mining wherein:

❖ the aggregate value of net worth as on the last date of the immediately preceding financial year exceeds ₹ 5 crores, or

❖ the aggregate value of the turnover made by the company from all products or activities during the immediately preceding financial year exceeds ₹ 20 crores, or

❖ the company's equity or debt securities are listed or are in the process of listing on any stock exchange.

2.1 COST ACCOUNTING RECORD RULES, 2011 (Provided for basic information only)

❖ Not applicable to a body corporate governed by a special Act

❖ Supersedes 36 Cost Accounting Records out of 44 issued till date

❖ Not applicable to following activities or products covered under individual Cost Accounting Records Rules notified on 7th December 2011:

Pharmaceuticals	Electricity Industry
Sugar	Fertilizers
Telecommunications	Petroleum Industry

Clarification – General Circular 67/2011

The new Cost Accounting Records Rules, 2011 (Common & 6 Industry specific) are not applicable to companies engaged in:

Wholesale Trading	Insurance	Recreation
Retail Trading	Education	Transport Services
Banking	Healthcare	Professional Consultancy
Financial	Tourism	IT & IT Enabled Services
Leasing	Travel	Research& Development
Investment	Hospitality	Postal/Courier services

- ❖ Job work operations or contracting/ sub-contracting activities and paid only the job work or conversion charges, such as, tailoring, baking, repairing, painting, printing, constructing, servicing, etc.
- ❖ A company yet to commence commercial operations.
- ❖ Ancillary products/activities of companies incidental to their main operations (i.e. products/activities that do not constitute their main line of business)
  - where the total turnover from the sale of each such ancillary products/activities do not exceed 2% of the total turnover of the company or
  - ₹ 20 crores, whichever is lower.
- ❖ Required details of all such ancillary products/activities to be maintained under a miscellaneous group and disclosed appropriately.

Compliance Report under CARR

Every company to which either Companies (Cost Accounting Records) Rules 2011 or any of the 6 Industry specific Rules apply shall submit a Compliance Report

- ❖ From 2011-12 for every financial year commencing on or after 01/04/2011 [for 6 Regulated Industries from financial year commencing on or after 07/12/2011]
- ❖ To be filed provided all the products/ activities of the company, excluding the exempted categories, are not covered under cost audit
- ❖ Within 180 days from close of financial year
- ❖ Annexures to be certified by a "Cost Accountant"
- ❖ Report to be approved by the Board of Directors

Supplementary Study Material on relevant Rules of 2014 would be provided in due course pursuant to final notification by the Ministry of Corporate Affairs, Government of India.

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 (CBEC) 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 CBEC."

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

CBEC 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 CBEC 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 per rates specified under Companies Act, 1956. 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 209(1) (d) of the Companies Act, 1956, i.e., where

Cost Accounting Records are statutorily required to be maintained, the Cost Accountant certifying the cost of production for captive consumption shall verify the correctness of the cost from these records. However, for manufacturers not covered under Section 209(1) (d) of the Companies Act, 1956, it is desirable that they also maintain cost accounting records in line with the records so prescribed as to facilitate determination and certification of cost of production.

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 209(1)(d) of the Companies Act, 1956.

In case where the product is covered under The Companies (Cost Accounting Records) Rules 2011 issued in pursuant to Section 209(1)(d) of the Companies Act, 1956, 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 209(1) (d) and cost audit thereof under section 233B of the Companies Act 1956. 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 209(1)(d) of the Companies Act, 1956 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 , CBEC 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 (41) of section 2 of the Companies act, 1956;

   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, 1956 (1 of 1956).

    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 CBEC. 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(on7+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
				RS/UNIT	RS	2008-09
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 31.3.2008						
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 :	
2005-06	110 Nos. Bulk Carrier
2006-07	125 Nos. Bulk Carrier
2007-08	53 Nos. Bulk Carrier

Production during 2007-08 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 1Apt -31March 2008			
		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** **Colours & Chemicals**	 827560 100182	 24.34 2.95
2	Direct Wages and Salaries :	6460	0.19
3	Utility : Power Steam Cost Heat Cost	 27200 44604 14620	 0.80 1.31 0.43
4	Works Overheads	60825	1.79
	Depreciation	19040	0.56

5	Quality Control Cost	-	-
6	Research & Development Cost	-	-
7	Administrative Overheads	5780	0.17
8	Total (1 to 7)	1106271	32.54
9	Add : Opening stock of Work – in – progress	22703	
10	Less : Closing stock of work –in –progress	33711	
11	Total (8+9+10)	1095263	32.07
12	Less : Credit for Recoveries /Scrap/By-products/misc income	37719	1.10
13	Packing cost	-	-
14	Cost of production	1057544	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	6558	0.19
19	Less : Closing stock of finished goods	6176	0.18
20	Cost of production for goods dispatched (17+18-19)	1057926	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	Processing cost	Total
	(₹/ MT)	(₹/MT)	(₹/MT)
1	2000	500	2500
2	3500	1000	3500
3	3500	1000	4500

If during the production process at stage3, the scrap is produced and the same is recycled at stage2 after making an expenditure of ₹ 200 per MT to make it suitable for re-processing at stage2, 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 209(1)(d) of the Companies Act, 1956, i.e., where Cost Accounting Records are statutorily required to be maintained, the Cost Accountant certifying the cost of production for captive consumption shall verify the correctness of the cost from these records. However, for manufacturers not covered under Section 209(1)(d) of the Companies Act, 1956, it is desirable that they also maintain cost accounting records in line with the records so prescribed as to facilitate determination and certification of cost of production.

7. Disclosure

(i) ***If there is any change in cost accounting principles and practices during the concerned period which may materially affect the cost of production in terms of comparability with previous periods, the same should be disclosed.***

(ii) ***If opening stock and closing stock of work -in-progress and finished goods are not readily available for certification purpose, the same should be disclosed.***

Appendix – 1

Name of the Manufacturer :
Address of the Manufacturer :
Registration No of Manufacturer :
Description of product captively consumed:
Excise Tariff Heading :
Statement of Cost of Production of _____________ manufactured / to be manufactured during the period _____________

		Qty	
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.

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.

The Companies (Cost Accounting Records) Rules, 2011 provide that every company, including a foreign company defined under section 591 of the Companies Act, 1956 which is engaged in production, processing, manufacturing or mining activities have to maintain cost accounting records in accordance with the Generally Accepted Cost Accounting principles (GACAP) and Cost Accounting Standards issued by the ICWAI, to the extent these are found to be relevant and applicable. The above Rules further provide that these will be applicable to companies wherein aggregate value of net worth as on the last date of the immediately preceding financial year exceeds five crores of rupees; or wherein the aggregate value of the turnover made by the company from sale or supply of all products or activities during the immediately preceding financial year exceeds twenty crores of rupees; or wherein the company's equity or debt securities are listed or are in the process of listing on any stock exchange whether in India or outside India.

The Companies (Cost Audit Report) Rules, 2011 cast a duty for a Cost Auditor appointed under Section 233B of the Companies Act, 1956 to certify inter alia that books and records maintained by the company are in conformity with the Cost Accounting Standards issued by the ICWAI to the extent these are found to be relevant and applicable.

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, 1956) 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	→	Company and associates own 51 percent of their Equity.

Nature of transactions: 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.

Volume of transaction: 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[2009 To M/s KLM,Nioda			
Item	**Quantity Nos**	**Rate ₹ /Unit**	**Amount (₹)**
1.Bottom Cap 2.Top Cap	2200 2200	2.79 2.26	6138 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 Basic Excise Duty Receivable A/c Education Cess Receivable A/c Secondary and Higher Education Cess Receivable A/c Vat recoverable	Dr Dr Dr Dr Dr	11110 889 18 9 481	
To Supplier	Cr		12507
On Payment Supplier To Bank	 Dr Cr	 12507	 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 15.9.2009 XXX			
FOB/CIF	FOB			
Bill of Entry No. and date	XXX dated 8.10.2009			
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,2009 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 2009:

Date	Receipts		Date	Issue (Qty)
	Units(tonnes)	Rupees/unit		
2-1-2009	300	4	7-1-2009	200
16-1-2009	500	6	18-1-2009	400
23-1-2009	450	5	29-1-2009	100

FIFO method:

Date	Receipt			Issue			Balance		
	Qty	**Rate (₹)**	**Amt (₹)**	**Qty**	**Rate (₹)**	**Amt (₹)**	**Qty**	**Rate (₹)**	**Amt (₹)**
1-1-09							-	-	-
2-1-09	300	4	1200				**300**	**4**	**1200**
7-1-09				200	4	800	**100**	**4**	**400**
16-1-09	500	6	3000				100	4	400
							500	6	3000
							600		**3400**
18-1-09				100	4	400	**200**	**6**	**1200**
				300	6	1800			
23-1-09	450	5	2250				200	6	1200
							450	5	2250
							650		**3450**
29-1-09				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(₹)**
1-1-09							-	-	-
2-1-09	300	4	1200				**300**	**4**	**1200**
7-1-09				200	4	800	**100**	**4**	**400**
16-1-09	500	6	3000				100	4	400
							500	6	3000
							600		**3400**
18-1-09				400	6	2400	100	4	400
							100	6	600
							200		**1000**
23-1-09	450	5	2250				100	4	400
							100	6	600
							450	5	2250
							650		**3250**
29-1-09				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(₹)
1-1-09							**-**	**-**	**-**
2-1-09	300	4	1200				**300**	**4**	**1200**
7-1-09				200	4	800	**100**	**4**	**400**
16-1-09	500	6	3000				**600**	**5.667***	**3400**
18-1-09				400	5.667	2000	**200**	**5.667**	**1133**
23-1-09	450	5	2250				**650**	**5.2****	**3380**
29-1-09				100	5.2	520	**550**	**5.2**	**2860**

Weighted average method:

* issue on18-1-09→(3400/600=5.667) ** issue on 29-1-09→(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	10000	5.20	52000	9500	5.08	48260
Loss 5%	500					
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.[3]***

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[4].***

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1 Adapted fromCAS-1 Para 6.5.19
2 Adapted from CAS-1 Para 6.3.5
3 Adapted from CIMA Terminology
4 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[5].***

4.6.2 Indirect Materials: ***Materials, the costs of which cannot be directly attributed to a particular cost object[6].***

4.7 Material Cost: ***The cost of material of any nature used for the purpose of production of a product or a service[7].***

4.8 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.

4.9 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[9].***

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.[10] 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[11].***

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.***

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5 Adapted from CAS 1-6.2.3
6 Adapted from CAS 1– 6.2.8
7 CAS-1-6.1.2
8 Adapted from CAS-1 Para 6.3.3 and 6.3.4
9 Adapted from Glossary of Management Accounting Terms- Page 62
10 Adapted from CAS 1_ Para 6.7.5
11 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[12] 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.***

12 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.

Further, The Companies (Cost Accounting Records) Rules, 2011 provide that every company, including a foreign company defined under section 591 of the Companies Act, 1956 which is engaged in production, processing, manufacturing or mining activities have to maintain cost accounting records in accordance with the Generally Accepted Cost Accounting Principles (GACAP) and Cost Accounting Standards issued by the ICWAI, to the extent these are found to be relevant and applicable. The above Rules further provide that these will be applicable to companies wherein:

a) aggregate value of net worth as on the last date of the immediately preceding financial year exceeds five crores of rupees; or

b) the aggregate value of the turnover made by the company from sale or supply of all products or activities during the immediately preceding financial year exceeds twenty crores of rupees; or

c) the company's equity or debt securities are listed or are in the process of listing on any stock exchange whether in India or outside India.

The Companies (Cost Audit Report) Rules, 2011 cast a duty on a Cost Auditor appointed under Section 233B of the Companies Act, 1956 for a company to certify inter alia that books and records maintained by the company are in conformity with the Cost Accounting Standards issued by the ICWAI to the extent these are found to be relevant and applicable.

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 being followed consistently but due to change in the principle with the notification of Cost Audit Report Rules, 2011 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, 1956, 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 01/04/2009 TO 30/04/2009

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 2 men @ ₹ 20 per hour 5 men @ ₹ 16 per hour 1 men @ ₹ 25 per hour	**Actual Gang worked** 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.***[3]

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.***[4]

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.***[5]

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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 CIMA Terminology

4 Adapted from CAS 1 paragraph 6.3.9

5 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.***[6]

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.

6 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.***[7]

4.10 Indirect Employee Cost: ***The cost which cannot be directly attributed to a particular cost object.***[8]

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.***[9]

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.***[10]

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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7 Adapted from CAS 1 paragraph 6.5.13
8 Adapted from CAS 1 paragraph 6.2.10
9 Adapted from CAS 1 paragraph 6.3.3
10 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[11].***
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.***

11 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".

Further The Companies (Cost Accounting Records) Rules, 2011 provides that every company, including a foreign company defined under section 591 of the Companies Act,1956 which is engaged in production, processing, manufacturing, or mining activities has to maintain cost accounting records in accordance with the generally accepted cost accounting principles and cost accounting standards issued by the ICAI, to the extent these are found to be relevant and applicable. The above Rules further provides that these will be applicable to companies wherein:

(a) aggregate value of net worth as on the last date of the immediately preceding financial year exceeds five crores of rupees; or

(b) the aggregate value of the turnover made by the company from sale or supply of all products or activities during the immediately preceding financial year exceeds twenty crores of rupees; or

(c) the company's equity or debt securities are listed or are in the process of listing on any stock exchange whether in India or outside India.

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°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°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 --- °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.

8.1.3Where 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

8.1.6Cost 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
2	Distribution cost : Operation &Main tenance cost of distribution line Depreciation Other Total Distribution cost	Per MT ₹ 1.00 ₹ 0.75 ₹ 0.75 ₹ 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: 2007-08 2008-09	 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.[2]

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 costs3. 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.[4]

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.[5]

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.

1 Adapted from CAS 1 paragraph 6.5.19
2 Adapted from CIMA Terminology
3 Adapted from CIMA Terminology
4 Adapted from CAS 1 paragraph 6.5.13
5 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[6]. 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.

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6 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 parties7.***
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.*

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7 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.

Further The Companies (Cost Accounting Records) Rules, 2011 provides that every company, including a foreign company defined under section 591 of the Companies Act, 1956 which is engaged in production, processing, manufacturing or mining activities have to maintain cost accounting records in accordance with the generally accepted cost accounting principles and cost accounting standards issued by the Institute, to the extent these are found to be relevant and applicable. The above Rules further provides that these will be applicable to companies wherein aggregate value of net worth as on the last date of the immediately preceding financial year exceeds five crores of rupees; or wherein the aggregate value of the turnover made by the company from sale or supply of all products or activities during the immediately preceding financial year exceeds twenty crores of rupees; or wherein the company's equity or debt securities are listed or are in the process of listing on any stock exchange whether in India or outside India.

The Companies (Cost Audit Report) Rules 2011 cast a duty on a Cost Auditor appointed under Section 233B of the Companies Act 1956 to certify inter alia that books and records maintained by the company are in conformity with the Cost Accounting Standards issued by the Institute to the extent these are found to be relevant and applicable.

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 Audit Report) Rules, 2011 (para 5 of the Annexure to Form II) the cost of secondary packing materials is to be exhibited as a separate line item 23 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 1956) 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:

<u>Name and address of Related Party</u>	XYZ Ltd (address)
<u>Nature of transactions:</u>	XYZ Ltd supplies packing bags
<u>Volume of transaction:</u>	During the year 500 HDPE bags were supplied @ ₹5 per bag for ₹2500
<u>Normal Price:</u>	₹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.***[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, 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.***[5]

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.***[6]

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[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]

For example: packing material supplied by the customer**.**

4.10 Marketing overheads: ***Marketing Overheads comprises selling overheads and distribution overheads.***

2 Adapted from CIMA Terminology
3 Adapted from CAS 7 paragraph 4.6
4 Adapted from CAS 1 paragraph 6.2.6 and also proposed in the CAS on Direct Expenses
5 Adapted from CAS 6 paragraph 4.6.1
6 Adapted from CAS 1 paragraph 6.3.9
7 Adapted from CIMA Terminology
8 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.***[9]

4.11.1.1 Reworks: ***Defectives which can be brought up to the standards by putting in additional resources.***[10]

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.***[11]

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.***[12]

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***[13]**.**

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.***[14]

9 Adapted from CAS 6 paragraph 4.4
10 Adapted from CAS 6 paragraph 4.4.1
11 Adapted from CAS 6 paragraph 4.4.2
12 Adapted from paragraph 4.9 of CAS 6
13 Adapted from CAS-1 paragraph 6.3.3 and 6.3.4
14 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.***[15]

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***

15 Adapted from CAS 6 paragraph 4.15

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[16].***
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.***

16 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.

Further, The Companies (Cost Accounting Records) Rules, 2011 provide that every company, including a foreign company defined under section 591 of the Companies Act, 1956 which is engaged in production, processing, manufacturing or mining activities have to maintain cost accounting records in accordance with the Generally Accepted Cost Accounting Principles (GACAP) and Cost Accounting Standards issued by the Institute, to the extent these are found to be relevant and applicable. The above Rules further provide that these will be applicable to companies wherein:

(a) aggregate value of net worth as on the last date of the immediately preceding financial year exceeds five crores of rupees; or

(b) the aggregate value of the turnover made by the company from sale or supply of all products or activities during the immediately preceding financial year exceeds twenty crores of rupees; or

(c) the company's equity or debt securities are listed or are in the process of listing on any stock exchange whether in India or outside India.

The Companies (Cost Audit Report) Rules 2011 cast a duty on a Cost Auditor appointed under Section 233B of the Companies Act, 1956 to certify inter- alia that books and records maintained by the company are in conformity with the Cost Accounting Standards issued by the Institute to the extent these are found to be relevant and applicable.

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, 1956), 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 overheads3, marketing overheads4 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.[5]

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

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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
5 Adapted from CIMA Terminology

they are regarded as an adjustment to the interest costs6. 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.[7]

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.[8]

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.[9]

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 CIMA Terminology
7 Adapted from CAS 1 Para 6.5.13
8 Adapted from CAS 2 Para 4.4
9 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.10

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 parties11.***
- ***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.

10 Adapted from of CAS 3 Para 5.1

11 Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

Study Note - 3

GUIDANCE NOTE ON MAINTENANCE OF COST ACCOUNTING RECORDS

This Study Note includes

3.1 INTRODUCTION

Section 209(1) (d) of the Companies Act, 1956, incorporated in 1965, is the backbone of statutory cost accounting in the Indian corporate sector. This framework put to practice, through promulgation of Cost Accounting Records Rules by the Government, has inculcated a sense of cost consciousness in large number of industries/companies. The mechanism of maintenance of cost records, to a very large extent, has helped industry to face the fierce competitive forces arising out of post-1991 liberalization and globalization. It also served well the legal and non-legal requirements of various regulatory authorities, government agencies, tariff/price fixation bodies, research organisations, etc.

Presently, the prescription of cost accounting records rules has been extended to all companies engaged in production, processing manufacturing and mining activities. Further, the Central Government has also prescribed uniform cost accounting records rules in place of product-wise records rules prescribed earlier. As such, it is necessary to explain the extent, scope and methodology of preparation and maintenance of requisite cost accounting records by the companies. This Guidance Note is an attempt to guide the members employed in various organizations and also those engaged in public practice to ensure that they follow a well-structured cost accounting system suited to the type, size & scale of operations that results in creating the intended cost accounting records leading to collection, assignment, apportionment and absorption of correct cost data to the relevant cost objects in the organization. The structure followed should also enable the Cost Auditor to audit and certify the cost statements for each product/ activity in accordance with the notified Cost Accounting Records Rules and Cost Audit Report Rules.

This Guidance Note is neither intended to supersede any Rules/Regulations/Orders issued by the Central

Government or by any other Authority nor may be construed as a mandatory replacement of the system of cost accounting that exist and is well suited in any organization. It is mere guide to supplement the efforts made by the members employed in various organizations and also those engaged in public practice to enable these organisations to follow a cost accounting system that conforms to the Generally Accepted Cost Accounting Principles and Cost Accounting Standards issued by the Institute and also complies with the Cost Accounting Records Rules notified by the Ministry of Corporate Affairs. Therefore, all users of this Guidance Note should familiarise themselves with all the Rules/Regulations/Orders and clarifications issued by the Central Government as well as the Standards and other pronouncements made by the Institute and may take assistance of this Guidance Note in a manner that will meet the requirement of the organizations without sacrificing with the fundamental principles that are enshrined either in any Statute or in the Standards prescribed by the Institute of Cost Accountants of India.

This Guidance Note has primarily focussed on the uniform Cost Accounting Records Rules notified by the Ministry of Corporate Affairs vide GSR 429(E) dated 3rd June, 2011. In addition, the common principles as embedded in the other six industry specific Cost Accounting Records Rules notified on 7th December, 2011 also remain covered; but the formats as prescribed in these industry specific CARR have to be followed and complied with fully.

3.2 COST ACCOUNTING RECORDS RULES (CARR)

Provisions in the Companies Act, 1956:

Section 209 of the Companies Act 1956 deals with the books of accounts to be maintained by a body corporate. The section provides as follows:

(1) Every company shall keep at its registered office proper books of account with respect to -

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

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

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

(d) In the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particular in the books of account.

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

(2) Where a company has a branch office, whether in or outside India, the company 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, made up to dates at intervals of not more than three months, are sent by the branch office to the company at its registered office or the other place referred to in sub-section (1).

(3) For the purposes of sub-sections (1) and (2), proper books of account shall not be deemed to be kept with respect to the matters specified therein, -

(a) if there are not kept such books as are necessary to give a true and fair view of the state of the affairs of the company or branch office, as the case may be, and to explain its transactions; and;

(b) if such books are not kept on accrual basis and according to the double entry system of accounting.

(4) The books of account and other books and papers shall be open to inspection by any director during business hours.

(4A) The books of accounts of every company relating to a period of not less than eight years immediately preceding the current year together with the vouchers relevant to any entry in such books of account shall be preserved in good order:

Provided that in the case of a company incorporated less than eight years before the current year, the books of account for the entire period preceding the current year together with vouchers relevant to entry in such books of account shall be so preserved.

(5) If any of the persons referred to in sub-section (6) fails to take all reasonable steps to secure compliance by the company with the requirements of this section, or has by his own wilful act been the cause of any default by the company there under, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both:

Provided that in any proceedings against a person in respect of an offence under this section consisting of a failure to take reasonable steps to secure compliance by the company with the requirements of this section, it shall be a defence to prove that a competent and reliable person was charged with the duty of seeing that those requirements were complied with and was in a position to discharge that duty:

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

(6) The persons referred to in sub-section (5) are the following, namely:-

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

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

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

In exercise of powers conferred by section 642(1) read with section 209(1) (d) of the Companies Act, 1956, the Central Government prescribes Cost Accounting Record Rules for the maintenance of cost records relating to the utilization of materials, labour and other items of cost, in the manner as prescribed, by specified class of companies engaged in production, processing manufacturing or mining operations of the prescribed products/activities.

Cost Accounting Records Rules 2011:

In exercise of the powers conferred by clause (b) of sub-section (1) of section 642 read with clause (d) of sub-section (1) of section 209 of the Companies Act, 1956, and in suppression of all the existing 44 CARRs, the Central Government has notified revised Cost Accounting Records Rules as per details given below.

G.S.R. No. 429(E) dated 3rd June, 2011 - Companies (Cost Accounting Records) Rules, 2011 issued in supersession of 36 cost accounting records rules	
	Rules Superseded
1	**Cost Accounting Records (Cycles) Rules, 1967** published vide G.S.R. 311 dated 2nd March, 1967
2	**Cost Accounting Records (Tyres & Tubes) Rules, 1967** published vide G.S.R. 1260 dated 10th August, 1967
3	**Cost Accounting Records (Air-Conditioners) Rules, 1967** published vide G.S.R. 1447 dated 16th September, 1967 and subsequently amended vide G.S.R. 668(E) dated 28th September, 1999
4	**Cost Accounting Records (Refrigerators) Rules, 1967** published vide G.S.R. 1448 dated 18th September, 1967
5	**Cost Accounting Records (Batteries other than Dry Cell Batteries) Rules, 1967** published vide G.S.R. 1467 dated 20th September, 1967 and subsequently amended vide G.S.R. 667(E) dated 28th July, 1999.
6	**Cost Accounting Records (Electric Lamps) Rules, 1967** published vide G.S.R. 1503 dated 27th September, 1967 and subsequently amended vide G.S.R. 670(E) dated 28th September, 1999
7	**Cost Accounting Records (Electric Fans) Rules, 1969** published vide G.S.R. 2298 dated 15th September, 1969
8	**Cost Accounting Records (Electric Motors) Rules, 1969** published vide G.S.R. 2574 dated 24th October, 1969
9	**Cost Accounting Records (Aluminium) Rules, 1972** published vide G.S.R. 334 dated 25th February, 1972 and subsequently amended vide G.S.R. 703(E) dated 28th September, 2001
10	**Cost Accounting Records (Vanaspati) Rules, 1972** published vide G.S.R. 1529 dated 27th November, 1972 and subsequently amended vide G.S.R. 287 dated 29h May, 1992
11	**Cost Accounting Records (Jute Goods) Rules, 1975** published vide G.S.R. 590(E) dated 29th December, 1975
12	**Cost Accounting Records (Paper) Rules, 1975** published vide G.S.R. 601(E) dated 31st December, 1975
13	**Cost Accounting Records (Rayon) Rules, 1976** published vide G.S.R. 606 dated 20th April, 1976 and subsequently amended vide G.S.R. 694 dated 31st August, 2000
14	**Cost Accounting Records (Dyes) Rules, 1976** published vide G.S.R. 605 dated 22nd April, 1976.
15	**Cost Accounting Records (Polyester) Rules, 1977** published vide G.S.R. 126(E) dated 24th March, 1977 and subsequently amended vide G.S.R. 692(E) dated 31st August, 2000
16	**Cost Accounting Records (Nylon) Rules, 1977** published vide G.S.R. 157(E) dated 1st April, 1977 and subsequently amended vide G.S.R. 695(E) dated 31st August, 2000
17	**Cost Accounting Records (Textiles) Rules, 1977** published vide G.S.R. 417(E) dated 28th June, 1977 and subsequently amended vide G.S.R. 29(E) dated 19th January, 1994.
18	**Cost Accounting Records (Dry Cell Batteries) Rules, 1978** published vide G.S.R. 45(E) dated 31st January, 1979
19	**Cost Accounting Records (Steel Tubes and Pipes) Rules, 1984** published vide G.S.R. 506(E) dated 10th May, 1984
20	**Cost Accounting Records (Engineering Industries) Rules, 1984** published vide G.S.R. 688 dated 25th June, 1984 and subsequently amended vide G.S.R. 279(E) dated 24th April, 2001
21	**Cost Accounting Records (Electric Cables and Conductors) Rules, 1984** published vide G.S.R. 767 dated 7th July, 1984.
22	**Cost Accounting Records (Bearings) Rules, 1985** published vide G.S.R. 664 dated 1st July, 1985
23	**Cost Accounting Records (Steel Plant) Rules, 1990** published vide G.S.R. 574 dated 31st July, 1990 and subsequently amended vide G.S.R. 281(E) dated 24th April, 2001.
24	**Cost Accounting Records (Insecticides) Rules, 1993** published vide G.S.R. 258(E) dated 3rd March, 1993

	G.S.R. No. 429(E) dated 3rd June, 2011 - Companies (Cost Accounting Records) Rules, 2011 issued in supersession of 36 cost accounting records rules	
	Rules Superseded	
25	**Cost Accounting Records (Soaps & Detergents) Rules, 1993** published vide G.S.R. 677(E) dated 29th October, 1993.	
26	**Cost Accounting Records (Cosmetics & Toiletries) Rules, 1993** published vide G.S.R. 678(E) dated 29th October, 1993	
27	**Cost Accounting Records (Footwear) Rules, 1996** published vide G.S.R. 186(E) dated 12th April, 1996	
28	**Cost Accounting Records (Shaving Systems) Rules, 1996** published vide G.S.R. 202(E) dated 6th May, 1996	
29	**Cost Accounting Records (Industrial Gases) Rules, 1996** published vide G.S.R. 271(E) dated 9th July, 1996	
30	**Cost Accounting Records (Motor Vehicles) Rules, 1997** published vide G.S.R. 537(E) dated 11th September, 1997 and subsequently amended vide G.S.R. 328(E) dated 3rd June, 1998, G.S.R. 329(E) dated 3rd June, 1998 and G.S.R. 280(E) dated 24th April, 2001	
31	**Cost Accounting Records (Cement) Rules, 1997** published vide G.S.R. 536(E) dated 11th September, 1997.	
32	**Cost Accounting Records (Milk Food) Rules, 2001** published vide G.S.R. 704(E) dated 28th September, 2001	
33	**Cost Accounting Records (Mining and Metallurgy) Rules, 2001** published vide G.S.R. 276(E) dated 24th April, 2001	
34	**Cost Accounting Records (Electronic Products) Rules, 2001** published vide G.S.R. 277(E) dated 24th April, 2001	
35	**Cost Accounting Records (Plantation Products) Rules, 2002** published vide G.S.R. 685(E) dated 8th October, 2002	
36	**Cost Accounting Records (Chemicals) Rules, 2004** published vide G.S.R. 562(E) dated 2nd September, 2004	
	Industry Specific Cost Accounting Records Rules	
	New Rules	**Rules Superseded**
37	G.S.R. No. 869(E) dated 7th December 2011 - **Cost Accounting Records (Telecommunication Industry) Rules 2011**	Cost Accounting Records (Telecommunications) Rules, 2002 vide G.S.R. 689(E), dated the 8th October, 2002
38	G.S.R. No. 870(E) dated 7th December 2011 - **Cost Accounting Records (Petroleum Industry) Rules 2011**	Cost Accounting Records (Petroleum Industry) Rules, 2002 vide G.S.R. 686(E), dated the 8th October, 2002
39	G.S.R. No. 871(E) dated 7th December 2011 - **Cost Accounting Records (Electricity Industry) Rules 2011**	Cost Accounting Records (Electricity Industry) Rules, 2001 vide G.S.R. 913(E), dated the 21st December, 2001
40	G.S.R. No. 872(E) dated 7th December 2011 - **Cost Accounting Records (Sugar Industry) Rules 2011**	Cost Accounting Records (Sugar) amended Rules, 1997 vide G.S.R. 388(E), dated the 15th July, 1997
41		Cost Accounting Records (Industrial Alcohol) Rules, 1997 vide G.S.R. 532(E), dated the 17th September, 1997.
42	G.S.R. No. 873(E) dated 7th December 2011 - **Cost Accounting Records (Fertilizer Industry) Rules 2011**	Cost Accounting Records (Fertilizers) Rules, 1993 vide G.S.R. 261(E), dated the 5th March, 1993
43	G.S.R. No. 874(E) dated 7th December 2011 - **Cost Accounting Records (Pharmaceutical Industry) Rules 2011**	Cost Accounting Records (Bulk Drugs) Rules, 1974 vide G.S.R. 130(E), dated the 14th March, 1974
44		Cost Accounting Records (Formulations) Rules, 1988 vide G.S.R. 452, dated the 22nd April, 1988.

SALIENT FEATURES OF NEW COST ACCOUNTING RECORDS RULES, 2011

The features outlined below pertain to all the 7 cost accounting records rules, viz., the Companies (Cost Accounting Records) Rules 2011 (Common CARR) and the 6 Industry Specific Cost Accounting Records Rules (IS-CARR)

1. Applicability [Rule 3]:

Class of Companies

The cost accounting records rules are applicable to all companies where:

a) the aggregate value of net worth as on the last date of the immediately preceding financial year exceeds five crore of rupees; or

b) the aggregate value of the turnover made by the company from sale or supply of all products or activities during the immediately preceding financial year exceeds twenty crore of rupees; or

c) the company's equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

The Common CARR or IS-CARR shall not apply to a body corporate governed by any special Act.

Nature of Activities:

Companies (Cost Accounting Records) Rules 2011 apply to all companies subject to the limits indicated above and engaged in production, processing, manufacturing or mining activities as defined in these Rules. However, the 6 industry specific cost accounting records rules apply to the activities as defined in the respective Rules as reproduced below.

Telecommunication:

"Telecommunication Activities" means any act, process, procedure, function, operation, technique, treatment or method employed in relation to telecasting, broadcasting, telecommunicating voice, text, picture, information, data or knowledge through any mode or medium and includes intermediate and allied activities thereof and these activities would, inter alia, include the following services or activities, including such services that require license or registration with the Ministry of Communications and Information Technology, Government of India, namely: -

(i) Basic Telephone Services;

(ii) National Long Distance Services;

(iii) International Long Distance Services;

(iv) Cellular Mobile Telephone Services;

(v) Wireless Local Loop (WLL) (Fixed or Mobile) Telephone Services;

(vi) Very Small Aperture Terminal Services;

(vii) Public Mobile Radio Trunk Services;

(viii) Global Mobile Personal Communication Services;

(ix) Internet or Broadband or Wireless Access service;

(x) Infrastructure Provider (IP-1);

(xi) Passive Telecom Infrastructure including Telecom Tower Facilities;

(xii) Cable Landing Stations; and

(xiii) Any other related, allied, intermediate or support services in relation to telecommunication activities not indicated above.

Petroleum:

"Petroleum Activities" means production, processing, manufacturing or mining of crude oil, gases [including Natural Gas, Compressed Natural Gas, Liquefied Petroleum Gas and regasified gases, etc. as defined in the Petroleum and Natural Gas Regulatory Board Act, 2006 (19 of 2006)] or Biogas or any other petroleum products, or included under Chapter 27 of the Central Excise Tariff Act, 1985 (5 of 1986), including the intermediate products and articles or allied products or activities thereof and includes storage, transportation or distribution of crude oil or gases or biogas or any or all of the petroleum products.

Electricity:

"Electricity Activities" means any act, process, procedure, function, operation, technique, treatment or method employed in relation to generation of electricity from any source of energy, and includes transformation, transmission, distribution, or supply of electricity by any mode, or medium, and further includes intermediate and allied activities thereof.

Sugar:

"Sugar Activities" means the activities relating to the production, processing, or manufacturing of any form or grade of sugar, molasses, or alcohol (including ethyl alcohol, rectified spirit, absolute alcohol, denatured alcohol, power alcohol, or solvent blends etc. but excluding potable alcohol) by using any raw materials, and includes the meaning assigned to them under Chapter 17 or Chapter 22 of the Central Excise Tariff Act, 1985 (5 of 1986) or of the Customs Tariff Act, 1975 (51 of 1975), and further includes the intermediate products and articles or allied products thereof.

Fertilizers:

"Fertilizer Activities" means production, processing, manufacturing or mining of any type of fertilizers whether nitrogenous, phosphatic, potassic or complex (organic, inorganic or mixed) and includes all types of fertilizers as defined in clause (h) of section 2 of the Fertilizer (Control) Order, 1985 made under section 3 of the Essential Commodities Act, 1955 (10 of 1955) or included under Chapter 31 of the Central Excise Tariff Act, 1985 (5 of 1986), and further includes the intermediate products and articles or allied products or activities thereof.

Pharmaceuticals:

"Pharmaceutical Activities" means production, processing, or manufacturing of bulk drugs or formulations and includes the meaning assigned to them under the Drugs (Prices Control) Order 1995 as amended from time to time, or included under Chapters 29 and 30 of the Central Excise Tariff Act, 1985 (5 of 1986), and further includes the intermediate products and articles or allied products thereof.

As per MCA General Circular No. 67/2011 dated 30th November 2011, the Companies (Cost Accounting Records) Rules, 2011 are not applicable to:

(i) Wholesale or retail trading activities.

(ii) Banking, financial, leasing, investment, insurance, education, healthcare, tourism, travel, hospitality, recreation, transport services, business/professional consultancy, IT & IT enabled services, research & development, postal/courier services, etc. unless any of these have been specifically covered under any other Cost Accounting Records Rules.

(iii) Companies engaged in rendering job work operations or contracting/ sub-contracting activities, and are paid only the job work or conversion charges, such as tailoring, baking, repairing, painting, printing, constructing, servicing, etc.

(iv) Companies engaged in the production, processing, manufacturing or mining activities till such time they commences their commercial operations.

(v) Ancillary products/activities of companies incidental to their main operations (i.e. products/activities that do not constitute their main line of business) and wherein the total turnover from the sale of each such ancillary products/activities do not exceed 2% of the total turnover of the company or ₹20 crores, whichever is lower. However, required details of all such ancillary products/activities may be maintained under a miscellaneous group and disclosed appropriately.

Year of Application:

Common-CARR - for every financial year commencing on or after 1st April 2011

IS-CARR - for every financial year commencing on or after the date of publication of the Rules, i.e., 7th December 2011.

However, companies that were covered under any of the earlier 44 Cost Accounting Records Rules shall continue to comply with those Rules, as the case may be, till the new Rules become applicable.

2. Compliance Report

Compliance Report has been defined under Rule 2 and its form, content and manner of authentication has been provided under Rule 5, 6 & 7.

Compliance Report has been defined as - "Compliance Report means compliance report duly authenticated and signed by a cost accountant in the prescribed form of compliance report".

Every company to which the Common CARR applies is required to submit a compliance report, in respect of each of its financial year commencing on or after the 1st day of April, 2011, duly certified by a cost accountant, along with the Annexure to the Central Government, in the prescribed form.

Every company to which any of the IS-CARR applies is required to submit a compliance report, in respect of each of its financial year commencing on or after the 1st day of April, 2012, duly certified by a cost accountant, along with the Annexure to the Central Government, in the prescribed form.

The rules have prescribed the form and contents of the Compliance Report and its Annexure. The Compliance Report consists of (a) the e-Form to be filed by the Company; and (b) Compliance Report and its Annexure:

(a) Form A for filing Compliance Report and other documents with the Central Government consists of Part I providing General Information of the Company and Part II consists of the attachments and digital signatures on behalf of the Company

(b) Form B is the Compliance Report and Annexure to the Compliance Report.

Time Limit for Submission:

Within one hundred and eighty days from the close of the company's financial year to which the compliance report relates.

3. Authentication and Certification of Compliance Report:

The Annexure to the compliance report is required to be approved by the Board of Directors and certified by a Cost Accountant before submitting the same to the Central Government by the company.

The term "cost accountant" as defined in the Rules means a cost accountants defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who is either a permanent employee of the company or 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.

The Council of the Institute has further clarified that a "cost accountant" within the definition of these Rules does not include:

a) A member holding a part-time certificate of practice; or

b) A member who is in full time employment whose membership fees are in arrears;

c) A member of ICWAI who has been admitted as a member through reciprocal arrangement of membership by virtue of being a member of Institute of Management Accountants USA.

The Rules have not prescribed any procedure for appointment of cost accountant to certify the Compliance Report. In case a company desires to have it certified by a Practicing Cost Accountant, it would be advisable to appoint the cost accountant by the Board since the Board has been made responsible to approve the Compliance Report. In case a company decides to get it certified by a permanent employee of the organisation, nominating/authorizing the employee cost accountant would be an internal matter of the company.

Further, there is no ceiling on the number of Compliance Reports that can be certified by a cost accountant in whole-time practice. A cost accountant working as permanent employee can certify the Compliance Report of the company where he is employed but he cannot certify Compliance Report of any other company even under the same group. A cost accountant who has been appointed as cost auditor of the company can also certify the Compliance Report of that company.

As per MCA General Circular No. 68/2011 dated 30th November 2011,if all the products/activities of a company, excluding the exempted categories, are covered under cost audit, then the company will not be required to separately file the compliance report. It has also been clarified that a company required to file Compliance Report shall be required to file only compliance report as per the notified Form-B and no other details of cost records are required to be filed with the Government.

It has further been clarified by the Institute that if one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products covered under Common-CARR or any of the IS-CARR but not covered under Cost Audit as per industry specific Cost Audit Orders dated 2nd May, 2011, 30th June, 2011 or 24th January 2012, the Company will be required to file a Compliance Report for the Company as a whole covering products under cost audit and products not under cost audit.

Further, if one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products not covered under either Common-CARR or any of the IS-CARRs, then the company will not be required to file a Compliance Report since the product(s)/activity(s) other than product(s)/activity(s) under Cost Audit are in the exempted category.

4. Compliance of Cost Accounting Standards and Generally Accepted Cost Accounting Principles

Rule 4(3) of the cost accounting records rules stipulates that the cost accounting records should be maintained in accordance with the Generally Accepted Cost Accounting Principles (GACAP) and Cost Accounting Standards (CAS) issued by the Institute of Cost Accountants of India to the extent these are found relevant and applicable.

5. Product and Product Group:

The Rules have defined "Product" and "Product Group" as below:

"Product" means any tangible or intangible good, material, substance, article, idea, know-how, method, information, object, service, etc. that is the result of human, mechanical, industrial, chemical, or natural act, process, procedure, function, operation, technique, or treatment and is intended for use, consumption, sale, transport, store, delivery or disposal.

"Product Group" in relation to tangible products means a group of homogenous and alike products, produced from same raw materials and by using similar or same production process, having similar physical or chemical characteristics and common unit of measurement, and having same or similar usage or application; and in relation to intangible products means a group of homogenous and alike products or services, produced by using similar or same process or inputs, having similar characteristics and common unit of measurement, and having same or similar usage or application.

For application of Product Group, reference may be made to the Guidance Note on Product Group Classification issued by the Institute.

Both the Compliance Report and the cost audit report rules have introduced submission of the reports according to the "product group". It is, however, to be kept in mind that the "product group" concept has been introduced for disclosure purposes only. ***It should be clearly understood that the cost accounting records are required to be maintained product-wise and unit-wise and not "product group wise"*** as per the relevant provision reproduced in the succeeding paragraph. For Compliance Report purposes and the abridged cost statement and other details required for submission of cost audit report are to be done according to "product group".

6. Maintenance of Cost Records

Every company to which these rules apply, including their units and branches, in respect of each of its financial year, are required to keep cost records on regular basis in such manner so as to make it possible to calculate per unit cost of production or cost of operations, cost of sales and margin for ***each of its products and activities carried out at individual production units or locations*** for every financial year on monthly/quarterly/half-yearly/annual basis.

These cost records are required to be maintained in accordance with the generally accepted cost accounting principles and cost accounting standards issued by the Institute of Cost and Accountants of India [formerly Institute of Cost and Works Accountants of India], to the extent these are found to be relevant and applicable. The cost accountant is required to clearly indicate and explain any variation, if any, in his compliance report or cost audit report as the case may be.

The cost records including statistical, quantitative and other records which enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in utilization of resources are required to be maintained. Cost records are required to be maintained on continuous basis from the basic stage of inputs to the final output. These rules also require that the records should be maintained in such a manner so that they are able to provide necessary data which is required to be furnished under these rules.

The rules also require that all such cost records and cost statements, maintained under these rules shall be reconciled with the audited financial statements for the relevant financial year specifically indicating expenses or incomes not considered in the cost records or statements so as to ensure accuracy and to reconcile the costing profit of all its products/activities with the overall profit of the company. The cost accountant is required to clearly indicate and explain any variation, if any, in his compliance report or cost audit report as the case may be.

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 would be important. It is advisable to maintain such records and details in a structured manner on a regular basis so that the accumulation is possible on a periodical basis. It is also to be noted that product-wise cost statement is the final outcome of maintenance of such cost records in a structured manner. The system should be geared to generate such cost statements on a periodical basis as stipulated by the rules. However, it is not necessary to mandatorily prepare cost statements periodically. For a clearer understanding, analogy may be drawn from maintenance of financial records which is geared to generate profit & loss account and balance sheet from the financial books at any point of time and such generation is possible when the financial books are structured in such a manner. A computerized system of accounting makes it possible. Similarly, the cost accounting system should be geared to generate the required cost statements at any given point of time.

An illustrative list of Cost Records can be as follows:

1. Production

1.1. Raw Material consumption register/report;

1.2. Production report;

1.3. Rejections/wastages/scrap report;

1.4. Report on stoppage of machines with reasons;

1.5. Idle time report with reasons;

1.6. Machine utilization report;

1.7. By-Product & Joint Products.

2. Work-in-Progress and Finished Goods

2.1 Process stock register- cost centre-wise and product wise;

2.2 Finished goods stock register- product-wise.

2.3 Daily Stock Accounts (DSA) maintained under Central Excise Law

3. Raw Materials and Stores Accounting

3.1 Goods received register;

3.2 Bin cards;

3.3 Materials/stores ledgers.

3.4 Packing Materials

4. Employee Cost

4.1 Attendance registers/ sheets;

4.2 Wages/salary sheets;

4.3 Leave and gratuity payments.

5. Repairs and Maintenance

5.1 Works order register / card showing material and spares consumed and labour utilized;

5.2 Procedure followed for routine maintenance;

5.3 Details major breakdowns & Repairs;

5.4 Details of Abnormal Repairs & Reconditioning activities.

6. Utilities (Water, Steam, Power, DM Water, Air, Effluent Treatment etc.)

6.1 Records of input and output;

6.2 Record of cost centre-wise allocation of outputs.

7. Overheads

7.1 Details such as production hours, labour hours, machine hours to facilitate distribution of overheads;

7.2 Overheads Keys.

8. Cost Accounts

8.1 Overheads analysis register;

8.2 Cost centre-wise assets register;

8.3 Product ledger;

8.4 Annexures and proformae as per rules, if any;

8.5 Reconciliation of profit/loss as per cost records and financial records. The Reconciliation Statement between cost accounts and financial accounts can also be treated as a Costing Profit & Loss Account. This statement shall normally start with the margin arrived at as per cost accounts and all other items of expenses not considered for determination of cost or incomes not considered for arriving at the margin as per cost accounts would get reflected.

9. Sales

9.1 Product-wise Sales analysis

9.2 Stock Transfer

9.3 Marketing/ Market Research Cost

The following steps can be taken to ensure proper maintenance of cost records:

(1) Study and examine the chart of accounts with special reference to the system of cost methods adopted by the company.

(2) Study the basic raw materials and packing materials, chemicals and stores required for the manufacture of the product and their sources.

(3) Study the organizational structure and know the details of manufacturing process.

(4) Examine whether cost centres are split-up into production & services functions

(5) The licensed capacity and installed capacity should be ascertained. Any addition to production capacity during the preceding two years should also be ascertained. It is to be noted that though the reporting in cost audit report is required to be done at a Product Group level, licensed capacity and installed capacity would continue to be ascertained machine wise as it is not feasible to ascertain such capacities at product/product group level.

(6) Examine the adequacy of internal checks and control.

(7) Before starting the assignment, meet the various important executives of the company and note down the functions, responsibilities and powers delegated to each.

(8) Obtain an understanding of the business and the production processes involved, the flow of the process, till the finished goods are packed and transferred to the finished stores for despatch.

(9) Obtain the Balance Sheets of the company for the past two years and make a note of the important points contained in the Directors' Report to the shareholders on the various financial, operation and technical matters.

(10) Study the books/records containing production records etc., statistics maintained by the factory(s) in compliance with the Excise and other Government requirements and note down the Licensed and Installed capacities. Ascertain the reasons for shortfall in production, if any, as compared to the previous two years.

(11) Compare actual production with the installed capacity.

(12) Prepare a complete quantitative analysis beginning with input materials (both direct and indirect), corresponding production at each stage of production, any by-product or joint products produced, scrap and wastages generated, quantity transferred for captive consumption and the stage from which such transfer is taking place and final reconciliation with that of sales and stocks in respect of each type of product.

(13) Study the Cost Accounting System followed by the company. Examine whether the same system is followed in case the Company is engaged in production of different and varied types of products manufactured at different locations and such locations are operating under different autonomous Divisions under the overall management of the Company.

(14) Make proper identification of various production and service cost centres and check whether the expenditure is initially booked to these cost centres correctly.

(15) Check whether the relevant cost accounting standards and generally accepted cost accounting principles (GACAP) are being followed for valuation of materials, utilities, overheads etc.

(16) It is necessary to prepare individual service/utilities cost statements, viz., Water, Steam, Power, DM

Water, Purified Air etc. Ensure consumption records of these utilities at various production and service centres properly maintained and allocate the costs on an equitable basis to the various consuming cost centres. In respect of supplies made to or received from other units of the company, ensure that the transfers are made at cost of production/generation of the utilities and that the method followed is consistent. In case of inter unit transfers at pre-determined transfer price in financial accounts, the same has to be reversed for cost accounts and considered at cost.

(17) Ascertain any abnormal reasons for low productions and/or high usage of services/ utilities and high down time in the plant. Find out whether these have been properly recorded and reported separately.

(18) Verify whether consistency is maintained with regard to cost accumulation, cost analysis, cost allocation and apportionment, cost treatment and costing procedures adopted for inventory valuation from period to period.

(19) Examine the records maintained for inter-company transfers.

(20) Ascertain if any Royalty/Technical Services Fee has been paid to Collaborator/Technology Supplier. If it is one-time lump sum payment, check whether the charge to cost of product is spread over the period for which benefit is to be derived out of the payment and the same is equitable and reasonable.

(21) Examine whether there is any Royalty agreement and check its effect on cost of production and allocation of the cost to the product.

(22) Examine the practice followed for maintaining quality of the product and related Quality Control Expenses. Check the amount incurred on quality control, quality audit etc. and their treatment in the cost of product.

(23) Examine whether the company is complying with the various legal provisions with respect to pollution control and the expenses incurred therefor and whether absorption of such cost in the product is done equitably and consistently.

(24) Cost of production should be derived for domestic sale and export sale separately.

(25) Verify the reconciliation statement between the profit/loss as per the cost accounts and as per the financial accounts. Also examine the variations and reasons thereof.

(26) Examine whether the data maintained in the cost record are reconciled with the relevant returns submitted by the company to government authorities.

(27) Where a system of standard costing is used, it should be ensured that such costs are converted into actual for the purpose of determining the figures required to comply with the requirements of Cost Accounting Record Rules. The method of adjustment of variances to arrive at the actual cost from the standard cost should be examined.

(28) Examine that cost statements have been prepared as per requirements of Cost Accounting Records Rules.

(29) Examine whether Cost Accounting Standards and Generally Accepted Cost Accounting Principles issued by the Institute of Cost Accountants of India are being followed.

(30) Examine whether there are any abnormal features affecting production during the year, e.g., strikes, lock-outs, major breakdowns in the plant, substantial power cuts, serious accidents, etc., and what is their impact on the cost of production.

(31) Examine if there are any special expenses, which have been directly allocated to products under reference, and what is the total amount as also the incidence per unit of product.

7. Cost Records, Cost Statements and Reconciliation Statements are to be preserved

All such cost records, cost statements and reconciliation statements, maintained under these rules, 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 are to be kept in good order.

8. Penal Provisions

The rules provide for penalty for cost accountant and companies as follows:

a) Default by a cost accountant

If default is made by the cost accountant in complying with the provisions of these rules, he shall be punishable with fine, which may extend to five thousand rupees.

b) Contravention by a Company

If a company contravenes any provisions of these rules, the company and every officer thereof who is in default, including the persons referred to in sub-section (6) of section 209 of the Act, shall be punishable as provided under sub-section (2) of section 642 read with sub-sections (5) and (7) of section 209 of Companies Act, 1956 (1 of 1956).

In order to prepare and maintain cost accounting records, the cost accountant should first familiarise himself with the industry where the records are to be maintained. Once the cost accountant has familiarised himself with the process of manufacture or production, he should classify the production process under different cost centres under which different elements of costs are to be collected and analysed. He should also then identify the different component of costs for the total cost build-up.

The steps involved in preparing the cost records are explained in the following chapters.

3.3 MATERIAL COST

The Cost Accounting Record Rules require maintenance of proper records showing separately all receipts, issues and balances both in quantities and cost of each item of raw material (including all direct charges up to the works) required for the production, processing or manufacturing of the products, consumables etc. The basis on which quantities, costs of issue and consumption are calculated are required to be indicated in the cost accounting records and followed consistently. Packing Material Cost has been dealt in the separate chapter of this Guidance Note.

1. Classification of Materials:

Materials are of two types:

1. **Direct Materials:** Materials the costs of which can be easily attributed to a cost object in an economically feasible way.
2. **Indirect Materials:** Materials, the costs of which cannot be attributed to a particular cost object.

1. Direct Materials should be classified in the cost statement under suitable heads:

- Raw materials,
- Components,
- Semi-finished goods and
- Sub-assemblies

Further, Direct materials should be classified as:

- Indigenous

- Imported and
- Self-Manufactured

2. *Indirect Material should be classified 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.

Cost of Material will cover all types of direct raw materials such as purchase price of raw materials and bought out components (finished and semi-finished). For raw material and merchandise inventory, which are purchased outright and not intended for further conversion, the identification of cost is relatively straightforward. The cost of these purchased materials will include the purchase price, transportation costs, insurance and handling costs and other expenses directly attributable to the acquisition. In case of imported raw materials, additional costs, such as, import duty, CVD etc. shall be included. Duties and taxes are to be added unless subsequently recoverable from the taxing authorities. However, duties and taxes, which are subsequently recoverable from the taxing authorities, such as, CENVAT, Countervailing Customs Duty (CVD), VAT/Sales Tax set-off etc. should not be included in the raw material cost. Trade discounts / Cash discount, rebates, duty drawbacks and other similar items should also be netted off against the raw material cost.

Cost of materials in the nature of process materials, dies & tools, packing materials etc., which are used as indirect materials for the production function should form part of the cost build-up. The method of calculation of landed cost and valuation thereof would be similar to raw material cost explained above. The quantity and value for each and every item of material stocked is required to be maintained separately with proper identification. It is to be ensured that:

(a) The basis of valuation of issues is consistent.

(b) The values should include all direct charges up to works, such as, freight and insurance, wherever identifiable, and

(c) The value should be after adjusting credit for CENVAT and other benefits in the nature of CENVAT, if availed by the Company.

(d) Any wastage, whether in storage, transit or for other reasons, should be shown separately and the method of dealing with such losses in cost should be indicated in the cost record by way of footnotes or explanatory notes or in some other suitable manner.

Group control accounts in cases of stores and spares may be maintained where difficulty is faced to maintain individual stock accounts for each item. Such a scheme may be operated by the use of Rate Cards.

In this method, the elaborate procedure of maintaining a priced stock ledger account for each material is dispensed with and in its place a rate card is kept up dated after such purchase so that the prices are always current and actual. Quantitative information is provided by the bin cards only.

Periodic reconciliation with the total stock control accounts will be necessary to prove the correctness of the valuation. Further, records of periodic physical verification of stocks and the manner in which discrepancies arising there from are dealt with should also be maintained.

2. Consumable Stores & Spares / Indirect Materials:

(a) Records of receipts, issues and balances, both in quantity and value, other process materials, small tools and machinery spares, indirect materials etc. are required to be maintained separately for each item. The cost shall include all direct charges up to works.

(b) The cost of consumable stores, small tools and machinery spares are to be collected under the relevant consuming cost center or department or product process on the basis of actual issues of these items. In the case of consumable stores and small tools, the cost of which are insignificant, instead of maintaining separate item-wise consumption records, the company may, if it so desires, maintain such records for the group of such consumable stores and tools.

(c) If any of the indirect materials used are produced in-house and such processing is done by any outside agency, the quantity sent for processing, quantity received back after processing and cost incurred thereon should be identified and recorded separately.

(d) Check Gate Pass/ Challan for the material sent outside for processing/ re-processing and see whether material sent through these have been received back by the Company.

3. Wastages/Spoilages:

(a) The quantity and value of wastage, spoilage, rejections and losses of raw materials, intermediates, process materials, consumable stores, small tools and machinery spares, whether in transit, storage, manufacture or at any other stage are required to be maintained for each item.

(b) The method followed for adjusting the above losses as well as the income derived from the disposal of rejected and waste materials including spoilage, if any, in determining the cost of product, is required to be indicated in the cost records.

(c) Any abnormal wastage or spoilage or rejection or losses are to be indicated distinctly and separately along with reasons thereof.

(d) Check Recycling of waste, if any.

(e) Check efficiency reports in which the waste is classified as normal or abnormal;

(f) Check Storage Capacity and its co-relation with waste;

(g) Check whether waste is as par Industry norms;

(h) Check waste as per machine design and cross–verify with the industry norms;

(i) Trend analysis of waste and its impact;

(j) Waste Accounting;

(k) Accounting for spoilage and its analysis.

4. Slow and Non-moving Items

The value of raw materials, intermediates and process materials, finished and semi-finished, consumable stores, small tools and machinery spares, which have not moved for more than twelve months are required to be maintained showing the item distinctly and clearly.

5. Principles of Measurement

A. Principles of valuation of receipt of materials

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/cash discount, rebate, taxes and duties refundable or to be credited by the taxing authorities).

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.

The valuation of receipt of materials is to be based on the terms and conditions stated in the purchase /supply order, source of supply i.e. indigenous or imported etc.

1. Valuation of Purchase of indigenous material

The purchase/supply order inter alia states:

(a) Specification of material being purchased

(b) Purchase price

(c) Quantity of supply

(d) Time of supply

(e) Place of supply

(f) Payment terms

(g) Other commercial conditions regarding inspection, rejection, trade discount etc.

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 FOR (Free on Rail) destination / FOR of supplier's place. If it is FOR 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 FOR 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 should 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
- Other taxes, if any.

1.1. Finance costs incurred in connection with the acquisition of materials shall not form part of material cost. Finance costs are interest etc. on borrowed funds and the same is not to be included in the cost of materials.

1.2. LC Charges / Bank Charges on purchase of materials which cannot be directly identified with a particular material will not form part of material cost but will form part of overheads..

1.3. 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 or any other reason. Such payments of storage are to be excluded from cost of materials calculation and are to be treated as a charge to the profit & loss account.

2. Valuation of Purchase of Imported material

Materials are imported from other countries depending upon the availability in the country/ economics of import. Import license may be required in certain cases. Purchase condition 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 etc. Purchaser has to pay transit insurance and freight from place of import to its destination. In case of CIF (Cost, Insurance & Freight) price, price includes besides basic price, transit insurance and freight. On receipt of goods, bill of entry/lading is prepared and other custom formalities are to be complied with for clearance of the goods.

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 should be accounted for at the actual rate of duty applicable so long as there is reasonable expectation that the enterprise will satisfy the conditions for the duty exemption or concession. In case the material is used for other than the intended purpose, provision for import duty, if any is to 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 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 should also be deducted from the cost of material.

h. LC Charges / Bank Charges on purchase of materials which cannot be directly identified with a particular material will not form part of material cost but will form part of overheads.

3. Self-manufactured materials are to be valued including direct material cost, direct employee cost, direct expenses, Factory/Production Overheads, share of administrative overheads relating to production but excluding share of other administrative overheads. Self-manufactured materials include material, components assemblies and sub-assemblies, accessories etc. manufactured internally for making the final product. For example, gear box assembly, steering system assemblies etc. 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 materials 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.

Self-manufactured materials are classified into two categories viz., intermediate products (used in the assembly of main product) which are exempt from excise duty. Other self-manufactured components if captively consumed, are subject to levy of excise duty on cost of production to be determined. While determining the cost of self-manufactured material for captive consumption and for other use, the following elements of costs are to be considered:

(a) Material consumed (indigenous, imported, bought out items, self-manufactured items, process material etc.)

(b) Direct employee cost

(c) Direct expenses (e.g. royalty, technical know-how charges for design, quality control, etc.)

(d) Research and Development

(e) Share of factory overhead (including factory administration and management expenses)

Finance cost and marketing overhead are not to be considered while valuing the self-manufactured material.

Self-manufactured components, if captively consumed and are subject to levy of excise duty, its valuation is to be determined as per CAS-4. Readers are requested to refer to Cost Accounting Standard (CA$-4) on Cost of Production for Captive Consumption issued by the Institute of Cost Accountants of India.

4. Spares :

(a) 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 amortized over a period, not exceeding the useful life of the equipment

(b) The spares which are specific to any equipment supplied at the time of purchase are amortized. Sometimes, capital spares are not separately invoiced but merged with the cost of equipment supplied. Such value may be amortized with the cost of machinery over its service life. It may be charged to cost based on machine hours utilized.

(c) 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 within the service life of the machinery.

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 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 suppliers or insurers 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.

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.

7. FOREX:

(a) The FOREX component of imported material cost should 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.

(b) The valuation of the foreign exchange transaction would be the value converted at the prevailing rate on the date of transaction. The cost records and financial accounts will have the same basis for alignment. The difference between the actual payment and the amount taken as material cost of goods received is taken to a separate financial account to show the exchange rate variations (not becoming part of cost calculations). The date of transaction will be considered to be the date when the property in the goods is transferred.

(c) Loss or Gain on Foreign Exchange on purchase of materials or for any other transaction involving Foreign Exchange is not a part of material cost or other transaction, as the case may be but is considered as a charge to the Costing Profit & Loss Account as a part of non-cost item.

8. **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 transporter/custom authorities for delay in clearance of wagon/vessel etc.

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 Costing Profit & Loss Account, i.e., the Reconciliation Statement.

9. Subsidy/Grant/Incentive :

(a) 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.

(b) 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 of the cost object.

10. Incentives

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.

Export incentives are sometimes recorded on the basis of receipt. 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.

DEPB: Duty Entitlement Pass Book Scheme should be checked, whether the benefit has been availed by the Assessee/company. Check the return for this purpose.

B. Principle of valuation of issue of material:

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 of issues once adopted should be followed consistently from one period to another and with uniformity between different product/units. If method of valuation is changed, its impact on costs of material should be disclosed.

The following are the valuation methods for issue of materials. Any of the methods may be adopted as per the suitability of the Industry.

- FIFO (First –in-First out)
- LIFO (Last in First out)
- Weighted Average Rate

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 additional shipment is received, depending upon the circumstances of the enterprise.

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. It is to be noted that LIFO method of valuation is not permissible under Accounting Standards. In case LIFO is followed for cost accounting purposes, proper reconciliation has to be made between the financial valuation and cost valuation.

2. Where materials are accounted at standard cost, the price variances related to materials should be treated as part of material cost.

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.

3. Any abnormal cost should be excluded from the material cost.

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 materials 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.

4. Wherever material costs include transportation costs.

The cost of procurement of materials is to be identified for proper allocation/apportionment to the materials/cost. In case inward transport /freight charges are indicated in the invoice which is for more than one material, inward transport cost shall be allocated to the quantity of different materials indicated in the invoice on reasonable and appropriate basis such as weight, volume, numbers etc.

If the material is carried singly, the cost of transportation should be allocated to the single material transported. If the material is carried by special carrier, it will be assigned to the specific material transported.

5. The material cost of normal scrap/ defectives which are rejects should be included in the material cost of goods manufactured. The material cost of actual scrap / defectives, not exceeding the normal should 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. 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.

7. Treatment of scrap when reintroduced in production process:

(a) An alternative to sale of scrap is that it 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. In such a situation, the realizable value of the scrap should be credited to cost of production and debited to raw material consumption. Other examples are (i) runners and risers generated in the course of dressing up of castings in foundry. Runners and risers are to be valued at raw material cost at pouring stage; (ii)Side trimmings from machine roll of paper or scrap generated at the finishing house of a paper mill is recycled and used as waste paper for pulp making. Valuation of such waste paper used for recycling is to be valued at purchase price of similar waste paper.

(b) The material cost of abnormal scrap will not form part of the material cost.

(c) 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.

(d) Before rectification work is taken up, it should be examined whether the estimated cost of rectification work would be commensurate with the value to be obtained and it would be more profitable than any other choice available.

(e) Repairing of a defective end product may result in either being sold as a proper product, at a lesser price as seconds/ or as a rejected one. The quality and extent of damage to specifications in a product determines the necessary requirement of repairing.

(f) If defectives / spoiled work cannot be made into a first-class / saleable finished unit with significant additional expenditure, it is to be disposed off as rejects. Rejects or scrap or waste is discarded material having some value.

(g) It is not always possible to pinpoint the exact cause and location for rejects. Further recovery is not affected by the location. For example if cables are rejected at final stage, efforts shall be made to recover the conductor metals which can be reused. In compliance with the Central Excise rules, the cables are chopped off in very short lengths and grossed together irrespective of the actual occurrence of wastage i.e. in wire drawing stage or in finishing stage. The recovery is therefore not credited to various cost centers but an overall view is taken and suitable adjustments are made in the cost records.

(h) In paper industry bamboo, hardwood, wood waste (Veneer waste, Rulla etc. from Plywood industry) is 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 material cost.

(i) 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.

8. Waste:

In production of yarn in textile industry, waste is generated. Waste cotton is reintroduced in blow room with a mix of raw materials again, but waste yarn may not be used in a similar manner. Waste may be also sold for salvage value or put into an alternative use in-house or outside the enterprise. The cost of wastage should be shared by the good units introduced into the production process e.g., 100 kg of materials is purchased at a price of ₹2 per kg. Normal wastage is 10%. The actual quantity available will be 90 kg. Now the issue price will be taken as ₹2.22 per kg. If additional cost is incurred to process the waste, such additional cost is taken as additional cost of production to the job/process or treated as departmental or manufacturing overheads appropriately. The cost of abnormal waste should not be included in material cost and charged to profit and loss account.

In chemical industries, materials may be lost due to evaporation e.g. petroleum products. Materials mixed with alcohol etc. may evaporate.

9. Spoilage:

It arises when the units produced do not meet the exact specification of the product. Spoilage is classified as normal spoilage and abnormal spoilage. Normal spoilage is to be absorbed by good production and abnormal spoilage is to be charged to profit and loss account.

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 sale as scrap.

When the spoilage materials are sold: This recovery is shared by all the good production as the cost of material is already shared by netting the good production. The material cost for the batch or process will get the benefit of this credit, if significant.

When spoilage is reused as raw material in another process or job, then the credit should be given to the process or job on the basis of the utility value of spoilage and charged to the job/ process using the material. Any additional cost incurred for further processing to make it fit for consumption will be reduced from the credit for benefit to the original job / process or charged to manufacturing overheads, if not so significant.

C. Assignment of costs

1. Assignment of material costs to cost objects: Material costs should be directly traced to a Cost object to the extent it is economically feasible and /or should be assigned to the cost object on the basis of material quantity consumed.

Assignment of material cost involves establishing a suitable procedure to identify and record the resources consumed by the cost object. For direct material the source document is material requisition. Details of material issued for manufacturing a product are recorded in it. It records the job number, type of material, and items listed are priced at their acquisition cost. 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 e.g. 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 etc. 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 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 material with the object. In other words material cost if not directly identified with the cost object on economic feasibility consideration, it should not result in misstatement of material cost of object.

Reconciliation of cost of material consumed–In order to have proper control on material consumption, 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 should be ensured both in quantity and value.

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 cannot be directly traceable to cost object, are to be assigned on some rational basis consistently. These bases could be based on some factor linking to the utilization. Technical estimates help in arriving at such rational basis.

   Illustration: 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 based 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.

Assignment of Costs – Direct Expenses

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 should be treated as part of the material cost.**

   It is relating to a production operation out sourced. 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 are treated as conversion charges to be loaded on to the value of material cost for inventory valuation.

   Example (1): Casting requires trimming, machining and polishing, heat treatment after pouring etc. One of these operations is subcontracted. The activity subcontracted and its cost is part of the material cost and inventorised.

   Example (2): A metal sheet is given to another unit for conversion into specific measurement for use in a press, the materials 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 prepared fit for the operation.

2. **Wherever part of the manufacturing operations / activity is subcontracted, the subcontract charges related to materials should 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 subcontract is to be treated as direct expenses and assigned directly to cost object.

Assignment of Costs – Indirect Materials

1. **The cost of indirect materials should 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 assigned to the various Cost centres or standing orders based on actual consumption determined on the basis of relevant documents like material requisition slips, invoices etc. duly authorized by concerned official. The value of indirect materials should therefore be collected in aggregate for each cost centre and be distributed as overheads assigned to the cost object on an equitable basis.

It is possible that some of the indirect materials may be purchased based on a delegation as may be decided by the enterprise authorities at the departmental level directly from the market instead of routing through the purchase department , stores etc. In such cases the indirect material cost will be assigned to the cost centre using the invoice document itself duly receipted with the proper head of account and the cost centre.

The cost of indirect materials should 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, electrical stores), spares etc. All the costs under different heads for the cost centres aggregated and collected should be distributed to the production cost centres on an equitable basis.

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

   Indirect materials like cost of catalysts, dies, tools, patterns etc. have longer service life. Special patterns are charged to the cost of the special jobs. But these patterns may be reused again. Where reuse is anticipated and can be logically estimated, it should be amortised over the production units to be benefitted by such cost. This also applies to dies, tools and catalysts.

   If certain chemicals are used as catalyst having life of more than one year the cost of such items should be amortised over the production units benefitted by such costs.

   In a process industry like steel plant, the materials like refractory, rolls and other process materials like catalysts, useful life is determined by many parameters like production, quality, metallurgical requirement and many other techno operational parameters. In certain cases, it may be difficult to ascertain the life of the process material. In such cases it may be charged off as and when it is issued for consumption.

3. **The cost of indirect material with life exceeding one year should be included in cost over the useful life of the material.**

   Where cost of indirect material is not relatable to product/process or there are no suitable technical norms exist, and the life of an indirect material is estimated beyond one year then it should be charged off to the cost.

CHECK LIST FOR MATERIAL ACCOUNTING AND CONTROLS

1. Ensure proper entries are made in stores ledger for raw materials and specific stores etc. in respect of receipts, issues and balances both in quantities and values.
2. Ensure that the procedure for purchase of raw materials and the standards fixed for its quality control are followed.
3. Ensure that the amount has been deducted from supplier's bills in case of supply of sub-standard materials.
4. The receipt entries should be made with reference to supplier's invoices and delivery challans, Goods received notes and as per the terms of contracts entered into with the suppliers. Any excess or short supplies made by the parties, and the basis on which such excess / short supplies were made are to be properly dealt with in the cost records as per the terms of settlement.

5. Ensure transit losses (if any) of raw materials has been properly dealt with in the cost records.
6. Ensure that the proper classification of material cost into direct and indirect categories has been made.
7. Proper system of stock verification at regular intervals should be in existence in the organization. There should be proper authorization for adjustment of physical inventory differences in the cost records. Ensure that all the goods received within the financial year are included in purchases.
8. There should be proper control systems to verify that the goods sent to outside for processing or re-processing, or job work are received back in the factory during the year. If the goods sent are not received, proper entries are to be passed in the books of account.
9. Ensure purchase returns are with original invoices or Debit Notes and also ensure credit for such purchase return has been obtained from the suppliers.
10. There should be proper reconciliation of the value of material issued by the Stores and received by the Plant. Similarly, there should be proper reconciliation of the movement of material to plant and processes.
11. The Company should have policy to treat the items of store as non-moving or slow moving. For control on such items, it is advisable that a list of non-moving and slow-moving store items should be prepared and the value of such items of stores in relation to total closing inventory should be determined.
12. For the control purpose, verify the chemical consumption with reference to raw material mix.
13. The Company should have proper e store accounting systems and procedures for indenting, purchasing, receiving and inspection. Similarly, the Company should have a set of documents/ proformae used for recording arrival of materials at the factory, their acceptance into stock, issues for consumption, return and transfer of materials between the departments and stores, written off unserviceable materials etc.
14. To avoid duplicate or fraudulent payments, there should be proper system of processing, passing and payment of purchase bills.
15. There should not be any delays in accounting of materials after their receipt in the factory.
16. For control purpose, there should be system of the bin cards and individual material wise priced stock ledgers are maintained. The bin cards are posted chronologically and balances as per bin card are compared with priced stock ledger.
17. For control purpose, the Company may have a procedure for issues of materials to the user departments.
18. Ensure that the freight and all other incidental expenses have been considered as part of the individual items of material cost.
19. Ensure that the material transferred for non-production or capital jobs are deducted from purchases.
20. The waste, spoilage or other losses of materials in storage and in process are properly accounted for and dealt in cost records as per generally accepted cost accounting principles and cost accounting standards issued by the Institute of Cost Accountants of India. Where insurance claims are received for transit losses or otherwise, the same amount should be deducted from the material cost. In case any recovery pertains to a prior period, the same should not be considered for cost records of the current financial period and the same would be treated as a reconciliation item.
21. Where transport costs are significant, the same should be shown separately.

D. CHECKLISTS FOR MATERIAL MANAGEMENT

The following can be a checklist to verify materials management:

Sl. No.	Business Activity		Objectives	Yes/No	Specify areas where such controls can be designed to fulfil the objectives	Deficiencies Noted	Management Action on how to maintain such documentation for recouping such deficiencies
1.	Managing Inventory	1.1	Whether inventory is saleable or usable.				
		1.2	Whether Inventory is adequately safeguarded				
		1.3	Whether adjustments to inventory prices or quantities relate to valid price changes and physical inventory differences.				
		1.4	Whether all adjustments to inventory prices or quantities are recorded accurately.				
2.	Receiving and Storing Raw Materials	2.1.	Whether Raw materials are received and accepted only if they have valid purchase orders.				
		2.2	Whether the Raw materials received are recorded accurately				
		2.3	Whether all raw materials received are recorded.				
		2.4	Whether the Receipts of raw materials are recorded timely and in the appropriate period.				
		2.5	Whether any defective raw materials are returned timely to suppliers				
3	Requisitioning Materials	3.1	Whether all transfers of raw materials to production are recorded accurately and in the appropriate period.				
4	Producing/ Costing Inventory	4.1.	Whether All recorded production costs are consistent with actual direct and indirect expenses associated with production.				
		4.2	Whether all direct and indirect expenses associated with production are recorded as production costs.				
		4.3	Whether all direct and indirect expenses associated with production are recorded accurately and in the appropriate period.				
		4.4	Whether all transfers of completed units of production to finished goods inventory are recorded completely and accurately in the appropriate period.				

Sl. No.	Business Activity		Objectives	Yes/No	Specify areas where such controls can be designed to fulfil the objectives	Deficiencies Noted	Management Action on how to maintain such documentation for recouping such deficiencies
		4.5	Whether all defective products and scrap resulting from the production process are valid and recorded completely and accurately in the appropriate period.				
5	Handling Finished Products	5.1	Whether finished goods returned by customers are recorded completely and accurately in the appropriate period.				
		5.2	Whether finished goods received from production are recorded completely and accurately in the appropriate period.				
		5.3	Whether the Goods received from production or returned by customers are only accepted in accordance with the organization's policies.				
6	Shipping Finished Products	6.1	Whether all shipments are recorded accurately.				
		6.2	Whether the Shipments are recorded timely and in the appropriate period.				
		6.3	Whether the Inventory is relieved only when goods are shipped with approved customer orders.				
		6.4	Whether the Costs of shipped inventory are transferred from inventory to cost of sales.				
		6.5	Whether the Amounts posted to cost of sales represent those associated with shipped inventory.				
		6.6	Whether the Costs of shipped inventory are transferred from inventory to cost of sales timely and in the appropriate period.				

Sl. No.	Business Activity		Objectives	Yes/No	Specify areas where such controls can be designed to fulfil the objectives	Deficiencies Noted	Management Action on how to maintain such documentation for recouping such deficiencies
7	Maintaining Inventory Master File	7.1	Whether there are only valid changes are made to the inventory management master file.				
		7.2	Whether there are all valid changes to the inventory management master file are input and processed.				
		7.3	Whether there are changes to the inventory management master file are accurate.				
		7.4	Whether there are Changes to the inventory management master file are processed timely.				
		7.5	Whether there are an inventory management master file remains pertinent				
	8. Inventory Accounting	8.1	Whether there are a periodic inventory counts are performed to confirm inventory records. Selection of items for count is segregated from performing the count, which is in turn segregated from recording the count. System count is reflected on cycle count worksheets (e.g. “Blind” counts are performed).				
		8.2	Whether there are physical counts verify quantities on hand.				
		8.3	Whether there are written instructions are used by physical count personnel that provide guidance on timing of the count, number and composition of the count teams, areas of responsibility, how to perform and record the physical counts and count sheet control.				
		8.4	Whether there are Discrepancies between physical counts and perpetual inventory records are researched prior to posting any adjustments to the perpetual and/or accounting records				
		8.5	Whether there are any inventory count crews are supervised.				
		8.6	Whether there are Receiving/shipping during physical counts is controlled.				
		8.7	Whether the Perpetual records are reconciled to physical counts.				
		8.8	Whether the perpetual/physical is reconciled to the general ledger.				
		8.9	Whether there are Procedures are in place to adjust slow moving, obsolete, or damaged items to their expected realizable value.				

Note: For more details readers may refer Cost Accounting Standard (CAS)-6 on Material Cost issued by the Institute of Cost Accountants of India.

3.4 PACKING MATERIAL COST

Packing materials are of various types. Type of packing material required for a product depend upon the nature of the product to be packed. It varies with industry to industry as items to be packed will be different as in the table below:

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.

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.

However for the purpose of this standard Packing Materials are classified into primary and secondary packing materials. In simple words the packing material used for holding a product is classified as "Primary Packing Material' and packing material used for storing, transport etc. is classified as 'Secondary Packing material. These aspects are dealt in detail under definition.

A. Packing Material Cost

The cost of material of any nature used for the purpose of packing of a product is called packing material cost.

It can be divided into two parts namely:

a) Primary Packing

b) Secondary Packing

Example:

Industry	Primary Packing Material	Secondary Packing Material
Pharmaceutical	Insertions related to product. Foils for strips of tablet and capsules.	Cartons used for holding strips of tablets and card board boxes used for holding cartons.
Industrial Gases	Cylinders or bottles which are used for filling the gaseous products.	
Confectionary Industry	Butter Paper and wrappers	Jars for holding wrapped chocolates. Cartons containing packs of biscuits.
Textile		Card board boxes used for holding cones on which yarn is woven.

Primary Packing Material is 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.

Above example indicates various types of primary packing material. For pharmaceutical industry primary packing material will be insertion related to product, Blister strips for tablets/ capsules, bottle, tubes etc. 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. But 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.

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 and display.

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 secondary packing and will form part of cost of sales.

However, classification between primary and secondary packaging would entirely depend upon the specific facts and circumstances of industry/product/business and may be decided after taking into consideration practical aspects and industry practice.

B. Principles of Measurement – Valuation of receipts of packing materials

The packing materials 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) 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 and source of supply i.e. indigenous or imported etc.

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, 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 overheads.

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 Credit, credit for countervailing custom duty credit, 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.

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, actual charges by the storage provider will be included in the cost.

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 recovered 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.

Other Issues:

(i) **Finance costs directly incurred in connection with the acquisition of packing materials should 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.

(ii) **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.

(iii) **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.

(iv) **Self-manufactured packing materials** should be valued including direct material cost, direct employee cost, direct expenses, job charges, Factory/Production 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. In the other words, the self-manufactured packing material should be valued by taking into account all the relevant cost incurred in manufacturing the packing material e.g. material cost, duties & taxes, freight inwards, insurance and other expenditure (net of trade discounts, rebate, taxes and duties refundable or to be credited), direct employees cost, direct expenses, utilities, job charges, Factory/Production Overheads, share of administration overheads, development & improvement expenses etc.

(v) **The valuation of captive consumption of packing materials shall be in accordance with of Cost Accounting Standard (CAS-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:

(a) Material consumed (indigenous, imported, bought out items, self-manufactured items, process material etc.)

(b) Direct employee cost (as per CAS-7)

(c) Direct expenses (for example cost of utilities, royalty, technical know-how charges for design)

(d) Quality control Cost

(e) Research and Development

(f) Share of factory overhead (including factory administration and management expenses)

(g) Inputs received free

(h) Adjustment for misc. income, if any.

(vi) **Normal loss or spoilage of packing material** prior to receipt in the factory should 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.

(vii) **Abnormal cost** arises due to some abnormal causes viz. heavy break-down in plant, theft, fire, material not according to required specification, etc. They are not considered in the cost of production and charged to costing 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 etc. 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.

(viii) If defectives / spoiled work cannot be made into a first-class / useable packing material without uneconomical expenditure, it is to be disposed off as rejects. Rejects or scrap or waste is discarded material having some value.

The rejection may occur in the following stages:

(1) In course of inspection

(2) Rejection in testing/packing at the finished stage

(3) Rejection by customers after finished products has been dispatched from the factory.

(ix) **Discarded packing material** is disposed of as scrap. Any value realized from disposal of discarded material if insignificant, is to be treated as other income. If discarded material can be reintroduced in the production of packing material, it shall be valued at its realizable scrap value.

(x) The FOREX component of imported packing material cost should be 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 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.

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

Demurrage and penalties are abnormal cost and are not part of the packing material cost. It is taken to reconciliation.

(xii) Any subsidy or grant or incentive or any such payment received or receivable with respect to packing material should 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.

C. Principles of valuation of issue of packing material

a) Issues shall be valued using appropriate assumptions on cost flow e.g. FIFO, LIFO, Weighted Average. The method of valuation once adopted should be followed consistently from one period to another and with uniformity between different product/units.

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 for valuation of issue of packing material. In addition, LIFO assumption can also be used, the Cost Accounting Standard on Material Cost (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 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.

b) If packing material costs includes transportation costs, determination of costs of transportation should be governed by the principle of average (equalized) cost of transportation as per Cost Accounting Standard (CAS-5).

Inward freight will 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 allocated 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.

c) The packing material cost will not include imputed cost. However in case of Cost of Production of Excisable Goods for Captive Consumption the computation of cost shall be as per Cost Accounting Standard (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.

d) If the packing material are accounted at standard cost the price variances related to such materials is to be treated as part of packing material cost and the portion of usage variances due to normal reasons should be treated as part of packing material cost. Usage variances due to abnormal reasons should be treated as part of abnormal 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.

e) The normal loss arising from the issue or consumption of packing materials should 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 / crate. These losses occur even under efficient operating condition and are referred to as normal loss. Thus Normal loss arising from the issue or consumption of packing materials is to be treated as a part of packing material cost.

f) Any abnormal cost where it is material and quantifiable should be excluded from the packing material cost. For example, loss of packing material due to major fire accident is abnormal loss and should be treated as abnormal Cost and should not form part of cost of the packing material consumed and it should be dealt with in the costing profit and 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.

g) 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.

D. Assignment of Cost

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, 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.

For assigning the packing material cost, the following principles should be kept in view:

a) Packing material cost should be directly traced to a cost object to the extent it is economically feasible.

b) If 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. For example, Nails, adhesive, tapes, gums etc. are consumed while packing the cost object. Such packing materials are used in small quantities and/or of not significant 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.

c) The packaging cost of reusable packing should be assigned to the cost object taking into account the number of times or the period over which it is expected to be reused. For example, gas cylinders are returnable packing material. 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 .

d) Cost of primary packing materials should form part of the cost of production. Certain products such as sugar, fertilizers, cement etc. are packed in HDPE / gunny bags and are transported / sold without any further packing. For such products even though there is only one type of packing material cost, it is treated as secondary packing and is taken as part of cost of sales.

e) Cost of secondary packing materials should form part of selling and distribution overheads. Since, these packing materials are used to make the product marketable.

Note: For more details readers may refer Cost Accounting Standard (CAS)-9 on Packing Material Cost issued by the Institute of Cost Accountants of India.

3.5 EMPLOYEE COST

1. Classification of Employee Cost

Employee cost, on the basis of relation with a cost centre / cost object is classified direct employee cost, and indirect employee cost, of product / service cost. Direct employee cost, is the cost of those workers who are readily identified or linked with a cost centre or cost object. Indirect employee cost is the wages of employees which are not directly allocable to a particular cost centre.

Employee Cost:

Employee Cost means 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. However, the following points need consideration in identification of employee cost:

1. Contract employees includes 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 in current period will not form part of the cost in the current period.

However, the 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 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.

Therefore, the term "employee costs" refers to the expenditure borne by employer for engagement of employees and include direct remunerations, allowances and bonuses, paid by an employer in cash or in kind to employee in return for work done. It includes payments to social saving schemes, payments for days not worked and remunerations in kind such as food, drink, fuel, company cars, etc. However, there are a number of costs which do not appear in the payroll but are employee related cost such as: recruitment costs, training costs, relocation costs, learning costs support / social costs, and Personnel Administration costs. **<u>The employee cost is also termed as Labour cost.</u>**

2. Categorization of Employees:

The employees in an organization may be categorized as:

a. Daily rated worker / badli worker, piece rate worker

b. Monthly paid worker

c. Contract basis

d. Temporary or regular

e. Skilled or unskilled

f. Executive / non-executive.

Remuneration paid to above categories of employees for the purpose of control is also classified accordingly i.e. casual labour cost, supervisory cost, etc.

Payment is made to employees as per their term of employment. For many employees remuneration is based on attendance. (Attendance is controlled by biometric / clocking system / manually). They work for a number of hours per day, and get paid at the end of the work or month. For others, their remuneration is based on the quantity and quality of their work, that is, the more good units they make or provide the higher their payment.

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 organization during the current period. Such payments for past period are items of reconciliation between Cost and Financial Accounts.

Similarly, short 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.

Idle time:

Idle time is 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.

Idle time happens due to various causes for which an employee is not responsible but full wages are paid to him. Even for employees who are paid on the basis of output, idle time payment may be required to be made. Idle time may be classified as under:

Normal Idle Time:

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, etc. It is treated as normal idle time. It is built in labour hour rate.

Abnormal Idle Time:

Idle time arises due to breakdown of machinery, power failures, non-availability of material, lock -out, atmosphere conditions, flood etc. is abnormal idle time and excluded from the cost.

Direct Employee Cost

Direct employee cost is that portion of wages and salaries which can be identified without any difficulty and charged to a cost object. It may be classified as direct when:

(a) There is a direct relationship to the product through a process or a costing unit;

(b) The cost may be measured in light of this relationship; and

(c) The cost is sufficiently material in amount.

Direct labour means labour spent in the actual production of the finished product or is labour immediately identifiable with product costs. It must be economically feasible to associate a labour cost with units produced before treating that cost as direct. "Economically feasible way" means cost effectiveness so that the cost accounting is not too expensive in relation to expected benefits. This concept is applicable not only to cost object, but also to job, process, such as melting, dying or galvanizing.

Employees performing the following operations are normally classified as direct employee:

- Machining operations
- Assembly operations
- Machine setting
- Heat treatment,
- Melting
- Process operation

The ultimate and practical criterion for classifying employee cost as direct is whether the work performed by an employee can economically be identified with the product or not.

Indirect Employee Cost:

Indirect Employee Cost is the cost which cannot be directly attributed to a particular cost object.

1. 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. 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 he is repair man or set-up man, he may be classified as indirect employee.

2. An 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.

3. 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.

4. Short Operations which require a relatively small amount of time to complete such as buffing, scouring and polishing may be treated as indirect employee if the operation takes less time than the unit time employed in labour accounting. If in a given plant the minimum unit time is 15 minutes, an operation consuming less than that amount should be classified as a short operation. Proration of the employee cost of these operations may be in some cases being best accomplished through allocation as indirect employee cost.

5. 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.

Cost Records for Employee Cost:

The following records need to be maintained by the Company to ascertain correct employee cost on each activity/ cost centre:

Particular	Recording	Remark
Clock Card/ Attendance Record	The time of coming in and leaving the factory premises, the employee will use this card at the factory gate for recording the starting and finishing time.	It is a document on which starting and finishing time of an employee is recorded Example: An employee by insertion into the time recording device ascertains the actual attendance time.
Daily or Weekly Time Sheet	It is a document on which the employee records how his time has been spent. The total time on the time sheet should correspond with the time shown on the clock card.	It will analyze his movement and when signed by the supervisor an analysis of the labour cost is made for various jobs and operations.
Job Cards	It is a single job or batch and is likely to contain entries relating to numerous employees. On job completion it will contain a full Records of the times and quantities involved in the job or batch.	It enables reconciliation of work time and attendance time as jobs usually goes for long duration.
Piece Work Cards	It shows the number of units processed or produced each day on the basis of which wages are payable.	Enables calculation of wages and evaluation of efficiency of the workers.
Payroll Accounting	It is involved in maintenance of records for the amounts due to the employees like wages and salaries including other allowances together with deductions made from the employee's earnings.	It aides to the management in calculation of wages and salaries of individual employees taking consideration his attendance and leaves together with other entitlements.
Employee or Labour Cost Accounting	It involves identifying the amount of labour cost to be charged to individual jobs and overhead accounts. The idle time analysis is also necessary for labour cost accounting.	It aids in identifying the information relating to the time spent on each job or process or number of units produced is obtained from the job cards, piece of work tickets etc.

Note:

(1) Proper records should be maintained to show the attendance and earnings of all employees assigned to the cost centers or departments and the work on which they are employed. The records should also indicate the following separately for each cost centre or department:

(a) piece rate wages (wherever applicable);

(b) incentive wages, either individually or collectively as production bonus or under any other scheme based on output;

(c) overtime wages;

(d) earnings of casual or contractual labour;

(e) bonus or gratuity, statutory as well as other;

(f) contribution to superannuating scheme;

(g) any other earnings of the nature specified in (a) to (f) above.

(2) The records should be maintained in such a manner as to enable the company to book these expenses cost centre-wise or department-wise for each products where the employees work in such a manner that it is not possible to identify them with any specific cost centre or department, the employees cost should be apportioned to the cost centers or departments on equitable and reasonable basis and applied consistently.

(3) The idle labour cost should be separately recorded under classified headings indicating the reasons therefore. The method followed for accounting of idle time payments should be disclosed in the cost records.

(4) Any wages and salaries allocable to capital works, such as, additions to plant and machinery, buildings or other fixed assets should be accounted for under the relevant capital heads. Similarly, payments in the nature of deferred revenue expenditure should be separately recorded under separate classified headings indicating the reasons therefor. The method followed for accounting of such payments in determining the cost of the product(s) under reference should be on equitable and reasonable basis and applied consistently.

(5) The cost of normal retirement benefits payable to employees should be recorded separately and charged to cost. The method followed for accounting of such costs in determining the cost of the products under reference should be on equitable and reasonable basis and applied consistently and disclosed separately. Termination benefits which are payable in addition to the normal retirement benefits, such as benefits under voluntary retirement scheme, should be treated as abnormal and should not form part of salaries and wages and cost of production.

In the case of accounting for direct labour costs methods vary because:

(a) The wage payment system themselves vary.

(b) Standard Labour Cost are used and

(c) The extent of the existing system of labour booking varies.

In organizations where time booking on a job wise basis or on an operation wise basis does not exist, it would be necessary to design and introduce a time booking system. Quite a few organizations employ a system of piece-rate wages payment where the basic labour cost will be much easier to be ascertained as it is on a per piece basis. However the dearness allowance which forms the bulk of the employee's pay packet remains a time-reckoned payment in all cases.

It will be necessary to convert the standards into actuals at the end of each accounting period in the case of each component or sub-assembly where cost booking is made at standard rate and time booking. A reconciliation of the direct labour cost as calculated from the pay rolls with the amount charged to the individual job costs, operation or process costs will be necessary to establish correctness.

Similarly, allocation of indirect labour and salaries will have to be done to the concerned overhead account on an actual basis from the pay roll analysis. The major point that will have to be kept in mind is the amount of labour costs chargeable to capital jobs/work.

Principles of Measurement

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 (to be checked later)

The Company should follow the principles and methods of computation of employee cost in cost records 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.

1. Employee Cost should be ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all the benefits.

a) Financial Benefits:

Based on Pay slips (which indicate department code), summary of gross earnings, deductions, working days etc., are prepared department wise / cost centre wise. Gross earning of an employee is the employee cost to the organization.

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. Thus contribution to Provident Fund, Employee State Insurance Scheme and FPS are charged as incurred.

Share of employers' contribution to PF, FPS and ESI should be identified to cost centre / department where the employee is working. In cases where it is not feasible, it should 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 is to be treated as Production overhead as it is not specific to any cost centre.

b) Non-financial benefits:

Non-financial benefits are offered to employees in several ways. These benefits are 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 benefits go to all the employees in the organization and is not limited to any individual, class, or group.

A few examples of non-financial benefits are mentioned below:-

- 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
- Pension Scheme

- 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.

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.

c. The fixed contribution plans involves a defined cost per employee and can be readily assigned to cost centers 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 centers / 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 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.

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:

a) 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 organization during the current period. Such payments for past period are items of reconciliation between Cost and Financial Account.

b) 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.

c) Employee cost does not include workers hired through contractor or agents as they are not on the roll of the organization and payments are made to the contractor and not to such workers.

2. **Bonus whether payable as a Statutory Minimum or on a sharing of surplus is to be treated as part of employee cost. Ex gratia payable in lieu of or in addition to Bonus should 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 organization to organization. However incentive payments made to employees form part of employee cost.

      (1) 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

         a) Individual employee level – based on his or her performance.

         b) Group of employees level – based on performance of a group of employees or team

         c) Unit level – where the incentives are paid on the basis of performance of the factory or other unit.

      (2) 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.

      (3) Any payment of bonus as a Statutory Minimum or on a sharing of surplus/incentive will form part of the employee cost. The bonus paid to employees should be identified with each cost centre/department. For determining labour hour rate, bonus should be estimated on the basis of past results and future forecast.

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.**

   a) Remuneration paid to officers, managers and executive directors of a corporate body whether paid as a fixed amount or paid whole or part of the remuneration as percentage of profits should 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.

   b) Remuneration paid to managerial personnel will be identified as production, administrative or selling overhead on the basis of services provided by them. However, the remuneration paid to non-executive directors should be treated as Administrative Overheads.

4. **Separation costs related to voluntary retirement, retrenchment, termination etc. should 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 payments under the above schemes are generally amortized over a period of 5 years. Earlier costs related to voluntary retirement, retrenchment/ termination compensation were treated as a part of non-cost items. As per cost accounting standard on employee cost, it should be amortized over the period benefitting from such costs. If this amount is charged off in the financial profit & loss account during the year of incurrence, the difference in the amount charged in cost accounts and the amount carried forward during the years of benefit would be reflected as a reconciliation item in the statement of reconciliation between cost accounts and financial accounts.

5. Employee cost should not include imputed costs.

Imputed cost of an employee should not form part of the employee cost as there is no cash payment and it is being used for the purpose of decision making.Cost of employee share options can be treated as part of employee cost provided the same is not a notional cost and involves an actual cash outlay

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.

Normal idle time is built in the labour hour rate and forms the part of the cost object. Abnormal idle time is the time lost and will not be 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 efforts.

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. However, 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. The payment for such abnormal idle time is charged to Costing Profit and Loss account.

7. Where Employee cost is accounted at standard cost, variances due to normal reasons related to Employee cost should be treated as part of Employee cost. Variances due to abnormal reasons should be treated as part of abnormal cost.

When standard costing system is in vogue in an organization, 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 should 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 and

(c) Taking trial runs.

i) Employee rate standard

The rates of pay expected to be paid to the employee is taken into account 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 from 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.

ii) 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 analysed. 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.

8. Any Subsidy, Grant, Incentive or any such payment received or receivable with respect to any Employee cost should 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.

9. **Any abnormal cost where it is material and quantifiable should not form part of the Employee cost.**

Abnormal Cost is 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 it is material and quantifiable. However, the materiality has not been defined in the Cost Accounting Standard (CAS-7: Employee Cost). 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 will not form part of cost of the production as not to distort the cost due to abnormal reasons. Therefore, it is dealt with in the costing profit and loss account.

10. **Penalties, damages paid to statutory authorities or other third parties should 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 item of expense, it will not form part of the employee cost and will be an item of reconciliation with financial accounts.

11. **The cost of free housing, free conveyance and any other similar benefits provided to an employee should 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 organization. Total expenses incurred for maintenance, repairs, depreciation, lease rent paid and any other related cost of housing is to be assessed and form part of employee cost.

The above treatment is also applicable to free conveyance provided which may be leased or owned. For leased vehicle hire charges and for owned vehicles, related expenses such petrol / diesel, maintenance and repair, depreciation of vehicles will form part of free conveyance provided to the employees.

12. **Any recovery from the employee towards any benefit provided e.g. housing should 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 should be adjusted against the relevant cost of the benefit. Net cost of benefits provided will form part of the employee cost.

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 generally accepted cost accounting principles 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 being followed consistently but due to change in the principle with the notification of Cost Audit Report Rules, 2011 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.

C. Assignment of Cost

1. **Where the Employee services are traceable to a cost object, such employees' cost should 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 Records 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. With computerisation, manual punching has now been replaced in most organisation by electronic swipe cards which are more efficient and provides online data to the payroll system.

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 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.

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.

2. **While determining whether a particular Employee cost is chargeable to a separate cost object, the principle of materiality should be adhered to.**

   Materiality and significance:

   The principle of materiality should 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 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.

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 are deployed in multiple locations and it is not possible to identify them with any cost centre or department. The cost of such employee 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 equipment 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.

4. **The amortised separation costs related to voluntary retirement, retrenchment, and termination etc. for the period should be treated as indirect cost and assigned to the cost objects in an appropriate manner. However unamortised amount related to discontinued operations, should not be treated as cost.**

   Voluntary retirement, retrenchment and termination cost are 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 are pro-rated over the years to be benefited by such payments, 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 should not be amortized over the remaining period, if the relevant production operation has been discontinued. For example in a textile mill Dyeing activity is discontinued after one year of the voluntary retirement scheme. Thus portion of unamortized separation cost relating to Dyeing activity is to be charged to Costing Profit and Loss account and will not be amortized for the balance period.

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 employees recruited department wise.

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 represents the overtime hours multiplied by the premium rate. The overtime payment is usually the double of regular wage rate. Thus payment of overtime is of two parts viz. the normal and extra payment (premium). **Accounting treatments of overtime shall be as under:**

Overtime which is based on single rate it is treated as employee cost. But where overtime is compensated at double rate, the overtime premium is to be assigned in one of the following ways:

Treatment 1: 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.

Treatment 2: In all other cases, it is usual to treat the premium as overheads and absorb the same as part of overheads.

7. Idle time cost should 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 such as lunchtime, holidays, personal needs etc. are built in the cost per hour of an employee and is part of employee cost.

Idle time cost (other than stated above) should be recorded as separate time on time ticket and standing code numbers established for this purpose. In continuous process industries, time lost due to machine breakdown or stand by purpose must be separately recorded, since time tickets are not utilized in most cases.

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.

Idle time is to be analysed between normal and abnormal idle time. Normal idle time shall be assigned to cost object if it is economically feasible. In other cases it should be treated as overhead. Abnormal idle time due to strike, flood, etc. is to be excluded from the cost of production.

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.

Note: For more details readers may refer Cost Accounting Standard (CAS)-7 on Employee Cost issued by the Institute of Cost Accountants of India.

3.6 UTILITIES

1. What is a Utility:

Production processes need several inputs other than raw material in the form of water, steam, electricity, etc. Such other inputs are known as utilities.

Classification of Utilities

Utilities are classified according to the nature of utility. Various types of utilities used in manufacturing process are:

Power	Purchased Power Generated Power (stand-alone) Co-generation
Water	Raw Water Treated water De-mineralized water Distilled water/softening water Chilled water 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

Measurement of cost of utility:

Cost of utility consists of direct employee cost, fuel, direct expenses, chemicals, stores and spares, repairs & maintenance, depreciation and inter utility transfer cost.

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 are given below:

Utility	Measure	Unit
Power	Units per hour	KWH or MWH
Steam	Weight/ Pressure	KG/ Cm2 at --- oC
Water	Volume	Litres/Kilo Litres
Heating	Thermal unit	K cal or BTU
Air	Pressure Volume	Kg/CM2 or M3

Principles of Measurement

1. Each type of utility shall be treated as a distinct cost object.

2. 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 etc. are distinct utilities, and the cost is collected and measured for each utility separately. The costs are booked to each utility through the initial documents such as supplier's bill, if directly identifiable with utility, payroll analysis sheet, stores requisition, expense voucher etc.

3. Cost of Utilities Purchased

Cost of utilities purchased will 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 of source for a given utility. For example, it 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 etc.).

The above treatment is also applicable to any other utility purchased, such as purchase of steam, coke oven gas, raw water from municipal sources, canal etc.

4. Cost of self-generated utilities for own consumption will comprise direct material cost, direct employee cost, direct expenses and Factory/Production Overheads

The cost of generating a utility may comprise water, fuel, electricity, 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, diesel 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 debit 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.

(i) Steam:

A separate statement of cost of steam is to be 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. The reported cost of steam is the average cost of generation at a particular production rate. Equated pressure shall be indicated in the statement of cost for steam. The net cost of operating the steam is equal to the cost of steam generation less the credit for power generation in the turbine.

(ii) 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 will include employee cost, fuel, power, repair and maintenance of tube wells, depreciation and overhead.

The total monthly cost of operating this department is divided by the number thousands of Kiloliters of water pumped during the month to determine the unit cost of water pumped.

(iii) 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 etc.

The cost of demineralised water is also arrived at on the above basis.

5. 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 tube well. Inter-utility cost is to be determined by the following method:

a) repeated distribution method;

b) simultaneous equation method;

c) other computer applications.

a) Repeated Distribution Method:

When this 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 centers and other utilities centre is determined based on usage.

ii) Cost of first utility is to be apportioned to production cost centers and other utilities in the proportion as determined in step (i) 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 centers.

b) Simultaneous Equation Method

Simultaneous equation method is adopted to take care of inter-utility distribution of cost of utilities to production cost centres with the help of mathematical formulation and solutions. Steps to be followed are:

i) Proportion of utility received by different utilities/production cost centre from a utility is assessed on the basis of records.

ii) The same ratios are used as coefficients in the equation framed for finding values of a utility.

iii) Solution of the equations gives the cost of service cost centers.

iv) Cost of utility to be distributed to production cost centers.

c) Other Computer Application Tools:

Various Computer applications are now available that takes care of inter-se allocation of Utilities based on the quantitative data of consumption.

5.1 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.

If utilities generated are transferred to inter units, the cost of distribution of such utilities will be included in the cost of utility. It will comprise cost of generating utility and distribution facility. Distribution may be through a pipe line/transmission line. The cost of maintenance of pipe line/ transmission for transfer of utility will be added to the cost of utility.

In case of intercompany transfer, cost of utility so transferred should comprise of direct material (fuel etc.), direct labour, direct expenses, chemicals, share of Factory/Production Overheads, distribution cost and share of administrative overhead.

5.2 Cost of Utilities generated for the sale to outside parties should comprise direct material cost, direct employee cost, direct expenses, Factory/Production Overheads, distribution cost, share of administrative overheads and marketing overheads.

The sale value of such utilities to outside parties will also include the margin.

6. Finance costs incurred in connection with the utilities should not form part of cost of utilities

While determining the cost of utility the finance cost i.e. interest related cost will not be considered as an item of cost.

7. The cost of utilities should include the cost of distribution of such utilities

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 etc.) will form part of the cost of utility supplied. It will include the cost of transportation through pipeline, stepping up / stepping down of power voltage, maintenance of distribution channels, etc.

8. Cost of utilities should not include imputed costs

Imputed cost does not involve any cash payment and should not be included in the cost of utility. However, in certain cases where a particular utility is produced and the same gets generated as a part of another process within the organisation as a by-product, the cost of such by-product utility may be valued at the cost of actual generation. Example: In an integrated paper mill, Steam is produced in Boilers for consumption in various processes. Steam is also generated as a by-product in the Soda Recovery process(conversion of black liquor to white liquor) and is used along with the other steam generated. In such a case, the steam generated at the Soda Recover Plant may be valued at the cost of generation of steam and the same is to be credited to cost of Soda Recovery and debited to Steam cost to arrive at the total steam consumption cost of the Paper Plant.

9. Where cost of utilities is accounted at standard cost, the price variances related to utilities should be treated as part of cost of utilities and the portion of usage variances due to normal reasons should be treated as part of cost of utilities. Usage variances due to abnormal reasons should 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 etc. 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 etc. Variances due to normal reasons should be treated as cost while the variances due to abnormal reasons are treated outside the cost of production.

10. Any Subsidy / Grant / Incentive or any such payment received / receivable with respect to any cost of utilities should 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.

11. 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, should be treated as abnormal cost. Cost of a Stand-by Utility should include the committed costs of maintaining such a utility.

Where utilities are created for captive consumption, utility plants are operated based on the production plan of end product. There may be a situation when end product itself may be operated at below normal capacity in adverse market conditions and recession. In such 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 or actual utilization whichever is higher. 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 an electricity generation through DG set. In case of purchased electricity, there cannot be a measure for capacity whereas for DG set there will be measure for capacity which again is to be related to the end product.

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 utilisation, unabsorbed cost is to be treated as abnormal cost.

12. 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 etc. Such cost will not form, part of the utility cost. Another example of abnormal cost is due to low capacity utilization.

13. Penalties, damages paid to statutory authorities or other third parties should not form part of the cost of utilities

Statutory authorities levy penalties for non-compliance of regulatory requirements. For example: not complying with boiler inspection, not safeguarding hazardous utility. Penalty so levied will not form part of the cost of utilities.

14. Credits/recoveries relating to the utilities including cost of utilities provided to outside parties, material and quantifiable, should be deducted from the total cost of utility to arrive at the net cost of utility.

Credit will be given for portion of utility utilized inside the production units (e.g. steam utilized in the generation of power or sold to the outside parties).The net cost arrived at should be then loaded to the different units benefitted by the use of a utility.

For 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 centers.

(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 overhead + administrative Overhead+ Marketing Overhead and Margin)

15. **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.**

    Cost accounting principles 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 Cost

1. **Assignment of cost of utilities, traceability to a cost object should be on an economically feasible manner.**

   The cost of utilities is to be assigned to the end user/ cost objects on the basis of meter readings. If no meters are installed, 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.

2. **Where the cost of utilities is not directly traceable to cost object, it should 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, etc.

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 etc. 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.

   Note: For more details readers may refer Cost Accounting Standard (CAS)-8Cost of Utilities issued by the Institute of Cost Accountants of India.

3.7 DIRECT EXPENSES

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.

Treatment of some of Direct Expenses is given below:

Examples of various direct expenses related to manufacture has been indicated above. These are dealt with as under:

1. **Royalty based on production**:

   Royalty is to be paid to Collaborators or technology suppliers in terms of agreement entered with them. It is payable either in relation to production or sales during the accounting period. If royalty payment is in respect of production of the goods captively consumed, then the same should be added as the cost element. If royalty is linked with sales volume or sales price, then royalty shall form part of selling overheads.

2. Royalty for Upgrading Technology for the captively consumed product

Royalty for Upgrading Technology for the captively consumed product is to be included in cost of production, irrespective of whether it is paid on production basis or sales basis.

Royalty for Marketing and Distribution, if paid, will be excluded from cost of production and should be considered as a part of Selling & Distribution Overheads. Sometimes, royalty payments are one-time payment at the time of installation of the unit and are identified with the plant cost. It is capitalized and depreciated along with plant and machinery cost.

3. Technical Assistance / Know-how fees:

Technical Assistance/ know-how fees should form part of product cost and 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 should be determined with reference to planned production.

4. Amortized cost of moulds, dies, patterns, patents 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.

5. Job / Processing Charges:

Job Work Charges / Processing Charges which are directly identified or linked with the products will form part of direct expenses.

6. Hire charges for tools and equipment:

Hire charges in respect of tools and equipment 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.

7. Charges for a particular product designing:

Product design charges to the extent amortized in respect of tools and equipment which can be directly identified with a particular product will form part of direct expenses.

8. Other Expenses

Other expenses which can be economically identified with a cost object shall be treated as direct expenses, such foreign travelling for export, travelling for execution of a specific job etc.

Direct Expenses based on Standard Cost

In some cases direct expenses are charged based on standard cost. Standard costs are used to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyze the causes of variances and take proper measure to control them.

Standards may be fixed for certain direct expenses such as job charges for loading, and unloading, packing charges of goods, Annual maintenance contract for certain equipment.

Principles for Measurement

1. Identification of Direct Expenses should be based on traceability in an economically feasible manner.

Measurement of direct expenses depends upon identification and traceability to cost object in an economically feasible manner. If an expense can be identified with a cost object/ product and is sufficient materiality in amount, it is treated as Direct Expenses. For tracing of direct expenses to a cost object, it requires an exercise to analyse the cost involved, benefit to accrue and over-riding requirement to identify direct expenses with the cost object.

For example:

Foreign travel for export: An analysis is to be made of the travelling expenses to identify the travelling expenses into domestic and foreign travel. Foreign travel is to be further analysed to identify and trace the travelling expenses for export of a product. If the benefit to accrue is not economically feasible, it is to be treated as Selling & Distribution Overhead.

2. **Direct Expenses incurred for the use of bought out resources should 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.**

Direct expenses are incurred for the use of bought out resources. These 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, etc.

In such case determination of Direct Expenses incurred for a cost object will depend upon the type of direct expenses. For Example, royalty payment is to be determined in terms of collaboration agreement. Job /hire charges will be as per work order and invoice. It shall include duties and taxes and other expenditure (freight/transport). For example if VAT / service tax is applicable for hiring of equipment, it will form part of hire charges. Direct expenses are to be net of any discount, rebate, taxes and duties (VAT/CENVAT) refundable, if any.

If any design and drawing or equipment is imported, custom duty payable / paid will form part of the cost.

3. **Direct expenses other than those referred to in preceding paragraph are to be determined on the basis of amount incurred in connection therewith.**

Dies, tools, scaffolding, etc. are sometime produced internally. Production Cost of these items is to be determined taking into the direct material cost, direct employee cost, direct expenses and Production overhead (including share of administrative overheads relating to production comprising factory management.) As and when a decision is taken to produce dies / tools in-house, a work order is issued and all the above expenses are recorded therein.

Whenever Development work is taken for improvement of the process of existing product based on research, development cost which can be traced to cost object. It will be treated as Direct Expenses.

4. **Direct Expenses paid or incurred in lump-sum or which are in the nature of 'one-time' payment, should be amortised on the basis of the estimated output or benefit to be derived from such direct expenses.**

In case of lump sum or one-time payment, for which benefit is derived in future period, it should be capitalized and written off over its useful life/or estimated production. For example Technical know-how fee paid should be capitalized and amortized over its useful /productive capacity expressed in terms of number of units it can produce.

5. **If an item of Direct Expenses does not meet the test of materiality, it can be treated as part of overheads.**

If an item of expense is to be treated as Direct Expense or Indirect Expense, it should be determined in terms materiality of an item. Materiality depends on the size and nature of item judged in particular circumstances. An item of expense / information is considered material if its misstatement (i.e. omission or erroneous statement) could influence the economic decisions of users based on the cost statement. For example Royalty is a material item from the point of view of information. It should be shown as a separate item in the cost records and not aggregated with overhead even though it may not be significant in term of the total cost of the product. In another case, AMC charges/job charges can be identified with the cost object but if not being material and significant in value, it may be treated as overhead.

6. **Finance Costs incurred in connection with the self-generated or procured resources should not form part of Direct Expenses.**

   Finance costs are interest etc. on borrowed funds. Finance costs are excluded from Direct Expenses. The letters of credit charges are for credit risk or a transaction risk (demand bill). Bank charges are in the nature of handling charges and are not for any credit term. These charges do not form part of the finance cost but to be considered as a part of administrative overheads.

7. **Direct Expenses should not include imputed costs.**

   Imputed cost does not involve any expense or cash outlay and as such it is not a part of cost of production.

8. **Where direct expenses are accounted at standard cost, variances due to normal reasons should be treated as part of the Direct Expenses. Variances due to abnormal reasons should not form part of the Direct Expenses.**

   If standards have been fixed for any direct expenses, such as job charges, AMC etc. / variance analysis of direct expenses should be done. Variance due to normal reason will form part of Direct Expenses and any abnormal variance will be excluded from Direct Expenses. The variance account enables management to observe the extent to which actual Direct Expenses are differing from planned objectives or predetermined estimates.

   For example, due to strike of the contracted labour, higher charges were paid to another contractor to get the job executed. The variance in the above situation should not form part of the Direct Expenses due to abnormal reasons.

9. **Any subsidy/grant/incentive or any such payment received/receivable with respect to any Direct Expenses should 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.

   Example:

   Subsidy may be for non-conventional energy and certain direct expenses on design and drawing have been incurred in this regard. Such Direct expenses shall be reduced to the extent of subsidy received while ascertainment of the cost of the non-conventional energy.

10. **Any abnormal portion of the direct expenses where it is material and quantifiable should not form part of the Direct Expenses.**

    Since inclusion of such items in cost will make the cost not comparable in a normal situation.

    Example:

    Certain Direct Expenses were incurred on design and drawing, but due to change in the specification of the product, these drawings were abandoned and were treated as abnormal cost on the ground of having materiality and quantifiable. In case such Direct Expenses cannot be quantified and are not material, it will form part of the Direct Expenses.

11. **Penalties, damages paid to statutory authorities or other third parties should not form part of the Direct Expenses.**

    Penalties/damages are levied by the statutory authorities for non-compliance with statutory requirements/delay and should not form part of the Direct Expenses.

Example:

- Penalty for delay in depositing Provident Fund contribution with the Provident Commissioner.
- Demurrages levied by transporter for not removing goods
- Penalties for keeping hazardous goods in unauthorized places in transit without proper safeguards.
- Penalties / Damages are an abnormal cost and do not form part of the Direct Expenses it is charged to profit & Loss account.

12. Credits/recoveries relating to the direct expenses, material and quantifiable, should be deducted to arrive at the net direct expenses.

If any credit is available relating to direct expenses, it is to be reduced from the direct expenses.

For example for a job on contract, special design and drawing charges were to be recovered from the client. While determining the cost of the job, design and drawing charges received should be credited to its cost.

13. 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 organization.

Thus change in cost accounting principle / law for determining the cost can be made when required by any law or for compliance with cost accounting standards or it results in appropriate presentation of cost statement/cost records.

Assignment of costs

Direct Expenses that are directly traceable to the cost object should be assigned to that cost object.

Assignment of Direct Expenses involves establishing a suitable procedure to identify and record the same by the cost object. Invoice / Agreement / Job on contract is the source documents indicating details of direct expenses. For internally produced equipment, Work Order is the source for assignment of cost. These documents record the cost object / cost centre / job number, etc. and items listed are charged at their acquisition cost.

Note: For more details readers may refer Cost Accounting Standard (CAS)-10 on Direct Expenses issued by the Institute of Cost Accountants of India.

3.8 DEPRECIATION

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, passage 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 expected useful life of the asset. Depreciation includes amortization of assets whose useful life is predetermined.

Depreciable assets are assets which

(i) are expected to be used during more than one accounting period; and

(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.

Useful life 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 enterprise.

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost1 in the financial statements, less the estimated residual value.

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 is to grouped with depreciation because intangible assets themselves are grouped with Fixed Assets in the presentation under Schedule VII of the Companies Act 1956.
3. The measurement of depreciation in Cost accounts is a mirror to the practices in financial accounts.
4. Even where an entity charges 100% depreciation in financial books of accounts, depreciation based on estimated life may be considered for costing purposes with the difference taken to Costing Profit & Loss or Reconciliation with Financial Accounts. It may, however, be kept in mind that in the absence of a costing balance sheet, the accounting and tracking of such depreciation has to be maintained properly in the cost books.
5. Where small value items are written off fully at the time of purchase in financial accounts, the same is generally adopted for cost accounts.
6. The cumulative depreciation charged in the Cost Accounts against any individual item of fixed asset should not exceed the original cost of the asset.
7. The assignment of depreciation should be done based on usage of fixed assets by various cost centres. The detailed Fixed Asset records should be maintained by the Company product/ cost centre wise. 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.

3.9 REPAIRS AND MAINTENANCE

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 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 and the cost of such repair work is expensed off in the year of incurrence.

Principles of Measurement

1. **The cost of Repairs and Maintenance is 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.

   Thus, it will be the aggregate of direct and indirect cost relating to repairs and maintenance activity.

Here,

Direct Cost = Cost of Materials+ Consumable Stores + spares + manpower + equipment usage + utilities and other identifiable resources consumed.

Indirect Cost = Cost of Resources common to various repairs and maintenance activities (e.g. Manpower, Equipment Usage and other cost allocable to such activities)

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

3. Cost of Repairs and maintenance activity carried out by outside contractors inside the entity should 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.

4. Cost of repairs and maintenance jobs carried out by contractor at its premises should 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 should also include the cost of other resources provided to the contractors.

5. Cost of repairs and maintenance jobs carried out by outside contractors will include charges made by the contractor and cost of raw materials, consumable stores, spares, manpower, equipment usage, utilities and other costs in such jobs.

6. Each type of repairs and maintenance is 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.

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

8. High value spare when replaced by a new spare and if it is reconditioned, which is expected to result in future economic benefits, the same should be taken into stock. Major overhaul is a periodic (generally more than one year) repair work carried out to substantially restore the asset to intended working condition and the cost of such repair work is expensed off in the year of incurrence and would form part of Repairs & Maintenance Cost. The principle is explained with the help of the example below.

Cost of equipment	₹10.00 crores
Cost of a major spare	₹ 1.00 crore

   When the major spare is issued as a replacement, it will be taken to maintenance cost (debit) At this time, the old (replaced) spare is taken for reconditioning.

   Let us assume that the original spare will have a life of five years and the reconditioned spare a life of one year. The value of the service potential of the reconditioned spare can therefore be put as ₹ 20 lakhs.

   Let us further assume that the cost of reconditioning is ₹15 lakhs. This also will be taken to maintenance cost (debit).

   The reconditioned spare will be taken to inventory (debit) and relieved from maintenance cost (credit) The amount to be taken, should be the measure of the service potential of the reconditioned spare which is ₹20 lakhs. However, accounting to CAS-12 the amount to be taken to inventory (debit) and relieved from maintenance cost (Credit) should not exceed the cost of reconditioning viz. ₹ 15 lakhs.

The accounting entries would be as below:

Repairs & Maintenance	Dr.		100.00 lakhs	
Inventory (Spares)		Cr.		100.00 lakhs
Being spare part issued replacing the old spare)				
Repairs & Maintenance	Dr.		15.00 lakhs	
Cash		Cr.		15.00 lakhs
(Being cost of repair & reconditioning of old spare)				
Inventory (Spares)	Dr.		15.00 lakhs	
Repairs & Maintenance		Cr.		15.00 lakhs
(Being Reconditioned Spare taken to stock)				

9. Finance Costs incurred in connection with the repairs and maintenance activities should not form part of Repairs and Maintenance Cost.
10. Repairs and maintenance costs should not include imputed costs.
11. Price variances related to repairs and maintenance, where standard costs are in use, should be treated as part of repairs and maintenance cost. The portion of usage variances attributable to normal reasons should be treated as part of repairs and maintenance cost. Usage variances attributable to abnormal reasons should be excluded from repairs and maintenance cost.
12. Subsidy/Grant/Incentive or amount of similar nature received/receivable with respect to repairs and maintenance activity, if any, should be reduced for ascertainment of the cost of the cost object to which such amounts are related.
13. Any repairs and maintenance cost resulting from some abnormal circumstances, if material and quantifiable, should not form part of the repairs and maintenance cost.
14. Fines, penalties, damages and similar levies paid to statutory authorities or other third parties should not form part of the repairs and maintenance cost.
15. Credits/recoveries relating to the repairs and maintenance activity, material and quantifiable, should be deducted to arrive at the net repairs and maintenance cost.
16. 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 law or a change would result in a more appropriate preparation or presentation of cost statements/cost records of an organization.

Assignment of Cost

1. Repairs and maintenance cost shall be traced to a cost object to the extent economically feasible.
2. If the repair and maintenance cost is not directly traceable to cost object, it should be assigned based on either of the following two principles:
   - Cause and Effect
   - Benefits received
3. If the repairs and maintenance cost is shared by several cost objects, the related cost should be measured as an aggregate and distributed among the cost objects.

Note: For more details readers may refer Cost Accounting Standard (CAS)-6 on Repairs and Maintenance Material Cost issued by the Institute of Cost Accountants of India.

3.10 COST OF SERVICE COST CENTRE

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 centers / other units and in some cases to outside parties.

Examples of service cost centers 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.

Principles of Measurement

1. Each identifiable service cost centre should be treated as a distinct cost object for measurement of the cost of services subject to the principle of materiality.
2. Cost of service cost centre should be the aggregate of direct and indirect cost attributable to services being rendered by such cost centre.
3. Cost of in-house services should include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such service. Cost of other resources should include related overheads.
4. Cost of services rendered by contractors within the facilities of the entity should 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. Cost of services rendered by contractors at their premises should 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 should also include the cost of resources provided to the contractors.
6. Cost of services for the purpose of **inter unit transfers** should also include distribution costs incurred for such transfers.
7. Cost of services for the purpose of **inter-company transfers** shall also include distribution cost incurred for such transfers and administrative overheads.
8. Cost of services rendered to outside parties shall also include distribution cost incurred for such transfers, administrative overheads and marketing overheads.
9. Finance costs incurred in connection with the Service Cost Centre shall not form part of the cost of Service Cost Centre.
10. The cost of service cost centre shall not include imputed costs.
11. 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.
12. 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.
13. 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.

14. Any abnormal cost where it is material and quantifiable shall not form part of the cost of the service cost centre.
15. Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of the service cost centre.
16. 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.
17. 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.

Assignment of Service Cost

1. Assigning cost of services based on traceability to a cost object in an economically feasible manner will be the guiding principle.
2. Where the cost of services rendered by a service cost centre is not directly traceable to a cost object, it will be assigned on the most appropriate basis.
3. The most appropriate basis of distribution of cost of a service cost centre to the cost centers consuming services is to be derived from logical parameters which could be related to the usage of the service rendered. The parameter should be equitable, reasonable and consistent.

Note: For more details readers may refer Cost Accounting Standard (CAS)-13 on Cost of Service Cost Centre issued by the Institute of Cost Accountants of India.

3.11 PRODUCTION OVERHEADS

Production 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.

Production Overheads are costs involved in the production process or in rendering services. Production overheads include administration cost relating to production, factory, works or manufacturing. The terms Production Overheads, Factory/Production Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

Since production overheads cannot be economically traced to products and services, they are assigned to them on some equitable basis. Production overheads include all expenses incurred by the factory from receipt of raw materials until completion of production.

For example,

- Salaries for staff for production planning, technical supervision, factory administration etc.
- normal idle time cost
- expenses for stores management
- consumable stores
- factory rent,
- factory light, fuel, power, repair, oil, gas and water

- 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.

Principles of Measurement

1. **Production overheads should be the aggregate of cost of resources consumed in production activities relating to indirect expenses incurred by the factory of an organization.**

   Production overheads generally represent the cost of shared services by various activities and processes in manufacture of final product. Production overheads comprise items of expenses Salaries of production staff, planning, technical supervision, factory administration, store management expenses, factory rental, factory repair and maintenance expenses etc. The principles of measurement as indicated above under Material Cost, Employee Costs and Utilities and under Repairs and Maintenance given hereinafter will apply to these elements included in production overheads.

2. The cost of product manufacturing services procured from outside should be determined at the value of 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.

3. If the subsidy or grant including any incentive or any amount of similar nature which is received or is receivable with respect to production overheads should be reduced for ascertainment of cost of the cost object to which such amounts are related.

4. The production overheads will not include any abnormal cost. Abnormal cost is an unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation

5. Fines, penalties, damages and similar levies which are paid to statutory authorities or other third parties should not form part of the production overheads.

6. Credits and recoveries relating to the production overheads including those rendered without any consideration which is of material value and are quantifiable should be deducted to arrive at the net production overheads.

7. Any change in the cost accounting principles applied for the measurement of the production overheads should be made only if it is required by law or for any compliance with the requirements of any standard or a change would result in a more appropriate preparation or presentation of cost statements/ cost records of an organization.

Assignment of cost

1. Assignment of production overheads to the cost objects should 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.

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.

2. There is a distinct preference for assigning production overheads on the basis of "cause and effect" analysis. What or who causes the costs to be incurred is a more rational criterion to charge costs rather than size or benefits received.

3. Directly allocable expenses identified with a Production Cost Centre are usually accumulated under respective production cost centres. The total of such expenses including apportioned share of Production/Factory Overheads are assigned to the products on the basis of resources used by the product at the production centre.

Examples of basis of primary distribution of some items of production overheads. These are only indicative and the basis may vary from industry to industry depending on the actual situation and keeping in mind the suitability of adopting one basis in preference to some other available basis:

Item of Cost	**Basis of Apportionment**
Power	H.P. rating of Machines x Hours x Load Factor
Fuel	Consumption Rate x Hour
Jigs, Tools &Fixtures	Machine hours or Man hours
Crane Hire Charges	Crane hours or weight of materials handled
Supervisors' Salary &Fringe Benefits	Number of Employees
Staff Welfare Cost	Number of Employees
Rent &Rates	Floor or Space Area
Insurance	Value of Fixed Assets
Depreciation	Value of Fixed Assets

4. 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.

5. 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. The basis of apportionment of Production/Factory Overheads and other common overheads to

production centres would vary from industry to industry. There cannot be any fixed recommended base of apportionment. The basis should be adopted keeping in mind that such apportionment should be equitable and justifiable.

6. 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 cost of services rendered by a service cost centre is not directly traceable to a cost object, it should be assigned on the most appropriate basis.
7. 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.
8. Charging overheads on the basis of "benefits received" by the various users is preferred. This requires some measure of benefit to be developed.
9. 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.
10. 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.
11. 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.

Note: For more details readers may refer Cost Accounting Standard (CAS)-3 on Overheads issued by the Institute of Cost Accountants of India.

3.12 ADMINISTRATIVE OVERHEADS

Administrative Overheads: Cost of all activities relating to general management and administration of an organisation.

Administrative overheads should not include production overheads, marketing overheads and finance cost. Though production overheads includes administration cost relating to production, factory, works or manufacturing. These expenses are sum of all expenses incurred in connection with the formulation and implementation of policy, direction, controlling the operations, which are not related to the production, marketing, or R&D activity.

These are indirect Costs that are incurred in support of programs, outputs or other operating activities. These include cost of functions such as senior management, information systems, finance and accounting, which usually cannot be assigned on a cause and effect basis. Other support costs that may be assigned on that basis such as purchasing (procurement), personnel (human resources), insurance and property logistics, are sometimes also included in this term.

For example,

- Salaries of administrative and accounts staff
- Directors' Fees
- General office expenses like rent, lighting, rates and taxes, telephone, printing and stationery, postage etc.

- Bank Charges
- Audit Fees
- Legal Expenses
- Depreciation
- Repair and Maintenance of office building etc.

Principles of Measurement

1. **Administrative overheads should be the aggregate of cost of resources consumed in activities relating to general management and administration of an organization.**

   Administration overheads generally represent 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 as indicated above under Material Cost, Employee Costs and Utilities and under Repairs and Maintenance given hereinafter will apply to these elements included in administrative overheads.

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

3. The cost of software which is developed in-house, purchased, licensed or which is customized and it includes up-gradation cost shall have to be amortized over its estimated useful life.

   When hardware requires up-gradation along with software up-gradation, then compatible estimated lives be used for the two sets of cost.

4. The cost of administrative services procured from outside should be determined at the value of 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. If the subsidy or grant including any incentive or any amount of similar nature which is received or is receivable with respect to any administrative overheads should be reduced for ascertainment of cost of the cost object to which such amounts are related.

6. The administrative overhead will not include any abnormal administrative cost.

   Example: Expense incurred in a situation of natural calamity is an abnormal expense and should not be included in administrative overheads.

7. Fines, penalties, damages and similar levies which are paid to statutory authorities or other third parties should not form part of the administrative overheads.

8. Credits and recoveries relating to the administrative overheads including those rendered without any consideration which is of material value and are quantifiable should be deducted to arrive at the net administrative overheads.

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 any compliance with the requirements of any standard or a change would result in a more appropriate preparation or presentation of cost statements/ cost records of an organization.

Assignment of Cost

1. The assignment of cost is guided by the traceability to a cost object in an economically feasible manner which forms as the guiding principle.
2. The assignment of administrative overhead is based upon the cost objects and based on either of the two principles:
   - **Principle of Cause and Effect-** Cause is the process or operation or activity and effect is the incurrence of cost.
   - **Benefits received –** overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.
3. The costs of shared services should be assigned to user activities on the basis of actual usage.
4. Where the resources by way of infrastructure are shared the cost should be assigned on a readiness to serve basis.
5. General management costs should be assigned on rational basis.

Note: For more details readers may refer Cost Accounting Standard (CAS)-11 on Administrative overheads issued by the Institute of Cost Accountants of India.

3.13 SELLING & DISTRIBUTION OVERHEADS

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.

Selling Costs include all costs relating to regular sales and sales promotion activities.

Examples of expenses which are included in selling cost 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. Market research cost
h. Royalty on sale
i. After sales service costs
j. Warranty costs etc.,

Distribution Costs are the costs incurred in handling a product from the time it is completed in the works until it reaches the ultimate consumer.

Distribution costs are the costs incurred for distribution of product to customers.

Examples of Distribution Costs:

a) Transportation cost
b) Secondary packing cost

c) Packing repacking / labeling at an intermediate storage location

d) Cost of warehousing salable products (cost of warehousing covers depots, godowns, storage yards, stock yards etc.)

e) Cost of delivering the products to customers.

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 equipment 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.

Principles of Measurement

1. The selling overheads and distribution overheads are collected under different cost pools such as:

Selling Overheads

(i) Sales Employees Cost

(ii) Rent

(iii) Travelling Expenses

(iv) Warranty Claim

(v) Brokerage & Commission

(vi) Advertisement relating to Sales and Sales Promotion

(vii) Sales Incentive

Distribution Overheads

(i) Secondary Packing

(ii) Freight &Forwarding

(iii) Warehousing &Storage

(iv) Insurance on goods in transit etc.

2. Selling Overheads or selling costs are a combination of direct costs relating to selling of products or service and indirect costs of sales management.
3. 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. Distribution costs include, cost of secondary packing, transportation costs, cost of warehousing, insurance on goods in transit etc. Cost of free samples is to be borne by the cost of products sold.
4. 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.
5. 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.

6. Standardized cost records should be kept for the expenses relating to transportation and computation of transportation cost.

7. 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.

Assignment of Cost

1. Some items of selling overheads and distribution overheads are directly identified and absorbed to products or services and remaining part of selling and distribution overhead along with the with share of administration overheads relating to selling and distribution activities are to be apportioned to various products or jobs or services on the basis of net actual sales value (i.e. Gross sales value less excise duty, sales tax and other government levies).

2. Selling costs are to be recorded or assigned to marketing segments first before being assigned to product. Thus selling costs must first be identified to markets, distribution channels, territories, salesman etc., before being assigned to orders and to products. However, the hierarchy of such analysis and identification would depend on the nature of business and specific circumstances.

3. Selling costs of a marketing segment are assigned to customer orders relating to the segment and then to products based on sales quantity or value. It facilitates customer profitability analysis when the order becomes the focal point of reference in cost accounting.

4. Distribution overheads or Costs are to be recorded or assigned as distribution cost incurred in handling a product from the time it is completed in the works until it reaches the ultimate consumer. These are the costs incurred for distribution of product to customers. These may be identified as Transportation cost, secondary packing cost, repacking / labeling at an intermediate storage location, cost of warehousing, cost of delivering the products to customers etc.

5. Cost of Transportation is aggregate 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.

6. Cost of transportation should be classified as inward transportation cost and outward transportation Cost. Inward transportation costs will form the part of the cost of procurement of materials which are to be identified for proper allocation/ apportionment to the materials / products. Outward transportation cost will form the part of the cost of sale and is to be allocated / apportioned to the materials and goods on a suitable basis.

7. 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

8. The transportation costs assigned to products are charged to units based on some measure which factors in the distance e.g. tonne km.

9. Transportation costs should be broadly 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. Penalty, detention charges, demurrage charges and other abnormal costs are excluded from transportation cost.

Note: For more details readers may refer Cost Accounting Standard (CAS)-3 on Overheads issued by the Institute of Cost Accountants of India.

3.14 COST OF FINANCE

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. The terms Finance costs and Borrowing costs are used interchangeably.

Principles of Measurement

1. 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.
2. Bank charges for negotiation of documents in connection with a purchase material or resources are generally treated as finance costs and should not be included in material cost or other resources.

   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 or other resources but are best excluded from material cost or other resources.
3. Interest when charged by the supplier for the whole of part of the credit period extended is treated as a finance charge. This is so even if the interest appears on the face of the invoice.
4. 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 costs.
5. Material is often held for long periods for seasoning, maturing etc. The storage and interest cost for such storage should be treated as part of material cost.

Assignment of Cost

1. Interest and Finance charges are accumulated under suitable heads as below in the financial books before they are taken to cost accounts:
    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

2. Working capital investment by product line should be arrived at directly or apportioned on the following:
   - **Raw Material Stocks –** Direct or on the basis of raw materials consumed
   - **Stores –** 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.
3. 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.
4. Where the assignment is done initially to product lines like interest on long term loans, such charges are assigned to individual products on the basis of cost of sales or sales.
5. For the purpose of assignment, Interest charges are grouped under
   i. interest on long term funds
   ii. interest on working capital funds
6. 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.
7. Consideration of imputed/notional Interest on owners' funds or any other notional interest is not an accepted practice in cost accounting and should not be considered as a part of cost.

3.15 COST BUILD-UP FOR A PRODUCTION/ MANUFACTURING INDUSTRY A PRACTICAL APPROACH

A cost accountant should study the client's organizational set-up and the processes involved in manufacturing the final product. The entire process should be classified under different production cost centres, Utilities (Water, Steam, Power etc.), Factory (Production) Overheads, Administration Overheads, and Selling & Distribution Overheads. The expenses booked under different expenses heads under an audited Profit & Loss Account can be taken as the base for allocation of expenses. It is assumed that the activity/cost centre for which an expense is incurred is captured at the time of incurrence.

In a computerized or ERP environment, a company would be capturing data under different cost/ activity centres. In such a situation, cost build-up is usually done on the basis of predetermined rates. However, use of predetermined standard rates for assignment and allocation of costs would give rise to variances and these would have to be adjusted to the respective cost elements periodically to arrive at the actual cost of products/activities. However, even in such an environment, all transactions affecting the financial profit & loss account of the company may not be captured in a manner that would also be reflected in the cost module in the periodic cost runs. In such a situation, it would be necessary to build a cost structure considering all items of expenses and incomes in the lines as explained below.

Expenses directly identifiable to a cost centre should be allocated to that centre/utility. Expenses of common nature, not directly identifiable to any of the production cost centre or utility centre should be accumulated under the different Overheads depending on its nature of incidence. An illustrative list of expense items is given below.

Employee Benefits

- Salaries, Wages, Bonus etc.
- Contribution to Provident & Other Funds
- Staff Welfare Expenses

Power & Fuel

- Fuel
- Water Charges

Consumable Stores and Spares

Repairs and Maintenance

- Plant & Machinery
- Buildings
- Others

Rent

Insurance

Rates & Taxes

Payment to Auditors

Travelling & Conveyance

Communication Expenses

Printing & Stationery

Bank Charges

Security Force Expenses

Sales Promotion Expenses

Handling Expenses

Miscellaneous Expenses

Transportation Charges

Quality Control

Royalty or Technical Know-how

Technical Assistant Fees

Lease Rent

Research and Development

Packing Expenses

Borrowing Charges

Loss on Assets Sold, Lost or Written Off

Exchange Rate Fluctuations

Provision for Doubtful Debts, Advances, Claims & Obsolescence

Depreciation

Total Expenses

Classification of Overheads:

As explained above, expenses which cannot be directly allocated to a cost centre, like, insurance, rent, rates & taxes, telephone, fax, printing & stationery, postage etc., should be classified under the three overheads according to its nature and source.

Secondary Allocation:

1. The costs accumulated as above for service utilities, like water, steam power etc., and should be allocated to different cost centers on the basis of units consumed by the user centre by crediting the respective utility centre.

2. The Factory/Production Overheads including apportioned share of service utilities should then be apportioned to the production cost centers on a suitable basis.

3. The total expenses of individual cost centers including the allocated service utility expenses and apportioned share of Factory/Production Overheads should be classified under Direct Charges (Variable) and Conversion Charges (Fixed) of that production cost centre.

4. The Direct Charges would include such expenses, which are allocated to a centre but are variable in nature. Examples are Piece Rate Wages, Production Incentives, Allocated share of Water, Steam, Power etc.

5. The total of expenses less the Direct Charges would constitute Conversion Charges.

6. The Direct and Conversion Charges arrived at as above will then be absorbed in the products based on the basis of absorption costing method. In this connection it should be kept in mind that conversion cost for manufactured goods should include only those costs that are associated with the units produced and is corollary to the principle that expenditure should be included to the extent to which it has been incurred in bringing the product to its present location and condition.

7. The allocation of fixed production overheads (conversion charges) for their inclusion in the costs of conversion is to be based on the normal capacity of the production facilities. In other words, the idle capacity cost should not be a part of the cost of production. The idle capacity is the difference between the practical capacity and the actual capacity utilized.

8. Normal capacity has been defined as the production expected to be achieved on an average over a number of period or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.

9. To arrive at normal capacity the following factors may be considered:

   a) the level of activity over the period of the normal business cycle and seasonal variations;

   b) the budgeted level of activity for the year under review and for the ensuing years; and,

   c) the level of activity achieved both in the year under review and in the previous, say three years.

   In practice, a normal level of activity is established by reference to the budgeted or expected level of activity over several years in relation to the installed capacity. It is suggested that, wherever applicable, the normal capacity of individual cost centre be determined in relation to the installed capacity of the primary machine of the cost centre.

The proportion of overheads allocated to a unit of production is not increased as a consequence of low production or idle plant, and overheads which are not allocated are recognized as an expense in the period in which they are incurred.

The normal capacity thus determined should be expressed in terms of, say, hours or unit of measure normally adopted by the industry. As explained earlier, the normal capacity of individual cost centers should be determined in line with above principles and the rate of absorption of conversion charges to product should be determined. The conversion charges of a cost centre is then to be apportioned to the product(s) passing through that cost centre for the number of hours or unit of measure, as applicable, multiplied by the rate. The unabsorbed portion of conversion charges, if any, is to be treated as a charge against profits and not as a part of the cost of production.

The Direct Charges being variable with the level of activity/production, should be absorbed in full based on the actual hours or actual unit of measure, as the case may be. Consequently, there would be no question of unabsorbed direct charges.

Realizable Value of Scrap and/or Bye-products:

The production process may generate scrap/wastes. This may fetch some value after being sold as scrap or waste. The actual value realized on such sale should be credited to the cost of production. Depending on the industry and the stage at which such scrap is generated, the credit may also be given to the cost of raw materials at the time of determining the landed cost of materials.

In case a by-product is obtained in the course of manufacture, the realizable value of the same should be credited to the cost of production.

Job Processing Charges:

The actual job work charges, if any, including freight, insurance and handling should form a part of the cost of production. The job work charges should be classified as a part of Direct Charges and is to be allocated to the product for which the job work has been incurred.

Administration Overheads:

Administration Overheads are to be apportioned to the products on a suitable basis. In smaller organizations or single unit companies, where there may not be a clear distinction of management functions, the cost of management may be allocated on suitable bases to the functions of production and selling. However, in large organizations, where the activities are categorized under different strategic business units or divisions, there necessarily is a corporate entity vested with the function of corporate management decisions. Such overheads should be classified under corporate expenses forming part of the total Administration Overheads.

Selling & Distribution Overheads:

The selling & distribution function is clearly overheads incurred, which are related to the selling activity of the organization.

A flow of cost build-up starting with the financial accounts is given below.

Expense Control Statement

	Particulars	Total ₹ '000	PCC1 ₹ '000	PCC2 ₹ '000	PCC3 ₹ '000	PCC4 ₹ '000	Power ₹ '000	Steam Rs.'000	FOH ₹ '000	AOH ₹ '000	S&D ₹ '000
1	Salaries & Wages	95,500	10,000	12,000	11,000	13,000	2,500	2,000	15,000	20,000	10,000
2	Incentive Wages	6,600	1,000	1,200	1,100	1,300	200	300	1,500		
3	Stores & Spares	11,800	2,000	2,500	3,000	1,500	500	300	2,000		
4	Repairs & Maintenance	8,400	1,000	1,500	2,000	1,100	150	150	2,500		
5	Insurance	2,450	100	150	200	250	50	50	500	550	600
6	Depreciation	8,060	1,100	1,150	1,200	1,250	30	30	1,000	1,100	1,200
7	Total (1 to 6)	1,32,810	15,200	18,500	18,500	18,400	3,430	2,830	22,500	21,650	11,800
	Allocation of Utilities:										
8	Steam(on units)	-	-	940	-	-	1,890	(2,830)	-		
9	Total (7 + 8)	1,32,810	15,200	19,440	18,500	18,400	5,320	-	22,500	21,650	11,800
10	Power(on units)	-	500	600	1,000	1,100	(5,320)	-	1,520	400	200
11	Total (9 + 10)	1,32,810	15,700	20,040	19,500	19,500	-	-	24,020	22,050	12,000
	Apportionment of Overheads										
12	Factory Overheads	-	5,220	6,270	5,740	6,790			(24,020)		
	(on Salaries & Wages)										
13	Total (11 + 12)	1,32,810	20,920	26,310	25,240	26,290	-	-	-	22,050	12,000
14	Administration Overheads										
	(on conversion cost up to FOH)	-	4,200	5,090	5,000	5,160				(22,050)	2,600
15	**Total (13 + 14)**	**1,32,810**	**25,120**	**31,400**	**30,240**	**31,450**	**-**	**-**	**-**	**-**	**14,600**
16	Variable Overheads	8,740	1,500	2,740	2,100	2,400					
17	Fixed Overheads	1,24,070	23,620	28,660	28,140	29,050					14,600
18	**Total (16 + 17)**	**1,32,810**	**25,120**	**31,400**	**30,240**	**31,450**	**-**	**-**	**-**	**-**	**14,600**

Calculation of Overhead Absorption Rates

	Particulars	Total	PCC1	PCC2	PCC3	PCC4	Power	Steam	FOH	AOH	S&D
19	No. of Machines		4	3	2	1					
20	No. of Working Days		330	330	330	330					
21	No. of Shifts		3	3	3	3					
22	No. of Hours in a shift		8	8	8	8					
23	Gross Available Hours		31,680	23,760	15,840	7920					
24	Less: Normal Down Time (%)		15%	20%	20%	15%					
25	Less, Normal Down Time (Hours) (23*24)		4,752	4,752	3,168	1,188					
26	Net Available Hours (23 - 25)		26,928	19,008	12,672	6,732					
27	Hours Worked/Utilised		25,000	18,500	12,672	6,400					
28	Capacity Utilisation (%) (27/26)		92.84%	97.33%	100.00%	95.07%					
	Machine Hour Rate (₹/Hour)										
29	Variable Overheads (16/27)		60.00	148.11	165.72	375.00					
30	Fixed Overheads (17/26)		877.15	1,507.79	2,220.64	4,315.21					

a) *The Variable and Fixed Overheads are to be absorbed to the product cost on the basis of the above rates multiplied by the number of hours utilised by a particular product at a particular cost centre*

b) *The Selling &Distribution will be absorbed in the product on the basis of sales realisation net of Excise Duty*

c) *PCC means "Production Cost Centre".*

	ALLOCATION BASIS	Total	PCC1	PCC2	PCC3	PCC4	Power	Steam	FOH	AOH	S&D
	Steam Units	750		250			500				
	Power Units	265	25	30	50	55			75	20	10
	Basis of AOH Apportionment										
	Total as per 13 above	1,10,760	20,920	26,310	25,240	26,290					12,000
	Less, Direct Charges										
	(Variable Overhead Allocations)										
	Steam	(940)	-	(940)	-	-					
	Power	(3200)	(500)	(600)	(1000)	(1100)					
	Incentive Wages	(4600)	(1000)	(1200)	(1100)	(1300)					
	Conversion Cost for AOH	1,02,020	19,420	23,570	23,140	23,890					12,000

Statement showing cost of Utilities like Water / Power / Steam etc.

I Quantitative Information

S.no.	Particulars	Unit	Current year	Previous year
1	Installed Capacity			
2	Quantity Produced			
3	Capacity Utilization (%)			
4	Quantity Purchased, if any			
5	Self-consumption including losses (to be specified)			
6	Net Units Available			

II Cost Information:

S.no.	Particulars	Quantity	Rate per unit	Amount	Cost per Unit	
					Current Year	Previous Year
		Unit	₹	₹	₹	₹
1	Materials Consumed (specify) (i) Indigenous (ii) Imported Se Self Manufactured/Produced					
2.	Process Materials/ Chemicals (specify)					
3.	Utilities (specify):					
4.	Direct Employees Cost					
5.	Direct Expenses (specify)					
6.	Consumable Stores and Spares					
7.	Repairs and Maintenance					
8.	Depreciation					
9.	Lease rent, if any					
10.	Other overheads					
11.	Sub-total (1 to11)					
12.	Less: Credit, if any					
13.	**Total cost (12-13)**					
	Apportionment: (cost centre-wise) 1. PCC 1 2. PCC 2 3. PCC 3					
	Total					

Statement showing Cost of PCC1

S.no.	Particulars	Quantity	Rate	Amount	Cost per Unit (Rs.)	
			₹	₹	Current Year	Previous Year
1.	**Raw Material** (a) Indigenous (b) Imported					
2.	Process Material/Chemicals (specify)					
3.	Utilities (specify details)					
4.	Direct Employee Cost					
5.	Direct Expenses (Specify)					
6.	Consumable Stores & Spares					
7.	Repairs and Maintenance					
8.	Quality Control Expenses					
9.	Research and Development					
10.	Technical Know-how/Royalty					
11.	Depreciation/Amortization					
12.	Other Production Overheads					
13.	Add/(Less) Stock Adjustments					
14.	Total					
15.	Less Credit for Wastage or By-products (Specify)					
16.	**Total Cost**					

S.no.	Products	Basis of apportionment of Cost	Actual Quantity	Amount (Rs.)
	Total Cost Apportioned to:			
	i) Sales			
	iii) Transferred to PCC-2			
	Total			

Statement showing Cost of Production and Sales

S.no.	Particulars	Quantity	Rate	Amount	Cost per Unit (Rs.)	
			₹	₹	Current Year	Previous Year
1	Materials Consumed (specify details)					
	a) Indigenous Purchased					
	b) Imported					
	c) Transferred from PCC1					
2	Process Materials/Chemicals (specify)					
3	Utilities (specify details)					
4	Direct Employees Cost					
5	Direct Expenses					
6	Consumable Stores & Spares					
7	Repairs & Maintenance					
8	Quality Control Expenses					
9	Research & Development Expenses					
10	Technical know-how Fee / Royalty, if any					
11	Depreciation/Amortization					
12	Other Production Overheads					
13	Total (1 to 12)					
14	Add/Less: Work-in-Progress Adjustments					
15	Less: Credits for Recoveries, if any					
16	Primary Packing Cost					
17	Cost of Production/Operations (12 + 13 to 17)					
18	Increase/Decrease in Stock of Finished Goods					
19	Less: Self/Captive Consumption (incl. Samples, etc.)					
20	Other Adjustments (if any)					
21	Cost of Production/Operation of Goods/ Services Sold (17 + 18 to 20)					
22	Administrative Overheads					
23	Secondary Packing Cost					
24	Selling & Distribution Overheads					
25	Interest & Financing Charges					
26	Cost of Sales (21 + 22 to 25)					
27	Net Sales Realization (Net of Taxes and Duties)					
28	Margin [Profit/(Loss) as per Cost Accounts] (27 - 26)					

3.16 RECONCILIATION STATEMENT

The Companies (Cost Accounting Records) Rules, 2011 issued by the Central Government vide GSR429(E) dated 3rd June, 2011 and Industry Specific Cost Accounting Records Rules issued by the Central Government for 6-regulated industries on 7th December, 2011 vide G.S.R. No. 869(E) - Cost Accounting Records (Telecommunication Industry) Rules 2011; G.S.R. No. 870(E) - Cost Accounting Records (Petroleum Industry) Rules 2011; G.S.R. No. 871(E) - Cost Accounting Records (Electricity Industry) Rules 2011; G.S.R. No. 872(E) - Cost Accounting Records (Sugar Industry) Rules 2011; G.S.R. No. 873(E) - Cost Accounting Records (Fertilizer Industry) Rules 2011and G.S.R. No. 874(E) - Cost Accounting Records (Pharmaceutical Industry) Rules 2011, require Reconciliation Statement vide clause 3 to Annexure to the Compliance Report as per the following format:

3. Reconciliation Statement:

Net Margin (Profit/Loss) as per Cost Accounts	**(In Rupees)**
A. From Product/ Manufactured Product Groups	
B. From Services Groups	
C. From Trading Activities	
Total as per Cost Accounts	
Add: Incomes not considered in Cost Accounts (if any)	
Less: Expenses not considered in Cost Accounts (if any)	
Add/Less: Difference in Stock Valuation	
Profit/ (Loss) as per Financial Accounts	

Comments:

Profit or Loss as per Cost Accounting Records:

a) Profit/ (Loss) as per cost accounting records for all product groups/ service groups would be available from the Margin as reflected in the Abridged Cost Statement in respect of all products manufactured or/and services rendered by the Company.

b) Profit/ (Loss) on Trading Activities should be separately calculated.

c) The sum total of above Margins would be the profit/(loss) of all the products/activities of the company as per cost records.

Incomes not considered in cost accounts:

a) Product-wise Cost Accounting Records would consider only the sales/income derived from the sale of such products. Any other Income of the company would not be considered to arrive at the Margins as per cost accounting records.

b) Other than income from sales of such products, there may be many other Incomes that would contribute towards the Profit/(Loss) of the company as per Profit & Loss Account.

c) Incomes which are 'Abnormal' or 'purely financial' in nature are such incomes which would not be considered in cost accounts.

d) Abnormal Income-means unexpected heavy income in the nature of windfalls, abnormal gains.

e) **Income of Purely Financial in nature: may be of the following nature:**

   (i) Interest received on investment, deposits outside the business

   (ii) Dividends received on investment outside the business

   (iii) Profits on sale of capital assets and investment

(iv) Fees received on transfer of shares

(v) Gains on foreign exchange fluctuation

(vi) Prior period income

(vii) Trading Profit

Expenses not considered in cost accounts – Expenses which are ‘Abnormal’ or ‘purely financial’ in nature are not considered as items of cost in cost accounts.

Abnormal Expenses –

a) Cost of abnormal wastage/defective work/spoilages etc.,

b) Losses due to theft or pilferage

c) Cost of acts of nature like earthquake, fire etc.

d) Expenses incurred during abnormal situations like strikes, war, accidents.

e) Unabsorbed Overheads due to under-utilization of capacities.

Expenses Purely Financial in nature: may be of the following nature: for e.g.:

(i) Loss on sale of capital assets and investments

(ii) Stocks written off

(iii) Stores written off

(iv) Demurrage Charges

(v) Stamp duty and expenses on issue and transfer of shares

(vi) Discount on bonds and debentures

(vii) Fines and Penalties

(viii) Loss on investments

(ix) Loss on foreign exchange fluctuations

(x) Premium on forward contract

(xi) Liquidated damages

(xii) Excise Duty

(xiii) Bad Debts,

(xiv) Donations

(xv) Prior period expenses

(xvi) Expenses on Buy Back of shares

(xvii) Preliminary expenses written off

(xviii) Trading Loss

(xix) Reference may be also made to CAS & GACAP for specific items of this nature

The profit arrived at for the company shall not include interest and dividend received on investments outside the business, capital gains, and any other income which is neither normal nor of recurring nature. The profit so arrived shall be the profit earned during the current financial period of the company.

Difference in Stock Valuation

The amount shown under this head would be the difference in stock valuation as per financial statement and cost accounting records.

3.17 LIST OF TERMINOLOGIES

Definitions:

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.

Abnormal Idle Time - An unusual or atypical employee idle time occurrence of which is usually irregular and unexpected or due to some abnormal situations.

Activity Based Costing (ABC) - A cost accounting method that measures the cost and performance of process related activities and cost objects. It assigns cost to cost objects based on their use of activities, and recognizes the causal relationship of cost drivers to activities.

Administrative Costs - Indirect Costs that are incurred in support of programs, outputs or other operating activities. They include costs of functions such as senior management information systems, finance and accounting, which usually cannot be assigned on a cause and effect basis. Other support costs that may be assigned on that basis such as purchasing (procurement), personnel (human resources), insurance and property logistics are sometimes also included in this term.

Administrative Overheads - Expenses in the nature of indirect costs, incurred for general management of an organization.

Assigning Costs - A process that identifies specific costs with programs, outputs, activities or other cost objects. There are three appropriate methods of cost assignment, listed here in order of preference:

(a) directly tracing costs wherever economically feasible:

(b) cause and effect when determinable; and

(c) allocating costs on a reasonable and consistent basis.

Avoidable Cost are cost associated with an activity that would not be incurred if the activity were not performed.

Batch Cost - It is the aggregate cost related to a cost unit which consist identity throughout one or more stages of production.

Business Process Reengineering - The radical redesign of processes (and the human and technical environment) to achieve improved results of operation.

Classification of cost is the arrangement of items of costs in logical groups having regard to their nature (subjective classification) or purpose (objective classification).

Items should be classified by one characteristic for a specific purpose without ambiguity.

Scheme of classification should be such that every item of cost can be classified.

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

Classifying Costs - A process of identifying costs by type, behaviour, account, source, accounting period, etc. so that those costs may be properly assigned to cost objects.

Common Cost - The cost of resources employed jointly in the production of two or more outputs that cannot be directly traced to ay one of those outputs.

Contract Cost - It is the cost of a contract with some terms and conditions of adjustment agreed upon between the contractee and the contractor.

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 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.

Cost Driver - Any factor that causes a change in the cost of an activity or output resulting in the activity consuming fewer or greater amounts of resources.

Cost Object - An activity, output or item whose cost is to be measured. In a broad sense, a cost object can be an asset account, organization, a function, a task, a product, a service or a customer.

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.

Examples of Cost Units :

- *Power - MW*
- *Cement/ Steel – MT*
- *Automobile - Number etc.*

Defectives - End product and/or intermediate product unit that do not meet quality standards. This may include reworks or rejects.

Differential Cost - It is the change in cost due to change in activity from one level to another.

Direct Employee Cost - The cost of employees which can be attributed to a Cost Object in an economically feasible way.

Direct Expenses - These are the expenses other than direct material or direct labour which can be identified or linked with the cost centre or cost object.

Direct Labour Cost - It is the cost of wages of those workers who are readily identified or linked with a cost centre or cost object.

Direct Material Cost - It is the cost of material which can be directly allocated to a cost centre or a cost object in an economically feasible way.

Distribution Costs - These are the cost incurred in handling a product from the time it is completed in the works until it reaches the ultimate consumer.

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.

Estimated Cost - It is the cost which is prepared in advance prior to the performance of operations or even acceptance of sale orders.

Expenses are other than material cost or labour cost which are involved in an activity. Expenditure on account of utilities, payment for bought out services, job processing charges etc. can be termed as expenses.

Finance Costs - Costs incurred by an enterprise in connection with the borrowing of funds.

Fixed Cost - It is the cost which does not vary with the change of 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.

Historical Costs - These are the actual costs of acquiring assets or producing goods or services.

Imputed Costs - These are hypothetical or notional costs, not involving cash outlay, computed only for the purpose of decision making.

Indirect Expenses - These are the expenses other than of the nature of material or labour and cannot be directly allocable to a particular cost centres.

Indirect Labour Cost - It is the wages of the employees which are not directly allocable to a particular cost centre.

Indirect Material - It is the cost of material which cannot be directly allocable to a particular cost centre or cost object.

Joint Cost - These 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.

Labour Cost means the payment made to the employees, permanent or temporary, for their services.

Marginal Cost - It 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 of the volume of output is increased or decreased by the unit.

Material Cost is the cost of material of any nature used for the purpose of production of a product or a service.

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.

Operating Cost - It 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.

Operation Cost - It is the cost where a specific operation is involved in a production process or business activity.

Opportunity Cost - It is the value of the alternatives foregone by adopting a particular strategy or employing resources in specific manner.

Out-of-Pocket Cost - It refers to a cost which need not be paid for acquiring any goods, assets or services. It does not involve any outflow of cash. It does not involve any outflow of cash. In competitive markets, out-of-pocket-costs help to arrive at fruitful decisions for conservancy of cash resources.

Pre-determined Costs - It is 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.

Process Cost - When the production process is such that goods are produced from a sequence of continuous or repetitive operations 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.

Production Cost - This cost is a sequence of operations which begins with supplying materials, engaging labour, using services and ends with primary packing of the product. Therefore, production cost will include direct material cost, direct labour cost, direct expenses and factory overheads.

Production Overhead - It is involved in the production process or in rendering service.

Rejects - Defectives which cannot meet the quality standards even after putting in additional resources.

Relevant Cost - These are the costs relevant for a specific purpose or situation.

Replacement Cost - It is the cost of an asset in the current market for the purpose of replacement.

Research & Development Costs - It is 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.

Reworks - Defectives which can be brought up to the standards by putting in additional resources.

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.

Semi-variable Costs - These contain both fixed and variable elements. They are partly affected by fluctuation in the level of activity.

Selling Costs - These are indirect costs related to selling of products or services and include all indirect cost in sales management for the organization.

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.

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.

Standard Cost - A pre-determined 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.

Sunk Costs - These are historical costs which are incurred i.e. 'sunk' in the past and are not relevant to the particular decision making problems being considered.

Unavoidable Costs - These are inescapable costs which are essentially to the 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.

Variable Costs - It 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 are termed as variable overhead,

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.

Study Note - 4

GACAP & COST ACCOUNTING STANDARDS AND COMPLIANCE REPORT

This Study Note includes

4.1 INTRODUCTION

The compilation of Generally Accepted Cost Accounting Principles (GACAP) is unique. 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 but 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, Ministry of Finance, (Cost Accounts Branch). 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 industry-wise Cost Accounting Record Rules 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 cost statements prescribed. 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 up to the works), the treatment of major repairs (to be prorated over the period benefited by such repairs), the costing of transfers of raw materials from own farms (sugar cane at government controlled price) and the like. This is not to deny that the Rules framed from time to time did have 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 Cost Accounting Record Rules did play a major part in unifying cost accounting principles as applied to various industries.

Similarly the regulatory agencies in charge of individual industries, particularly the Fertilizer Industry Co-ordination Committee, the Drug Price Control Authority, the Central Electricity Regulatory Commission, Telecom Regulatory Authority of India- all played a role in evolving a more consistent set of cost accounting principles.

The Cost Audit Report Rules as amended from time to time 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 amendment of the Rules in 2001 prescribing a single proforma for cost reporting for all industries was a landmark event. It ushered in "General Purpose Cost Statement", which is unique in the global practice of cost accounting.

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, or 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. The Certificate at the end of the format 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 acknowledged the existence of an uncodified 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 Accounting Records) Rules, 2011 on June 3, 2011. 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 and Works Accountants of India (ICWAI) 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 Accounting Records) Rules, 2011 which require maintenance of cost records according to Cost Accounting Standards and GACAP 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.

4.2 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;
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;

4.3 SCOPE

The scope is to codify the cost accounting principles presently being followed by business entities and others in India in preparing and presenting cost information – more particularly the General Purpose Cost Statements covered by Cost Audit. It also covers the widely used practices which implement these principles.

It draws on the Cost Accounting Record Rules which inter alia also lay down some principles, the Guidance Notes issued by the ICWAI, the Cost Accounting Standards 1-5 issued by ICWAI during 2001-2005 which have been applied in practice for some years now, Cost Accounting Standards 6-12 which have been on the Standards book for a period ranging upto three years and which have been mandated for application for more than a year now and the observed practices of Indian Corporate in preparing Cost Statements for audit purposes and by business entities and others.

4.4 NATURE OF CONTENT AND FORMAT

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.

1. It explicitly incorporates the principles already contained in the Cost Accounting Standards 1-13 issued by the Cost Accounting Standards Board (CASB) in India without necessarily repeating them.
2. In areas not covered by the standards, it reflects the cost accounting principles found in the Cost Accounting Record Rules prescribed for the 44 industries in the past.
3. Where somewhat conflicting principles have been laid down by the CARR in different industries, it will attempt 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 will be mentioned with an indication of the preferred practice.
4. 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.
5. It also reflects the Cost Accounting Principles contained in the Guidance Notes and other publications issued by ICWAI from time to time.
6. 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.
7. The document stipulates the main principles in **bold letters** followed by explanation in normal type.

4.5 CONCEPTUAL FRAMEWORK

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 fulfill 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 and 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" is used in this document.

- **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.

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: ***is the difference between practical capacity and normal capacity or actual capacity utilization whichever is higher.***

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

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.

Actual Capacity Utilization: ***is the volume of production achieved in relation to installed capacity.***

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 includes administration cost relating to production, factory, works or manufacturing.

Allocation of overheads: ***Allocation of overheads is assigning a whole item of cost directly to a cost centre.***

An item of expense which can be directly related to a cost centre is to be allocated to the cost centre. For example, depreciation of a particular machine should be allocated to a particular cost centre if the machine is directly attached to the cost centre.

Apportionment of overhead: ***Apportionment of overhead is distribution of overheads to more than one cost centre on some equitable basis.***

When the indirect costs are common to different cost centres, these are to be apportioned to the cost centres on an equitable basis. For example, the expenditure on general repair and maintenance pertaining to a department can be allocated to that department but has to be apportioned to various machines (Cost Centres) in the department. If the department is involved in the production of a single product, the whole repair & maintenance of the department may be allocated to the product.

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).***

Cartage: ***is 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 indirect items of expenses from books of account and supportive/ corroborative records in logical groups having regards to their nature and purpose.***

Overheads are collected on the basis of pre-planned groupings, called cost pools. Homogeneity of the cost components in respect of their behaviour and character is to be considered in developing the cost pool. Variable and fixed overheads should be collected in separate cost pools under a cost centre. A great degree of homogeneity in the cost pools are to be maintained to make the apportionment of overheads more rational and scientific. A cost pool for maintenance expenses will help in apportioning them to different cost centres which use the maintenance service.

Committed Cost: ***The cost of maintaining stand-by utilities shall be the committed 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 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.*

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: *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.*

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.

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.

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.*

Defectives: *Packing materials that do not meet quality standards. This may include reworks or rejects.*

Depot: *are 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: *The cost of employees 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 Cost, are the costs incurred in handling a product from the time it is ready for despatch until it reaches the ultimate consumer.*

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: ***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.***

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.

Equalized Freight ***means average freight.***

Equalized Transportation Cost ***means average transportation cost incurred during a specified period.*** **Excess Capacity Utilization** ***is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is more than installed capacity.***

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. The terms Finance costs and Borrowing costs are used interchangeably.

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.***

Freight: ***is the charge paid or payable to an outside agency for transporting materials/ goods from one place to another place.***

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 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.

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.***

Indirect Materials: ***Materials, the costs of which cannot be directly attributed to a particular cost object.***

Installed Capacity: ***is the maximum productive capacity according to the manufacturers' specification of machines / equipments. Installed capacity of the unit / plant is determined after taking into account imbalances in different machines / equipment in the various departments / production cost centres in the unit / plant and number of working shifts.***

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: ***is the production capacity of the plant for which license has been issued by an appropriate authority.***

Marketing overheads: ***Marketing Overheads are also known as Selling and Distribution Overheads.***

Material Cost: ***The cost of material of any nature used for the purpose of production of a product or 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: ***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 of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object.***

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.***

Packing Materials: Materials used to hold, identify, describe, store, protect, display, transport, promote and make the product marketable and communicate with the consumer.

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: ***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 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.

Production Overheads: ***Indirect costs involved in the production process 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: ***is 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.***

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 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.***

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, also known as Selling Costs, are the expenses related to sale of products and include all Indirect Expenses in sales management for the organization.***

Semi Variable Costs: ***contain both fixed and variable elements. They are partly affected by fluctuation in the level of activity.***

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.

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.***

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.

Stand-by service: ***Any facility created to safeguard against the failure of the main source of service.***

Stand-by utilities: ***Any utility created to safeguard against the failure of the main source of inputs.***

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: ***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.***

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.***

4.6 PRINCIPLES APPLICABLE TO ELEMENTS OF COST

The following sections 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.**

Reference to Elements of Cost

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** (CAS 6-5.1.1).

   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 in the form of Expenses 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 the overheads of 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 material 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 included in 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** (CAS 6-5.1.5).

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** (CAS 6-5.1.6).

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 Cost Accounting Record Rules 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.

   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.

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** (CAS 6-5.1.7).

10. **Self Manufactured Materials (and Self manufactured components and sub assemblies) are valued at cost including Direct Material cost, Direct Employee cost, Factory overheads and share of administrative overheads relating to production. Share of other administrative overheads, finance cost and marketing overheads are excluded** (CAS 6-5.1.3 and 6.5.3).

11. **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 goods production. Material cost of abnormal scarp/defectives should not be included in the material cost, but treated as loss after giving credit to the realizable value of such scrap/defectives** (CAS 6-5.4)

12. **Issues of materials are valued using appropriate assumptions on cost flow** (CAS 6-5.2.1).

    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.** (CAS 6-2.1, 6-2.2 and 6-3.1).

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** (CAS 6-2.1).

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** (CAS 6-2.2).

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** (CAS 6-3.2).

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.

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** (CAS 7-5.1).

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** (CAS 7-5.2).

3. In some industries the following alternate treatments are also followed pursuant to the requirements of the Cost Accounting Records Rules prescribed for those industries;

    a. Treat the statutory minimum bonus as cost and the balance is treated as a non-cost item.

    b. Treat the entire bonus as a component of cost of sales.

4. **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** (CAS 7-5.3).

    Remuneration of Non Executive Directors will not be considered as part of Employee cost but treated as part of administrative overheads.

5. Performance Incentives must be accumulated over the entire production and not recognised after the threshold limit for earning the incentive is reached.

6. **Separation costs related to voluntary retirement, retrenchment, termination etc. should be amortized over the period benefiting from such costs** (CAS 7-5.4).

7. Amount payable to employees during the lay off period or for the strike period or during suspension, is a loss and consequently is not included in cost.

8. Cost of employee share options is treated as part of employee cost.

    It is becoming common for employees to be compensated on the basis of share options. The

GAAP generally requires that the compensations should be measured at the fair value of the stock options at the grant date. Often it is difficult to determine such costs at individual employee level and hence the cost of employee share option is usually treated as overhead.

9. Gratuity, pension and other superannuation benefits, measured using actuarial valuation method or any other methods, are part of Employee Cost.

10. **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.** (CAS 7-6.4).

11. **Recruitment costs, Training costs and other such costs is treated as overheads and dealt with accordingly.** (CAS 7-6.5).

12. **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** (CAS 7-6.6 and 7-6.7).

13. **Where the employee service is directly traceable to a Cost object, such cost is assigned on the basis of time consumed.** (CAS 7-6.1).

14. **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** (CAS 7-6.2).

Direct Expenses

1. **The identification of Direct Expenses is based on traceability in an economically feasible manner** (CAS 10-5.1).

   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.** (CAS 10-5.3).

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.** (CAS 10-5.2.1).

4. **Other Direct Expenses other than those referred above are determined on the basis of amount incurred in connection therewith.** (CAS 10-5.2.2).

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.** (CAS 10-5.1).

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** (CAS 10-6.1).

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** (CAS 8-5.2).

   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 such as and a share of the factory overheads** (CAS 8-5.3.1).

   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** (CAS 8-5.3.2).

4. **A Cost of utilities generated for Intercompany transfer is arrived as Cost of self generated utilities plus Distribution cost plus Share of administrative overheads.** (CAS 8-5.3.3).

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.** (CAS 8-5.3.4).

6. **The Cost of Utilities includes Cost of distribution of such utilities** (CAS 8-5.3.4).

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** (CAS 8-5.9).

8. **Cost of stand by utility includes the committed costs of maintaining such utility** (CAS 8-5.9).

9. **While assigning cost of utilities, traceability to a cost object in an economically feasible manner is the guiding principle** (CAS 8-6.1).

   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** (CAS 8-6.3).

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** (CAS 12-5.1).

2. **Cost of in-house repair and maintenance activity will include cost of materials, consumable stores, spares, manpower, equipment usage, utilities and other resources used in the activity** (CAS 12-5.2).

3. **Cost of repair 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** (CAS 12-5.3).

4. **Cost of repair 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** (CAS 12-5.4).

5. **Each type of repairs and maintenance is treated as a distinct activity, if material and identifiable** (CAS 12-5.6.1).

6. **The cost is measured for each major asset category separately** (CAS 12-5.6.2).

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** (CAS 12-5.7).

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** (CAS 12-5.8).

9. **Cost of major overhaul is amortized on a rational basis** (CAS 12-5.9).

   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 costs is traced to a cost object to the extent economically feasible** (CAS 12-6.1).

11. **Where it is not directly traceable, it is assigned based on either of the principles of Cause and Effect or Benefits received** (CAS 12-6.2).

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. (CAS-13-4.9)

3. The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably. (CAS-13-4.2)

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.** (CAS-3(R-1) 6.1)

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. (CAS-3(R-1) 6.2)

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).** (CAS-3(R-1) 6.3.2)

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 charge costs rather than size or benefits received.

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. (CAS-3(R-1) 6.4)

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. (CAS-3(R-1) 6.5)

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. (CAS 13-6.2)

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. (CAS 13-6.3)

18. Charging overheads on the basis of "benefits received" by the various users is preferred. This requires some measure 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.

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 (CAS 2-4.4).

22. Under absorbed fixed overheads are carried to Costing Profit & Loss Account or 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 VII of the Companies Act 1956.

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. **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 tax purposes, companies are required to use regular rates of depreciation for accounting purposes. Even where an entity uses 100% depreciation rates in 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 costing purposes, with the amount being shown in reconciliation with financial accounts.

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 as reflecting the true cost of depreciation.**

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 organization.** (CAS 11-5.1).

   The principles of measurement of Material cost, Employee costs, Utilities, Repairs and 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 costs** (CAS 11-5.2).

3. **The cost of software (developed in house, purchased, licensed or customized), including up-gradation should be amortized over its useful life.** (CAS 11-5.3).

   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.** (CAS 11-5.4). **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** (CAS 11-6.2).

   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 are best recorded or assigned to marketing segments first before being assigned to product. Thus selling costs must first be identified to markets, distribution channels, territories, salesman etc., before being assigned to orders and to products.

2. Selling costs of a marketing segment are assigned to customer orders relating to the segment and then to products based on sales quantity or value.

   It facilitates customer profitability analysis when the order becomes the focal point of reference in cost accounting.

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 handled 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. Some Cost Accounting Record Rules 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.

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. Changes in the costing principles and methods applied must be disclosed with the effect.

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 of 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.

4.7 APPLICATION GUIDANCE

Material Cost

1. Under the erstwhile Cost Accounting Record Rules, 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 cost of material must be taken less an implicit interest for the elongated period of credit must be regarded as 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 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.

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 Rs.8500/- per month by way of Basic + DA.

   c) Extending the bonus to employees not covered under the Payment of Bonus Act – presently Rs.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 no. of employees or employee cost of each cost centre or cost object.

13. 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.

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 AS15 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. Cost Accounting Standard 1 excludes them from cost. It is interesting to note that some Cost Accounting Records recommend the inclusion of such payment in employee cost with proration over the years benefited by such payment. This appears to be the preferred treatment though it may not be generally accepted in practice today.

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 live 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, it is usual to change 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, dematerialized 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 Cost Accounting Record Rules generally 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, such consumption is generally netted against the output and only the output meant for other users is costed. This has got the effect of grossing up the unit cost for the costs of internal consumption of utilities.

11. Output of utilities is generally distinguished in terms of quality. In the case of water, water generated from bore wells or pumped from a nearby river is identified as raw water, with the output of a water treatment plant 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 uneconomic 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 way 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 costed 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, no 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 no 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 no 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 no.

10. it is also usual to treat the maintenance crew as a 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 no. 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 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 in financial accounts, such expenditure is charged to the Profit and Loss Account of the period, driven largely by tax deductibility considerations. However in Cost Accounts, these major repair job costs were prorated over the years, with the difference appearing in Reconciliation statements of the respective years. This treatment was required in the past by the Cost Accounting Record Rules for most industries. With Accounting Standard 26 on Intangible Assets coming into force, creating referred Revenue Expenditure assets is not favoured. There is however a strong case for continuing the earlier treatment since cost accounting is governed by a different set of principles.

Production Overheads

1. The continued use of the term 'overheads' is unfortunate. It is more appropriate to refer to them as indirect costs.

2. 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.

3. Increasingly with the spread of information technology, more and more costs can be identified with the final cost object. Even small materials which would not be preciously identified with the products in an economically feasible way can now have the issues recorded by product.

4. 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.

5. 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.

6. 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.

7. 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.

8. 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.

9. 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	-H.P Rating of Machines x hours x LF*
Fuel	-Consumption rate x hour
Jigs, Tools & Fixtures	-Machine hours or Man-hours
Crane Hire Charges	-Crane hours or weight of material handled
Supervisor's salary & fringe Benefits	-Number of employees
Labor Welfare cost	-Number of employees
Rent & Rates	-Floor or space area
Insurance	- Value of fixed Asset
Depreciation	-Value of fixed Asset

10. 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 change to it. This is actively discouraged now.

11. Changing overheads on the basis of benefits received by the various cost centres is preferred. This requires some measure of benefit to be developed.

12. 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.

13. 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.

14. 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.

15. Given the information processing capability, individual items of overheads or groups of them are taken up for redistribution.

16. 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.

17. 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 recording of costs to cost centres, the appropriateness definition of 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.

18. 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 basis commonly used are listed below (reproduced from Cost Accounting Standard 3 para 5.6).

Base of Denominator	**Applicability**
Unit of Production	When single product is produced or various products are similar in specification
Direct labor cost	When conversion process is labor intensive and wage rates are substantially uniform
Direct labor hour	When conversion process is labor intensive
Machine hour or Vessel Occupancy or Reaction hour or Crushing hour etc	When production mainly depends on performance of the base

19. 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.

20. Under absorbed fixed overheads are carried to Costing Profit & Loss Account or Reconciliation with financial accounts.

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 (CAS 2 para 4.4). In arriving at the practical capacity, the following are factored:

    - holidays
    - no of shifts
    - shift duration

- 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.,

22. 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.

23. 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.

24. 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 Cost Accounting Record Rules 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. 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 Cost Audit Report Rules 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 spindlage.

Selling and Distribution Overheads

1. The use of the term "Selling and Distribution Overheads" is unfortunate since some of these costs 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 / labeling 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 must be able to record separately transportation cost from factory to depots (primary freight) and from depot to customer place (Secondary freight)

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. In the last few years, following the new set of Cost Accounting Record Rules and Cost Audit Report Rules, there is recognition for interest and finance charges as cost.

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, 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.

Applicability of Cost Accounting Practices

1. The above discussions embody the cost accounting practices followed in various industries while applying the cost accounting principles.

2. However they may vary from practices adopted by specific regulated industries like banks, electricity, fertilisers. In many cases these practice are laid own 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.

4.8 COST ACCOUNTING STANDARDS

Preface to Cost Accounting Standards:

The Council of the Institute of Cost Accountants of India, has constituted 'Cost Accounting Standards Board' (CASB) with the objective of formulating cost accounting standards, after recognizing the need for structured approach to the measurement of cost so as to provide guidance to the user organizations, government bodies, regulators, research agencies, academic institutions and others to achieve uniformity and consistency in classification, measurement and assignment of costs.

The composition of the CASB will be broad based and ensure participation of all interest groups in the standard setting process. The chairman of the CASB will be nominated by the council of the Institute. Apart from six members of the council nominated on the CASB the following will be represented on the CASB:-

1) A nominee of the central government representing ministry of corporate affairs
2) Adviser (Cost), cost audit branch, ministry of corporate affairs, government of India
3) A nominee of the central government representing the Central Board of Excise and Customs, government of India
4) A nominee of the central government representing the Central Board of direct Taxes
5) Two members of the institute representing leading companies
6) Four nominees from regulators i.e. CAG, RBI, SEBI, IRDA,TRAI...etc
7) Two nominees from professional institutions i.e. ICAI and ICSI
8) Three nominees of industry associations viz ASSOCHAM, CII, FICCI....etc
9) Two nominees from academic institutions like IIM, MDI, Universities...etc
10) Four eminent practicing members of the institute
11) President is authorized to include a maximum of two eminent persons having knowledge and expertise in the cost and management accounting / Accounting standards not falling under the categories as defined in the constitution

Objectives and Functions of the Cost Accounting Standards Board:

The objectives of the CASB are to develop high quality Cost Accounting Standards to enable the management to take informed decisions and to enable regulators to function more effectively by integrating, harmonizing and standardizing cost accounting principles and practices.

The following will be the functions of the CASB:-

a) To issue the framework for the cost accounting standards
b) To equip the cost & management accounting professionals with better guide lines on cost accounting principles
c) To assists the members in preparation of uniform cost statements under various statutes
d) To provide from time to time interpretations on Cost Accounting standards
e) To issue application guidance relating to particular standard
f) To propagate the cost accounting standards and to persuade the users to adopt them in the preparation and presentation of general purpose cost statement

g) To persuade the government and appropriate authorities to enforce cost accounting standards, to facilitate the adoption thereof, by industry and corporate entities in order to achieve the desired objectives of standardization of cost accounting practices

h) To educate the users about the utility and the need for compliance of cost accounting standards

Overview of Cost Accounting Standards issued till date are as follows:

CAS No	Title	Objective
CAS 1	Classification of Cost	For preparation of Cost Statements
CAS 2	Capacity Determination	To bring uniformity and consistency in the principles and methods of determination of capacity with reasonable accuracy
CAS 3	Overheads	To bring uniformity and consistency in the principles and methods of determining overheads with reasonable accuracy
CAS 4	Cost of Production for Captive consumption	To determine the assessable value of excisable goods used for captive consumption
CAS 5	Average (Equalized) cost of transportation	To determine averaged / equalized transportation cost
CAS 6	Material Cost	To bring uniformity and consistency in the principles and methods of determining the material cost with reasonable accuracy in an economically feasible manner
CAS 7	Employee Cost	To bring uniformity and consistency in the principles and methods of determining the employee cost with reasonable accuracy
CAS 8	Cost of Utilities	To bring uniformity and consistency in the principles and methods of determining the cost of utilities with reasonable accuracy
CAS 9	Packing Material Cost	To bring uniformity and consistency in the principles and methods of determining the packing material cost with reasonable accuracy
CAS 10	Direct Expenses	To bring uniformity and consistency in the principles and methods of determining the Direct Expenses with reasonable accuracy
CAS 11	Administrative Overheads	To bring uniformity and consistency in the principles and methods of determining the Administrative overheads with reasonable accuracy
CAS 12	Repairs and Maintenance	To bring uniformity and consistency in the principles and methods of determining the Repairs and Maintenance cost with reasonable accuracy
CAS 13	Cost of Service Cost Centre	To bring uniformity and consistency in the principles and methods of determining the Cost of Service cost centre with reasonable accuracy
CAS 14	Pollution Control Cost	To bring uniformity and consistency in the principles and methods of determining the Pollution control costs with reasonable accuracy
CAS 15	Selling and Distribution Overheads	To bring uniformity and consistency in the principles and methods of determining the Selling and Distribution Overheads with reasonable accuracy

CAS 1 - "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.

5. Scope

3.1 The standard on classification of cost should be applied in assessment of cost of a product or service, application of costing technique and in case of management decision making by the manufacturing industries in India.

3.2 The standard is to be followed by an enterprise, whether covered under section 209(1)(d) of the Companies Act,1956 or not, to classify cost in order to prepare cost statement on uniform basis to make it relevant and understandable for effective cost management.

3.3 The standard has also to be followed for the purpose of assessment of cost of production or valuation of product or the valuation of stock to be certified for calculation of duties and taxes, tariffs and other purposes as the case may be. The cost statement prepared based on standard will be used for assessment of excise duty and other taxes, anti-dumping measures, transfer pricing etc.

4. Definitions:

4.1 Cost: Cost is a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services.

4.2 Manufacturing of goods or rendering services involves consumption of resources. Cost is measured by the sacrifice made in terms of resources or price paid to acquire goods and services. The type of cost is often referred in the costing system depends on the purpose for which cost is incurred. For example material cost is the price of materials acquired for manufacturing a product.

***4.3* Cost Centre: Any unit of Cost Accounting selected with a view to accumulating all cost under that unit. The unit may be a product, a service, division, department, section, a group of plant and machinery , a group of employees or a combination of several units. This may also be a budget centre**.

4.4 **C**ost 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

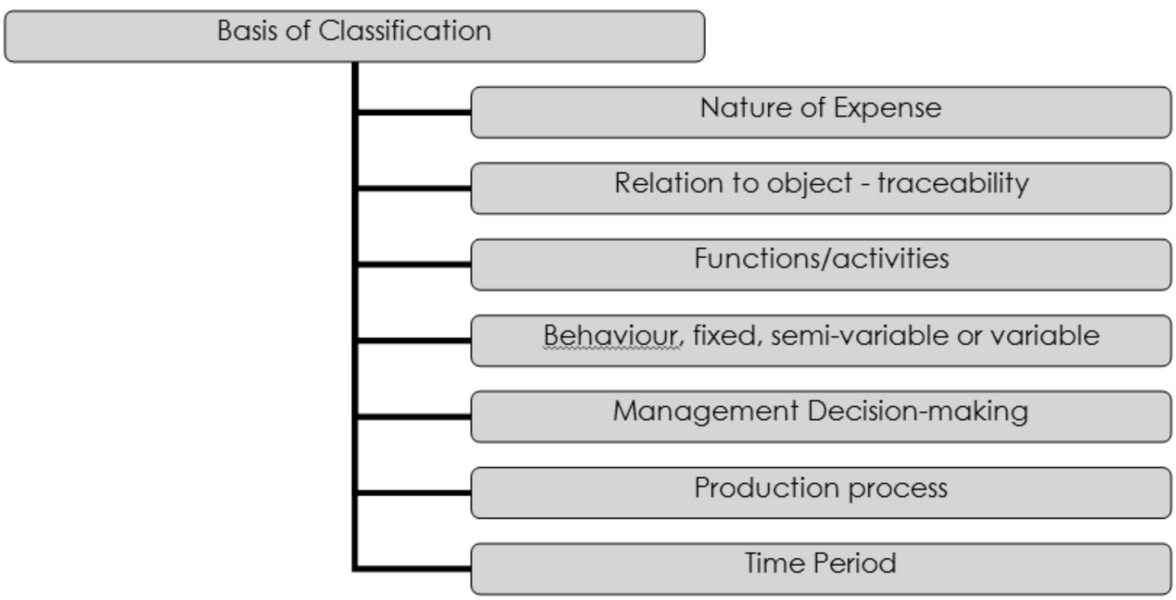
5. Basic Rules for Classification of Costs

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 :



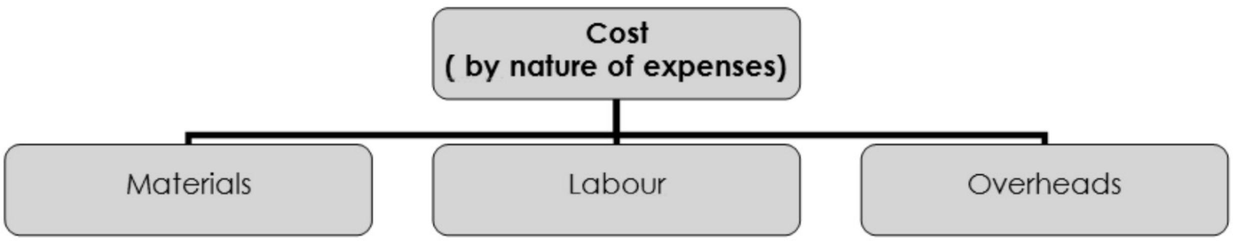
5.5 Classification of cost is the process of grouping the components of cost under a common designation on the basis of similarities of nature, attributes or relations. It is the process of identification of each item and the systematic placement of like items together according to their common features. 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.

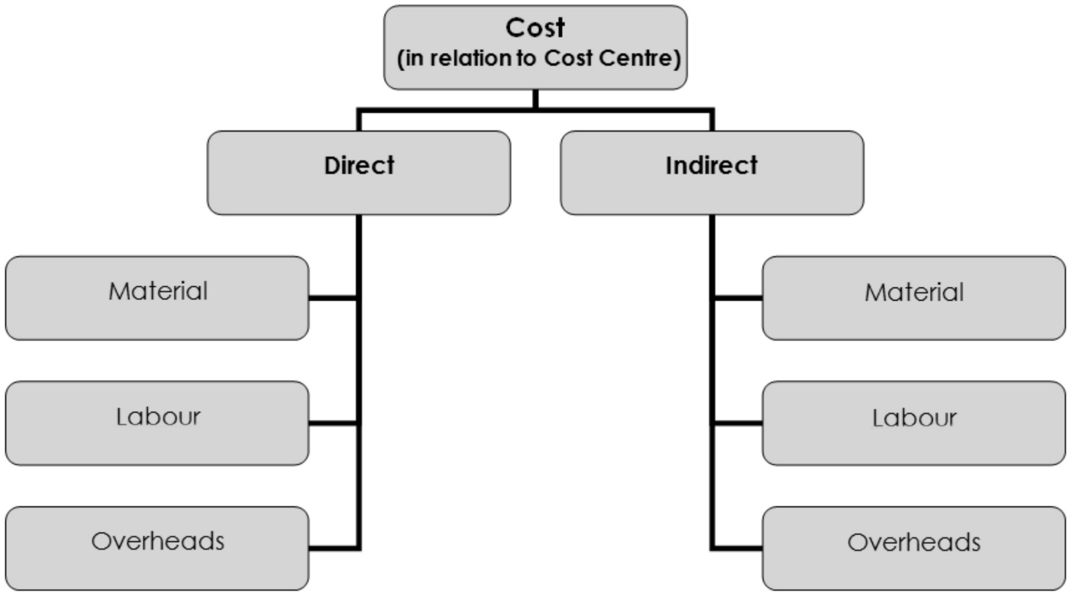
6.1.5 Labour cost include salaries and wages paid to permanent employees, temporary employees and also to employees of the contractor. Here, salaries & wages include all fringe benefits like Provident Fund contribution, gratuity, ESI, overtime, incentives, bonus , ex-gratia, leave encashment, wages for holidays and idle time etc.

6.1.6 Expenses are other than material cost or labour cost which are involved in an activity.

Expenditure on account of utilities, payment for bought out services, job processing charges etc. can be termed as expenses.

By Relation to Cost Centre

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 .

6.2.3Direct 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.

3.3.4Direct Labour Cost is the cost of wages of those workers who are readily identified or linked with a cost centre or cost object.

3.3.5Here, 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.

3.3.6Direct Expenses are the expenses other than direct material or direct labour which can be identified or linked with the cost centre or cost object.

3.3.7 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

3.3.8 Indirect Material is the cost of material which can not be directly allocable to a particular cost centre or cost object.

3.3.9 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.

3.3.10 ndirect labour cost is the wages of the employees which are not directly allocable to a particular cost centre.

3.3.11 Examples of indirect labour :

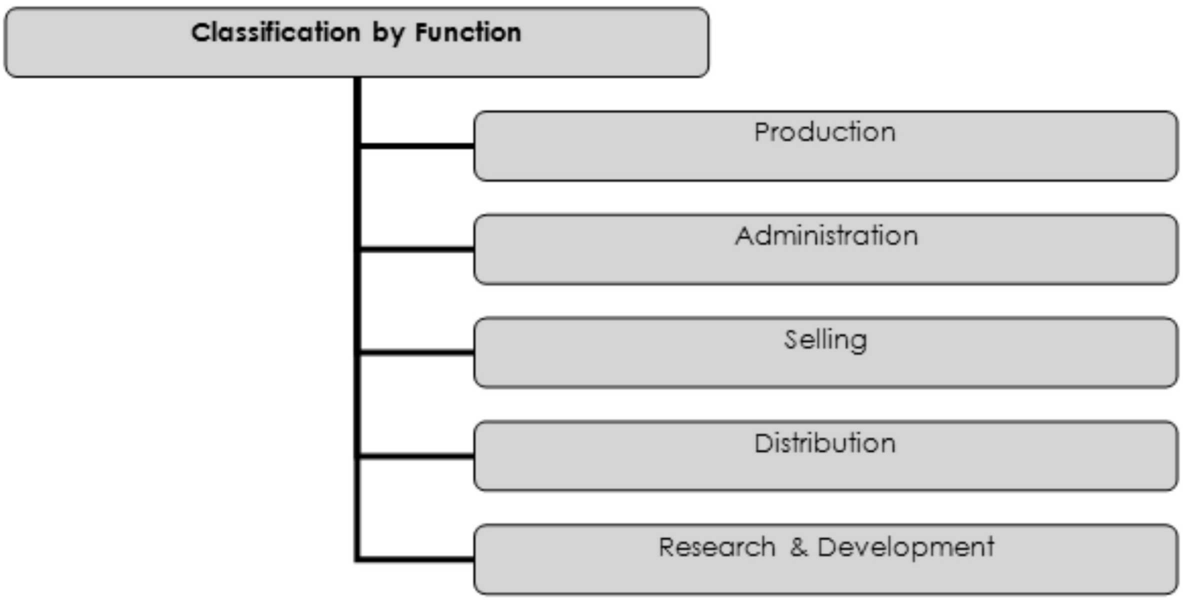
- Salaries of staff in the administration and accounts department
- Salaries of security staff etc

3.3.12 Indirect expenses are the expenses other than of the nature of material or labour and cannot be directly allocable to a particular cost centres.

3.3.13 Indirect expenses are not be allocable to a particular cost centre. Examples – insurance, taxes and duties,

6.3 By functions/activities:

6.5.1 Costs should be classified according to the major functions for which the elements are used into the following major functions:



2.2.2Production 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)

2.2.3Production overhead is the indirect costs involved in the production process.

6.5.4 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.

6.5.5 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.

6.5.6 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.

6.5.7 Selling costs are indirect costs related to selling of products or services and include all indirect cost in sales management for the organization.

6.5.8 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

9.9.9 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.

9.9.10 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.

6.5.11 **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.**

6.5.12 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

Particulars	**Amount (Rs.)**
(1) Direct Material Cost	
(2) Direct Labour Cost	
(3) Direct Expenses	
(4) Prime Cost = (1) + (2) + (3) = (A)	
(5) Production Overhead	
(6) Administrative Overhead	
(7) Research & Development cost (Apportioned)	
(8) Cost of Production (B) = (4) + (5) +(6) +(7)	
(9) Selling Cost	
(10) Distribution Cost	
(11) Cost of Sales = (8) + (9) +(10)	

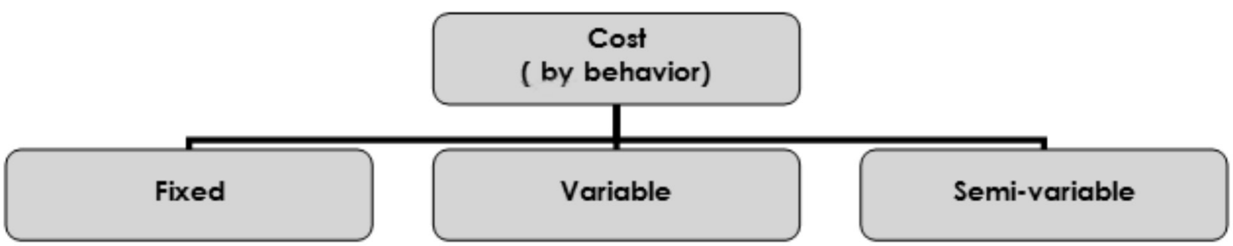
Note: To arrive at value at different points as indicated above adjustment with opening and closing stock is necessary at following different points:

(a) opening and closing stock of raw materials

(b) opening and closing stock of work-in-progress & finished goods

6.4 By Behaviour

6.4.1 **Costs are classified based on behaviour as fixed cost, variable cost and semi-variable cost depending upon response to the changes in the activity levels.**



6.4.2 Fixed Cost is the cost which does not vary with the change in the volume of activity in the short run. These costs are not affected by temporary fluctuation in activity of an enterprise. These are also known as period costs.

6.4.3 Examples for fixed cost : salaries, rent, audit fees, depreciation etc.

6.4.4 Variable Cost is the cost of elements which tends to directly vary with the volume of activity. Variable cost has two parts – (a) Variable direct cost; and (b) Variable indirect costs. Variable indirect costs are termed as variable overhead.

6.4.5 Examples of variable cost are materials consumed, direct labour, sales commission, utilities, freight, packing, etc.

6.4.6 Semi Variable Costs contain both fixed and variable elements. They are partly affected by fluctuation in the level of activity.

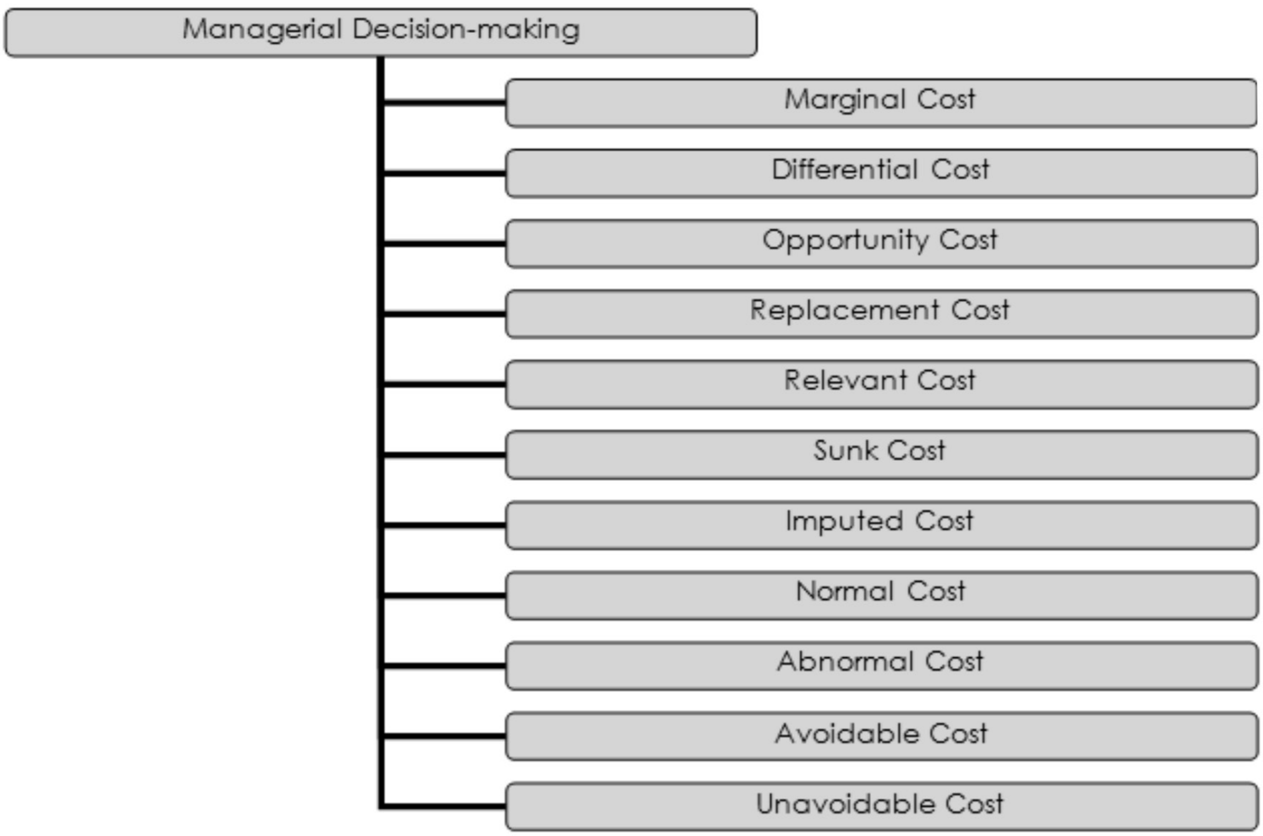
6.4.7 Examples of semi-variable cost : Factory supervision, maintenance, power etc.

Note :

1. The characteristics of fixed costs are (1) fixed amount within an output range (2) fixed cost per unit decreases with increased output
2. The characteristics of variable Cost: (1) The variable cost varies directly with volume of activities or production (2) variable cost remains constant per unit within a range of activity .

6.5 For Management Decision Making

6.5.1 Costs are classified for the purpose of management decision making under different circumstances as under :



6.5.2 **Marginal cost is the aggregate of variable costs, i.e. prime cost plus variable overhead. Marginal cost per unit is the change in the amount at any given volume of output by which the aggregate cost changes if the volume of output is increased or decreased by one unit.**

6.5.3 Marginal cost is used in Marginal Costing system. For determining marginal cost, semi-variable costs, if any, are segregated into fixed and variable cost. Then, variable costs plus the variable part of semi-variable costs is the total marginal cost for the volume of production in consideration.

Example:

(A) Production : 45,000 units

(B) Cost

Particulars	Fixed Cost (Rs.lakhs)	Variable Cost (Rs.lakhs)
Material cost		4.50
Labour cost		2.45
Fixed Cost	4.80	
Variable Production & Selling overhead		2.30
Semi-variable Cost(after segregation fixed and variable part)	5.20	2.00
Total Marginal Cost		11.25
Marginal Cost per unit (Rs. 11,25,000/45000 units)	Rs. 25.00 per unit	

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 (Rs. lakhs)	Differential cost (Rs. lakhs)	Differential cost per unit (Rs.)
(a) 1.00	-	30.00	-	-
(b) 1.20	0.20 (b) –(a)	35.00	5.00	25.00
(c) 0.80	0.20 (a) –(c)	26.00	- 4.00	- 20.00

(+) Incremental cost ; (-) Decremental cost

6.5.7 **Opportunity Cost is the value of the alternatives foregone by adopting a particular strategy or employing resources in specific manner.**

6.5.8 It is the return expected from an investment other than the present one. The opportunity cost is considered for selection of a project or justification of investment, studying viability of an investment option.

Example: A machine is currently being used to produce product P. It can also be used to produce product Q which can fetch Rs 60,000 profit. Then the opportunity cost of using the machine is Rs 60000.

6.5.9 Replacement Cost is the cost of an asset in the current market for the purpose of replacement.

6.5.10 Replacement cost is generally used for determining the optimum time of replacement of an equipment or machine in consideration of maintenance cost of the existing one and its productive capacity.

6.5.11 Relevant Costs are costs relevant for a specific purpose or situation.

6.5.12 In the context of decision making relating to a specific issue, only those costs which are relevant are considered. A particular cost item may be relevant in a decision making and may be irrelevant in some other decision making situation. For example, present depreciated cost of machine is relevant in case of decision of its sale but it is irrelevant in case of decision of its replacement.

6.5.13 Imputed Costs are hypothetical or notional costs, not involving cash outlay, computed only for the purpose of decision making.

6.5.14. In economics, 'imputed' indicates an ascribed or estimated value when there is no criteria of absolute monetary value for such purpose. In national income estimation wages of housewives are imputed. Similarly, in farming operations, the wages or salaries of owner are imputed. Imputed costs are similar to opportunity costs. Interest on internally generated fund, which is not actually paid is an example of imputed cost.

6.5.15 Sunk Costs are historical costs which are incurred i.e. 'sunk' in the past and are not relevant to the particular decision making problem being considered.

6.5.16 Sunk costs are those that have been incurred for a project and which will not be recovered if the project is terminated. While considering the replacement of a plant, the depreciated book value of the old asset is irrelevant as the amount is a sunk cost which is to be written off at the time of replacement.

6.5.17 Normal Cost is a cost that is normally incurred at a given level of output in the conditions in which that level of output is achieved.

6.5.18 Normal cost includes those items of cost which occur in the normal situation of production process or in the normal environment of the business. The normal idle time is to be included in the ascertainment of normal cost.

6.5.19 Abnormal Cost is an unusual or a typical cost whose occurrence is usually irregular and unexpected and due to some abnormal situation of the production.

6.5.20 Abnormal cost arises due to idle time for some heavy break down or abnormal process loss. They are not considered in the cost of production for decision making and charged to profit & loss account.

6.5.21 Avoidable Costs are those costs which under given conditions of performance efficiency should not have been incurred.

6.5.22. Avoidable costs are logically associated with some activity or situation and are ascertained by the difference of actual cost with the happening of the situation and the normal cost. When spoilage occurs in manufacture in excess of normal limit, the resulting cost of spoilage is avoidable cost. Cost variances which are controllable may be termed as avoidable cost.

6.5.23 Unavoidable Costs are inescapable costs which are essentially to be incurred, within the limits or norms provided for. It is the cost that must be incurred under a programme of business restriction. It is fixed in nature and inescapable.

6.6. By nature of production process

6.6.1 Costs are also classified on the basis of nature of production or manufacturing process.

- Nature of production process
  - Batch Cost
  - Process Cost
  - Operation Cost
  - Operating Cost
  - Contract Cost
  - Joint Cost

6.6.2 Batch Cost is the aggregate cost related to a cost unit which consist of a group of similar articles which maintain its identity throughout one or more stages of production.

6.6.3 Process cost: When the production process is such that goods are produced from a sequence of continuous or repetitive operations or processes, the cost incurred during a period is considered as process cost. The process cost per unit is derived by dividing the process cost by number of units produced in the process during the period.

6.6.4. Accounts are maintained for cost of a process for a period. The average cost per unit produced during the period is process cost per unit.

6.6.5 Operation Cost is the cost a specific operation involved in a production process or business activity.

6.6.6. When there are distinctly separate operations involved in a process, cost for each operation is found out for effective control mechanism.

6.6.7 Operating Cost is the cost incurred in conducting a business activity. Operating costs refer to the cost of undertakings which do not manufacture any product but which provide services.

6.6.8 **Contract cost is the cost of a contract with some terms and condition of adjustment agreed upon between the contractee and the contractor.**

6.6.9. Contract cost usually implied to major long term contracts as distinct from short term job costs. Escalation clause are sometimes provided in the contract in order to take care of anticipated change in material price, labour cost etc.

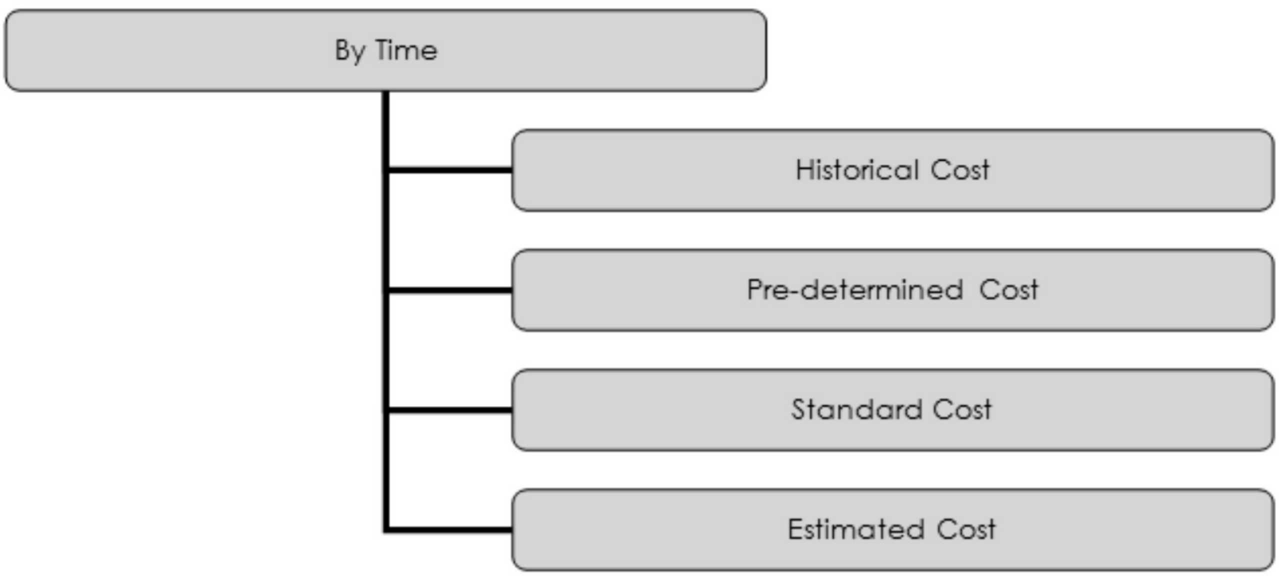
6.6.10 Joint Costs are the common cost of facilities or services employed in the output of two or more simultaneously produced or otherwise closely related operations, commodities or services.

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)

COST ACCOUNTING STANDARD ON CAPACITY DETERMINATION

The following is the COST ACCOUNTING STANDARD 2 (CAS 2) issued by the Council of the Institute of Cost and Works Accountants of India on "CAPACITY DETERMINATION". The standard deals with determination of capacity of a unit. In this Standard, the standard portions have been set in bold italic type. These are to be read in the context of the background material which has been set in normal type.

1. Introduction

Better utilization of capacity means better utilization of resources. It is an important consideration for cost determination and cost reduction. Thus, it is essential to establish the capacity of the plant. Cost Accounting Records Rules under section 209(1) (d) of Companies Act, 1956 and Cost Audit Report Rules, 2001 under section 233B of the said Act specify that comparative statement of installed capacity and actual capacity utilization is to be recorded and furnished in order to assess the operating level.

2. Objective

1.1 The objective of the standard is to prescribe the method of determination of capacity to be applied uniformly and consistently.

1.2 The standard is to help the management to identify the bottlenecks, imbalances and idle capacity for effective use of various resources.

1.3 The standard is to help in proper allocation, apportionment and absorption of cost.

5. Scope

1.1 The standard should be followed for capacity determination required to be carried out for any purpose or under provisions of any Act, Rules or Regulations except where capacity determination has been prescribed otherwise.

1.2 The standard shall also be followed for maintaining cost records under the Cost Accounting Records Rules or for furnishing information on Capacity Utilization under the Cost Audit Report Rules issued pursuant to Section 209(1) (d) and section 233B of Companies Act,1956 respectively.

1.3 The standard is applicable for an undertaking, whether existing or new, where there is expansion of more than 5% of the existing capacity due to introduction of new machines or productive resources. Similarly, the standard is also applicable where there is more than 5% reduction of the existing capacity due to disposal or withdrawal or impairment of old machines or productive resources.

4. Definitions

1.1 'Licensed Capacity' is the production capacity of the plant for which license has been issued by an appropriate authority.

1.2 'Installed Capacity' is the maximum productive capacity according to the manufacturers' specification of machines / equipment. Installed capacity of the unit/plant is determined after taking into account imbalances in different machines/ equipment in the various departments / production cost centres in the unit / plant and number of working shifts.

1.3 'Practical or Achievable Capacity' is the maximum productive capacity of a plant reduced by the predictable and unavoidable factors of interruption pertaining to internal causes.

Thus, practical capacity is the installed capacity minus the inevitable interruptions due to time lost for preventive maintenance, repairs, set ups, normal delays, weekly off-days and holidays etc. Practical capacity does not consider the external factors causing reduction in production e.g. lack of orders.

1.4 'Normal Capacity' is the production achieved or achievable on an average over a period or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance.

Normal capacity is practical capacity minus the loss of productive capacity due to external factors.

1.5 'Actual Capacity Utilization' is the volume of production achieved in relation to installed capacity.

1.6 'Idle Capacity' is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is less than installed capacity.

1.7 'Excess Capacity Utilization' is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is more than installed capacity.

1.8 'Abnormal idle capacity' is the difference between practical capacity and normal capacity or actual capacity utilization whichever is higher.

5. Determination of Installed Capacity

1.1 Installed capacity is determined based on :

i) Manufacturers' Technical specifications

ii) Capacities of individual or interrelated production centres.

iii) Operational constraints / capacity of critical machines

iv) Number of shifts

v) Any other factor

1.2 In case of manufacturers' technical specifications are not available, the estimates by technical experts on capacity under ideal conditions may be considered for determination of installed capacity.

1.3 In case a product passes through different production processes and each process is having different capacity then the process which brings effective or ultimate production shall be considered for deciding installed capacity.

6. Determination of Practical / Achievable Capacity

1.1 Practical capacity or achievable capacity should be determined after adjustment of the following with the installed capacity.

(i) Available production hours taking into consideration holidays, normal shut down days and normal idle time.

(ii) Normal time loss in batch change over, break downs of machines, repairs etc.

(iii) Loss in efficiency due to ageing of the machines/ equipment

(iv) Number of shifts

(v) Any other factor

7. Determination of Normal Capacity

1.1 Normal capacity is determined based on the productive capacity achieved over a period of time, say average of three normal years out of preceding five years or expected to be achieved over a period of time, say next three to five years .

1.2 This capacity is determined after adjustment of external factors with practical capacity.

1.3 Normal capacity of production process involved in the production of a product or the productive capacity of the plant as a whole should be taken into account to arrive at normal capacity for a product or plant, as the case may be .

1.4 The periods influenced by abnormalities should be excluded for this purpose.

Explanation:

1. In case the same products with different specifications and of different ranges in terms of size, type, variety etc. are manufactured, then there is a need to determine equivalence among them in order to determine the capacity.

2. In case some intermediate products / components etc are also produced, they should be taken into consideration for determining equivalent capacity.

3. In case some machines are leased out/let out or some machines are taken on lease, resulting decrease / increase in capacity should also be considered.

8. Disclosure

1.1 The details of basis for arriving at the capacity, variables used and assumptions made should be disclosed.

1.2 Any change in the installed capacity due to modifications in the machines / equipment or addition of balancing equipment or disposal or impairment of some machines / equipment should be disclosed.

1.3 The licensed capacity and installed capacity should be disclosed in absolute term of production whereas practical capacity, normal capacity and actual capacity utilization should be disclosed in absolute term as well as in percentage of installed capacity.

1.4 In case the same products with different specifications and of different ranges in terms of size, type, variety etc. are manufactured, then there is a need to determine equivalence among them and capacity should be established in terms of equivalent units.

1.5 In case some machines are taken on lease or some machines are leased out, their impact in terms of increase/ decrease in capacity should be disclosed separately.

1.6 In case of low capacity utilization as compared to the installed capacity, reasons for the same should be disclosed. Comments on the shortfall in production should also specify the factors which are controllable and uncontrollable in short term or in long term.

1.7 *In case of excess capacity utilization, the same should be disclosed separately in absolute terms and in terms of percentage with reasons.*

Exhibit 1

Particulars	
Manufacturers' Specifications - capacity per hour	= 500 units
No of shifts (each shift 8 hours)	= 3 shifts
Holidays in a year: Sundays Other holidays Annual maintenance is done within these 13 holidays Preventive Weekly Maintenance for the machine on Sunday.	= 52 days = 13 days
Normal idle capacity for batch change over, Lunch, personal need etc	= 1 hr per shift
Production based on sales expectancy in past 5 years = 30.1, 26.9, 29.7, 24.4 and 30.2 lakh units	
Actual Production for the year	= 30.1 lakh units
Calculation	
Installed Capacity for the machine = (365 days x 8 hrs/day x 3 shifts x 500 units per capacity hour)	= 45.8 lakh units
Practical Capacity = [(365 – 52 - 13) x (8 - 1)] x 3 x 500 =	= 31.5 lakh units
Out of the past five years, normal capacity is average of 3 normal years Normal Capacity = (30.1 + 29.7 + 30.2) / 3 = 30.0 lakh units	= 30.0 lakh units
Actual Capacity Utilization = 30.1 lakh units = 68.7 %	= 68.7 %
Idle Capacity = (45.8 – 30.1) lakh units = 15.7 lakh units	= 31.3 %
Abnormal idle capacity = (31.5 – 30.1) lakh units	= 1.4 lakh units

CAS-3

COST ACCOUNTING STANDARD ON "OVERHEADS"

The following is the text of the COST ACCOUNTING STANDARD 3 (CAS- 3) issued by the Council of the Institute of Cost and Works Accountants of India on "Overheads". The standard deals with the method of collection, allocation, apportionment and absorption of overheads" In this Standard, the standard portions have been set in bold italic type. These should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 In Cost Accounting the analysis and collection of overheads, their allocation and apportionment to different cost centres and absorption to products or services plays an important role in determination of cost as well as control purposes. A system of better distribution of overheads can only ensure greater accuracy in determination of cost of products or services. It is, therefore, necessary to follow standard practices for allocation, apportionment and absorption of overheads for preparation of cost statements.

2. Objective

1.1 The standard is to prescribe the methods of collection, allocation, apportionment of overheads to different cost centres and absorption thereof to products or services on a consistent and uniform basis in the preparation of cost statements and to facilitate inter-firm and intra-firm comparison.

2.2 The standardization of collection, allocation, apportionment and absorption of overheads is to provide a scientific basis for determination of cost of different activities, products, services, assets, etc.

2.3 The standard is to facilitate in taking commercial and strategic management ₹ decisions such as resource allocation, product mix optimization, make or buy decisions, price fixation etc.

2.4 The standard aims at ensuring better disclosure requirement and transparency in the cost statement.

3. Scope

1.1 ***The standard should be followed for treatment of overheads by all enterprises including companies covered under Cost Accounting Records Rules issued in pursuant to Sec 209(1)(d) of the Companies Act, 1956 or under the provisions of any other Act, Rules and Regulations.***

1.2 The standard shall be applied in Cost and Management Accounting practices relating to

(a) Cost of products, services or activities

(b) Valuation of stock

(c) Transfer pricing

(d) Segment Performance

(e) Excise / Custom duty, VAT, Income Tax, Service Tax and other levies, duties and abatement fixation

(f) Cost statements for any other purpose

4. Definitions:

2.7 Overheads – Overheads comprise of indirect materials, indirect employee costs and indirect expenses which are not directly identifiable or allocable to a cost object in an economically feasible way.

Overheads are to be classified on the basis of functions to which the overheads are related (Refer to 'Classification of cost' – CAS-1), viz

- Production overheads
- Administrative overheads
- Selling overheads
- Distribution overheads

Overheads may also be classified on the basis of behaviour such as variable overheads, semi-variable overheads and fixed overheads.

Variable overheads comprise of expenses which vary in proportion to the change of volume of production. For example, cost of utilities etc.

Fixed overheads *comprise of expenses* ***whose value do not change with the change in volume of production such as salaries, rent etc.***

Semi-variable overheads are partly affected by change in the production volume. They are further segregated into variable overheads and fixed overheads

Any items of overheads arising out of abnormal situation in business activity should not be treated as overheads. They are charged to Costing Profit and Loss Account. Items not related to business activities such as donation, loss / profit on sale of assets etc are also not to be treated as overheads.

Borrowing cost and other financial charges including foreign exchange fluctuations will not form the part of overheads.

2.8 Collection of Overheads - Collection of overheads means the pooling of indirect items of expenses from books of account and supportive/ corroborative records in logical groups having regards to their nature and purpose.

Overheads are collected on the basis of pre-planned groupings, called cost pools. Homogeneity of the cost components in respect of their behaviour and character is to be considered in developing the cost pool. Variable and fixed overheads should be collected in separate cost pools under a cost centre. A great degree of homogeneity in the cost pools are to be maintained to make the apportionment of overheads more rational and scientific. A cost pool for maintenance expenses will help in apportioning them to different cost centres which use the maintenance service.

2.9 Allocation of overheads – Allocation of overheads is assigning a whole item of cost directly to a cost centre.

An item of expense which can be directly related to a cost centre is to be allocated to the cost centre. For example, depreciation of a particular machine should be allocated to a particular cost centre if the machine is directly attached to the cost centre.

2.10 Apportionment of overhead - Apportionment of overhead is distribution of overheads to more than one cost centre on some equitable basis.

When the indirect costs are common to different cost centres, these are to be apportioned to the cost centres on an equitable basis. For example, the expenditure on general repair and maintenance pertaining to a department can be allocated to that department but has to be apportioned to various machines (Cost Centres) in the department. If the department is involved in the production of a single product, the whole repair & maintenance of the department may be allocated to the product.

2.11 Primary and Secondary Distribution of Overheads :

In case of multi-product environment, there are common service cost centres which are providing services to the various production cost centres and other service cost centres. The costs of services are required to be apportioned to the relevant cost centres. First step to be followed is to apportion the overheads to different cost centres and then second step is to apportion the costs of service cost centres to production cost centres on an equitable basis. The first step is termed as primary distribution and the second step is termed as secondary distribution of overheads.

4.6 ***Absorption of overheads - Absorption of overheads is charging of overheads from cost centres to products or services by means of absorption rates for each cost center which is calculated as follows :***

$$\text{Overhead absorption Rate} = \frac{\text{Total overheads of the cost centre}}{\text{Total quantum of base}}$$

The base (denominator) is selected on the basis of type of the cost centre and its contribution to the products or services, for example, machine hours, labour hours, quantity produced etc.

Overhead absorbed = Overhead absorption rate x units of base in product or service

4.7 ***Normal Capacity is the production achieved or achievable on an average over a period or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance. (CAS-2)***

5. Apportionment and absorption of Production Overheads

1.1 Overheads are to be apportioned to different cost centres based on following two principles :

i) Cause and Effect - Cause is the process or operation or activity and effect is the incurrence of cost. Apportionment of overheads based on this criterion ensures better rationality as it is guided by the relationship between cost object and cost.

ii) Benefits received – overheads are to be apportioned to the various cost centres in proportion to the benefits received by them.

1.2 Primary Distribution of overheads :

Basis of primary apportionment of items of production overheads is to be selected to distribute them among the cost centres following the above two principles as given above in 5.1.

Basis of apportionment must be rational to distribute overheads. Once the base is selected, the same is to be followed consistently and uniformly. However, change in basis for apportionment can be adopted only when it is considered necessary due to change in circumstances like change in technology, degree of mechanization, product mix, etc. In case of such changes, proper disclosure in cost records is essential.

Examples of basis of primary distribution of some items of production overheads

Item of Cost	**Basis of Apportionment**
Power	(H.P. rating of Machines x hours x LF *
Fuel	Consumption rate x hour
Jigs, tools & fixtures	Machine hours or Man hours
Crane hire charges	Crane hours or weight of materials handled
Supervisors' salary & fringe benefits	Number of employees
Labour welfare cost	Number of employees
Rent & rates	Floor or Space area
Insurance	Value of fixed asset
Depreciation	Value of fixed asset

* LF = Motor Load Factor

5.3 **Secondary Distribution of Overheads*:***

Secondary distribution of overheads may be done by following either Reciprocal basis or Non-Reciprocal Basis. While reciprocal basis considers the exchange of service among the service departments, non-reciprocal basis considers only one directional service flow from a service cost centre to other production cost centre(s).

5.4 Secondary Apportionment of Overheads on Reciprocal Basis

The services rendered by certain service cost centres are also utilized by other service cost centres. In reciprocal secondary distribution, the cost of service cost centres are apportioned to production cost centres as well as other service cost centres. In such case, any one of the following three methods may be followed :

I. Repeated Distribution Method

II. Trial & Error Method

III. Simultaneous Equation Method

5.4.1 Repeated Distribution Method

Steps to be followed under this method are :

i) The proportion at which the costs of a service cost centres are to be distributed to production cost centres and other service cost centres are determined.

ii) Costs of first service cost centres are to be apportioned to production cost centres and service cost centres in the proportion as determined in step (i).

iii) Similarly, the cost of other service cost centres are to be apportioned.

iv) This process as stated in (ii) and (iii) are to be continued till the figures remaining undistributed in the service cost centres are negligibly small. The negligible small amount left with service centre may be distributed to production cost centres.

Exhibit 1 : Reciprocal Overheads Apportionment : Repeated Method

	Production Department		Service Department		
	Machine	**Assembly**	**Finishing**	**Stores**	**Repair**
Ratio of apportionment from Stores	50%	20%	15%	-	15%
Ratio of apportionment from Repairs	40%	35%	15%	10%	-
Distribution from Primary distribution	35,500.00	31,900.00	14,800.00	5,000.00	6,000.00
Stores Dept.	2,500.00	1,000.00	750.00	(5,000.00)	750.00
Total	38,000.00	32,900.00	15,550.00	0.00	6,750.00
Repairs and Maintenance Dept	2,700.00	2,362.50	1,012.50	675.00	(6,750.00)
Total	40,700.00	35,262.50	16,562.50	675.00	0.00
Stores Dept.	337.50	135.00	101.25	(675.00)	101.25
Total	41,037.50	35,397.50	16,663.75	0.00	101.25
Repairs and Maintenance Dept	40.50	35.44	15.19	10.13	(101.25)
Total	41,078.00	35,432.94	16,678.94	10.13	0.00
Stores Dept.	5.06	2.03	1.52	(10.13)	1.52
Total	41,083.06	35,434.96	16.680.00	0.00	1.52
Repairs and Maintenance Dept	0.61	0.53	0.23	0.15	(1.52)
Total	41,083.67	35,435.49	16.680.68	0.15	0.00
Stores Dept.	0.10	0.03	0.02	(0.15)	0.00
Total	41,083.77	35,435.52	16,680.71	0.00	0.00

5.4.2 Trial and Error Method

This method is to be followed when the question of distribution of costs of service cost centres which are interlocked among themselves arises. In the first stage, gross costs of services of service cost centres are determined and then in the second stage, costs of service centres are apportioned to production cost centres. Steps to be followed :

i) The proportion at which the costs of a service cost centre to be distributed to production cost centres and other service cost centres is determined.

ii) Cost of first service cost centre is distributed to the other service centres in the proportion of service they received from the first as assessed in step (i).

iii) In the next step, total cost of second service cost centre so arrived has to be distributed to the other service centres in the proportion of service they received from the second as assessed in step (i).

iv) Similarly, the cost of other service cost centres are to be apportioned to the service cost centres.

v) This process as described in (iii) and (iv) is to be continued till the figures remaining undistributed in the service cost centres are negligibly small.

vi) At the last, total cost of service cost centres to be distributed to production cost centres.

Exhibit 2 : Reciprocal Overhead Apportionment

	Production Department			**Service Department**	
	Machine	**Assembly**	**Finishing**	**Stores**	**Repair**
Ratio of apportionment from Stores	50%	20%	15%	-	15%
Ratio of apportionment from Repairs	40%	35%	15%	10%	-
Distribution from Primary distribution	35,500.00	31,900.00	14,800.00	5,000.00	6,000.00
Stores Dept.	2,500.00	1,000.00	750.00	(5,000.00)	750.00
Total	38,000.00	32,900.00	15,550.00	0.00	6,750.00
Repairs and Maintenance Dept	2,700.00	2,362.50	1,012.50	675.00	(6,750.00)
Total	40,700.00	35,262.50	16,562.50	675.00	0.00
Stores Dept.	337.50	135.00	101.25	(675.00)	101.25
Total	41,037.50	35,397.50	16,663.75	0.00	101.25
Repairs and Maintenance Dept	40.50	35.44	15.19	10.13	(101.25)
Total	41,078.00	35,432.94	16,678.94	10.13	0.00
Stores Dept.	5.06	2.03	1.52	(10.13)	1.52
Total	41,083.06	35,434.96	16.680.00	0.00	1.52
Repairs and Maintenance Dept	0.61	0.53	0.23	0.15	(1.52)
Total	41,083.67	35,435.49	16.680.68	0.15	0.00
Stores Dept.	0.10	0.03	0.02	(0.15)	0.00
Total	41,083.77	35,435.52	16,680.71	0.00	0.00

5.4.3 Simultaneous Equation Method

The simultaneous equation method is to be adopted to take care of secondary distribution of cost of service cost centres to production cost centres with the help of mathematical formulation and solution. Steps to be followed :

i) Proportion of service benefits received by different cost centres from a cost centre are assessed on the basis of records

ii) The same ratios are used as coefficients in the equations framed for apportionment of cost of service cost centres to production cost centres.

iii) Solution of the equations gives the cost of service cost centres.

i v) Cost of service cost centres to be distributed to production cost centres

Exhibit 3: Reciprocal Overhead Apportionment: Simultaneous Equation Method

	Production Department			Service Department	
	Machine	**Assembly**	**Finishing**	**Stores**	**Repair**
Ratio of apportionment from Stores	50%	20%	15%	-	15%
Ratio of apportionment from Repairs	40%	35%	15%	10%	-
Distribution from Primary distribution	35,500.00	31,900.00	14,800.00	5,000.00	6,000.00
Stores Dept.	2,500.00	1,000.00	750.00	(5,000.00)	750.00
Total	38,000.00	32,900.00	15,550.00	0.00	6,750.00
Repairs and Maintenance Dept	2,700.00	2,362.50	1,012.50	675.00	(6,750.00)
Total	40,700.00	35,262.50	16,562.50	675.00	0.00
Stores Dept.	337.50	135.00	101.25	(675.00)	101.25
Total	41,037.50	35,397.50	16,663.75	0.00	101.25
Repairs and Maintenance Dept	40.50	35.44	15.19	10.13	(101.25)
Total	41,078.00	35,432.94	16,678.94	10.13	0.00
Stores Dept.	5.06	2.03	1.52	(10.13)	1.52
Total	41,083.06	35,434.96	16.680.00	0.00	1.52
Repairs and Maintenance Dept	0.61	0.53	0.23	0.15	(1.52)
Total	41,083.67	35,435.49	16.680.68	0.15	0.00
Stores Dept.	0.10	0.03	0.02	(0.15)	0.00
Total	41,083.77	35,435.52	16,680.71	0.00	0.00

Let x, y be Stores Dept and Repairs & Maintenance Dept Expenses respectively.

$X - 0.10y = 5,000$

$(0.15\ x) + y = 6,000$

Solving, we find $x = 5,685.28$ and $y = 6,852.79$

Now distribution of expenses will be as follows:

	Production Department			Service Department	
	Machine	**Assembly**	**Finishing**	**Stores**	**Repair**
Ratio of apportionment from Stores	50%	20%	15%	-	15%
Ratio of apportionment from Repairs	40%	35%	15%	10%	-
Amounts from Primary distribution	35,500.00	31,900.00	14,800.00	5,685.28	6,852.79
Stores to Production Cost Centres	2,842.63	1,137.06	852.79	(5,685.28)	-
Repairs and Maintenance to Production Cost Centres	2,741.14	2,398.46	1,027.92	0.00	(6,865.79)
Total	41,083.77	35,435.52	16,680.71	0.00	0.00

5.5 Secondary Apportionment of Overheads on Non-Reciprocal basis

In non-reciprocal secondary distribution, the costs of service cost centres are apportioned to the production cost centres. Steps involved are :

ii) The cost of first service cost centre is apportioned on a suitable basis to production cost centres.

iii) The next step is to apportion the cost of second service centre to the production cost centres as indicated in stage (i).

iv) The process is to be continued till the costs of all service cost centres are apportioned.

Exhibit 4: Non-Reciprocal Overheads Apportionment

Expenses	Basis of allocation/ apportionment	Total (₹)	Production Department			Service Department	
Consumable Stores	Direct Materials	15,400	5,200	6,000	2,000	600	1,600
Supervision	Direct Wages	22,800	7,900	5,100	6,100	2,200	1,500
Rent & Rates	Area	10,000	3,000	2,000	2,500	1,000	1,500
Insurance	Asset Value	2,000	800	900	200	50	50
Depreciation	Asset Value	30,000	12,000	13,500	3,000	750	750
Power	H.P. x Hours x Load Factor (LF)	9,000	5,400	3,600	-	-	-
Light & Heat	Area	4,000	1,200	800	1,000	400	600
Total		93,200	35,500	31,900	14,800	5,000	6,000

Secondary Distribution:

Expenses	Basis of allocation/ apportionment	Total (₹)	Production Department			Service Department	
Primary Distribution (as per earlier table)		93,200	35,500	31,900	14,800	5,000	6,000
Stores	Direct Material (9:6:5)		2,250	1,500	1,250	(5,000)	-
Repairs & Maintenance	Direct (2:3:1)		2,000	3,000	1,000	-	(6,000)
Total		93,200	39,750	36,400	17,050	0	0

6.6 Common bases for absorption of Production overheads from production cost centres to products or services :

Bases of denominator	Applicability
Unit of Production	When single product is produced or various products are similar in specification.
Direct labour cost	When conversion process is labour intensive and wage rates are substantially uniform
Direct labour hour	When conversion process is labour intensive
Machine Hour or Vessel Occupancy or Reaction Hour or Crushing Hour etc	When production mainly depends on performance of the base

6.7 Absorption of Production Overheads and production capacity

Overheads shall be analysed into variable overheads and fixed overheads.

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

The fixed production overheads and other similar item of fixed costs such as quality control cost shall be absorbed in the production cost on the basis of the normal capacity or actual capacity utilization of the plant, whichever is higher.

In case of less production than normal, under-absorption of overheads shall be adjusted with Costing Profit & Loss Account. In case of higher production than normal, the over-absorption of overheads shall also be adjusted with Costing Profit & Loss Account.

8.8 Absorption of Production overheads :

Production Overheads absorption rate for each cost centre is to be determined with the help of quantum base as indicated in 5.6 above and the formula as indicated below :

Fixed Overhead Absorption Rate = [Fixed Overheads / Normal or actual quantum of base, (whichever is higher)]

Variable overheads absorption rate = (Variable overheads / Actual quantum of base)

5.9 A pre-determined rate may be used on a provisional basis for internal management decision making such as cost estimates for quotation, fixation of selling price etc. These rates are to be calculated for each cost centre for a particular period. Budgeted overheads for the respective cost centres for the period concerned are to be taken as numerator and budgeted normal base for the period as denominator for determining the rate.

Pre-determined Overhead Rate = [Budgeted overheads for the period / Budgeted normal base for the period]

The amount of total overheads absorbed by a product, service or activity will be the sum total of the overheads absorbed from individual cost centres on pre-determined basis. The difference between overheads absorbed on pre-determined basis and the actual overheads incurred is the under- or over-absorption of overheads.

The under- or over- absorption of overheads is mainly due to variation between the estimation and actual.

6. Apportionment and absorption of Administrative Overheads

1.1 Administrative overheads include the following items of cost :

Printing and stationery, other office supplies

Employees cost – salaries of administrative staff

Establishment expenses – Office rent & rates, insurance, depreciation of office building and other assets, legal expenses, audit fees, bank charges etc.

1.2 Administrative overheads are to be collected in different cost pools such as :

- General Office
- Personnel department
- Accounts department
- Legal department
- Secretarial department etc

1.3 Administrative overheads are to be further analysed into two – one for production activities and other for sales and distribution activities. Costs collected under the cost pools indicated in 6.2 above are to be distributed to administrative overheads relating to production activities and administrative overheads relating to selling and distribution activities on rational basis for each cost pool.

1.4 Administrative overheads relating to production activities are to be apportioned to different production cost centres on the basis conversion costs of production cost centres. The apportioned overheads are absorbed to products on the basis of the normal capacity or actual capacity, whichever is higher.

In case of under-absorption or over-absorption of administrative overheads relating to production, the same shall also be adjusted with Costing Profit & Loss Account.

7. **Apportionment and absorption of Selling overheads and Distribution overheads**

7.1 ***The selling overheads and distribution overheads are collected under different cost pools such as :***

Selling Overheads :

(i) Sales Employees cost

(ii) Rent

(iii) Traveling expenses

(iv) Warranty claim

(v) Brokerage & Commission

(vi) Advertisement relating to sales and sales promotion

(vii) Sales incentive

(viii) Bad debt etc

Distribution Overheads :

(i) Secondary Packaging

(ii) Freight & forwarding

(iii) Warehousing & storage

(iv) Insurance etc.

2.2 Some items of selling overheads and distribution overheads are directly identified and absorbed to products or services and remaining part of selling and distribution overhead along with the with share of administration overheads relating to selling and distribution activities are to be apportioned to various products or jobs or services on the basis of net actual sales value (i.e. Gross sales value less excise duty, sales tax and other government levies).

8. **Presentation and Disclosure:**

1.1 Once the basis of collection, allocation , apportionment and absorption for different production cost centres are selected, the same shall be followed consistently and uniformly

1.2 Change in basis for collection, allocation, apportionment and absorption can be adopted only when it is compelled by the change in circumstances like change in technology, *refinement and improvement in the basis* ***etc and the change would provide more scientific approach. In case of such changes, proper disclosure in cost records is essential..***

1.3 Any change in basis for collection, allocation, apportionment and absorption which has a material effect on the cost of the product should be disclosed in the cost statements. Where the effect of such change is not ascertainable wholly or partly, the fact should be indicated in the cost 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% 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.

5. 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.

2.2 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.

2.2 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.

2.3 **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 stage3, the scrap is produced and the same is recycled at stage2 after making an expenditure of Rs 200 per MT to make it suitable for re-processing at stage2, then scrap will be valued @ ₹ (2500 – 200) i.e ₹ 2300. If no expenditure is involved to make scrap re-usable, the scrap value will be @ Rs 2500. The scrap value for the scrap produced during a period calculated at the rate as explained above may be deducted to find out the cost of production for the period.

5.13 Miscellaneous Income

Miscellaneous income relating to production shall be adjusted in the calculation of cost of production, for example, income from sale of empty containers used for despatch of the captively consumed goods produced under reference.

5.14 Inputs received free of cost

In case any input material, whether of direct or indirect nature, including packing material is supplied free of cost by the user of the captive product, the landed cost of such material shall be included in the cost of production.

5.15 Moulds, Tools, Dies & Patterns etc received free of cost

The amortization cost of such items shall be included in the cost of production.

5.16 Interest and financial charges

Interest and financial charges being a financial charge shall not be considered to be a part of cost of production.

5.17 Abnormal and non-recurring cost

Abnormal and non-recurring cost arising due to unusual or unexpected occurrence of events, such as heavy break down of plants, accident, market condition restricting sales below normal level, abnormal idle capacity, abnormal process loss, abnormal scrap and wastage, payments like VRS, retrenchment compensation, lay-off wages etc. The abnormal cost shall not form the part of cost of production.

6. Cost Sheet

The cost sheet should be prepared in the format as par Appendix – 1 or as near thereto as possible. The manufacturer will be required to maintain cost records and other books of account in a manner, which would facilitate preparation and verification of the cost of production. For manufacturers covered under the ambit of Section 209(1)(d) of the Companies Act, 1956, i.e., where Cost Accounting Records are statutorily required to be maintained, the Cost Accountant certifying the cost of production for captive consumption shall verify the correctness of the cost from these records. However, for manufacturers not covered under Section 209(1)(d) of the Companies Act, 1956, it is desirable that they also maintain cost accounting records in line with the records so prescribed as to facilitate determination and certification of cost of production.

7. Disclosure

(i) If there is any change in cost accounting principles and practices during the concerned period which may materially affect the cost of production in terms of comparability with previous periods, the same should be disclosed.

(ii) If opening stock and closing stock of work -in-progress and finished goods are not readily available for certification purpose, the same should be disclosed.

Appendix – 1

Name of the Manufacturer :
Address of the Manufacturer:
Registration No of Manufacturer:
Description of product captively consumed:
Excise Tariff Heading:

Statement of Cost of Production of _____________ manufactured / to be manufactured during the period _____________

		Qty	
Q1	Quantity Produced (Unit of Measure)		
Q2	Quantity Despatched (Unit of Measure)		
	Particulars	Total Cost (₹)	Cost/unit (₹)
1.	Material Consumed		
2.	Direct Wages and Salaries		
5.	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		
15.	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.**

Illsustration 1. Raj & Co. furnish the following expenditure incurred by them and want you to find the assessable value for the purpose of paying excise duty on captive consumption. Determine the cost of production in terms of rule 8 of the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 and as per CAS-4 (cost accounting standard) (i) Direct material cost per unit inclusive of excise duty at 10% - ₹ 1,320 (ii) Direct wages - ₹ 250 (iii) Other direct expenses - ₹ 100 (iv) Indirect materials - ₹ 75 (v) Factory Overheads - ₹ 200 (vi) Administrative overhead (25% relating to production capacity) ₹ 100 (vii) Selling and distribution expenses - ₹ 150 (viii) Quality Control - ₹ 25 (ix) Sale of scrap realized - ₹ 20 (x) Actual profit margin - 15%.

Solution: Computation of Cost of Production (as per CAS-4)

Particulars	**Amount (₹)**
Direct Material (exclusive of Excise Duty) [1,320 x 100/112.36]	1,174.80
Direct Labour	250.00
Direct Expenses	100.00
Works Overhead [indirect material (75) plus Factory OHs (200)]	275.00
Quality Control Cost	25.00
Research & Development Cost	Nil
Administration Overheads (to the extent relates to production activity)	25.00
Less: Realizable Value of scrap	(20.00)
Cost of Production	1,829.80
Add: 10% as per Rule 8	183.00
Assessable Value	2,012.80

Illustration 2. Determine the cost of production on manufacture of the under-mentioned product for purpose of captive consumption in terms of Rule 8 of the Central Excise Valuation (DPE) Rules, 2000 - Direct material - ₹ 11,600, Direct Wages & Salaries - ₹ 8,400, Works Overheads - ₹ 6,200, Quality Control Costs - ₹ 3,500, Research and Development Costs - ₹ 2,400, Administrative Overheads - ₹ 4,100, Selling and Distribution Costs ₹ 1,600, Realisable Value of Scrap - ₹ 1,200. Administrative overheads are in relation to production activities. Material cost includes Excise duty ₹ 1,054.

Solution: Cost of production is required to be computed as per CAS-4. Material cost is required to be exclusive of CENVAT credit available.

Particulars	**Amount (₹)**
Material Consumed (Net of Excise duty) (11,600 – 1,054)	10,546
Direct Wages and Salaries	8,400
Direct Expenses	--
Works Overheads	6,200
Quality Control Cost	3,500
Research and Development Cost	2,400
Administrative Overheads	4,100
Less: Sale of Scrap	(1,200)
Cost of Production	33,946
Add: 10% Profit margin on cost of production (i.e. 33,946 x 10%)	3,395
Assessable Value as per Rule 8 of the valuation rules	37,341

Note - (1) Indirect labour and indirect expenses have been included in Works Overhead

(2) In absence of any information, it is presumed that administrative overheads pertain to production activity.

(3) Actual profit margin earned is not relevant for excise valuation.

Illustration 3. Hero Electronics Ltd. is engaged in the manufacture of colour television sets having its factories at Kolkata and Gujarat. At Kolkata the company manufactures picture tubes which are stock transferred to Gujarat factory where it is consumed to produce television sets. Determine the Excise duty liability of captively consumed picture tubes from the following information: - Direct material cost (per unit) ₹ 800; Direct Labour ₹ 100; Indirect Labour ₹ 50; Direct Expenses ₹ 100; Indirect Expenses ₹ 50; Administrative Overheads ₹ 50; Selling and Distribution Overheads ₹ 100. Additional Information: - (1) Profit Margin as per the Annual Report of the company for 2012-13 was 12% before Income Tax. (2) Material Cost includes Excise Duty paid ₹ 73 (3) Excise Duty Rate applicable is 12%, plus education cess of 2% and SHEC @ 1%.

Solution: Cost of production is required to be computed as per CAS-4. Material cost is required to be exclusive of CENVAT credit available.

Computation of Cost of Production (as per CAS-4)

Particulars	Amount (₹)
Material Consumed (Net of Excise duty)(800 – 73)	727
Direct Wages and Salaries	100
Direct Expenses	100
Works Overheads	100
Quality Control Cost	--
Research and Development Cost	--
Administrative Overheads (relating to production capacity)	50
Less: Sale of Scrap	--
Cost of Production	1,077
Add: 10% Profit margin on cost of production (i.e. 33,946 x 10%)	108
Assessable Value as per Rule 8 of the valuation rules	1,185

Note - (1) Indirect labour and indirect expenses have been included in Works Overhead

(2) In absence of any information, it is presumed that administrative overheads pertain to production activity.

(3) Actual profit margin earned is not relevant for excise valuation.

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**

1.1 To bring uniformity in the application of principles and methods used in the determination of averaged/equalized transportation cost.

1.2 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.

3.3 To provide transparency in the determination of cost of transportation.

3. **Scope**

1.1 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 :

1.1 ***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.

1.2 ***Inward Transportation cost is the transportation expenses incurred in connection with materials / goods received at factory or place of use or sale/removal.***

1.3 ***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***

1.4 ***Freight is the charges paid or payable to an outside agency for transporting materials/ goods from one place to another place.***

1.5 ***Cartage is the expenses incurred for movement of goods covering short distance for further transportation for delivery to customer or storage.***

1.6 ***Transit insurance cost is the amount of premium to be paid to cover the risk of loss /damage to the goods in transit.***

1.7 ***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.

1.8 ***Equalized transportation cost means average transportation cost incurred during a specified period.***

1.9 ***Equalized freight means average freight.***

5. Maintenance of records for ascertaining Transportation Cost

1.1 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.

1.2 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.

1.3 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.

1.4 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.

1.5 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.

1.6 Records for transportation cost from factory to depot and thereafter shall be maintained separately.

1.7 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.

1.8 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.

1.9 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.

1.10 For common transportation cost, both for own fleet or hired ones, proper records for basis of apportionment should be maintained.

1.11 Records for transportation cost for exempted goods, excisable goods cleared for export shall be maintained separately.

1.12 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:

1.1 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.

1.2 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.

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

4.5 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 6.5. 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	
B5.	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)	
B15.	**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)	
C5.	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)	

Appendix 3

Name of the Manufacturer:
Address of the Manufacturer:
Statement of apportionment of Outward Transportation Cost to different goods and Determination of Averaged outward Transport Cost for the period ending……..

A	Quantitative Information	Total	Excisable goods		Specific Rated Goods	Goods Cleared for Export	Exempted goods	Goods cleared on MRP basis	Goods cleared from factory to Customer	Others (Specify)
			Product Group 1	Product Group 2	Product Group 3					
A1	Goods transported outwards (UM*)									
A2	Goods Transport 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 = Unit of Measurement

Seal & 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 Fairview of the average transport cost.

Date: Seal & Signature of Cost Accountant

Place: 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.

5. 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.[3]***

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 6.5.5
3 Adapted from CIMA Terminology

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[4].***

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[5].***

4.6.2 Indirect Materials: ***Materials, the costs of which cannot be directly attributed to a particular cost object[6].***

4.7 Material Cost: ***The cost of material of any nature used for the purpose of production of a product or a service[7].***

4.8 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.

4.9 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[9].***

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.[10] 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[11].***

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,***

4 CAS 1- Para 6.5.13
5 Adapted from CAS 1-6.2.3
6 Adapted from CAS 1– 6.2.8
7 CAS-1-6.1.2
8 Adapted from CAS-1 Para 6.5.3 and 6.5.4
9 Adapted from Glossary of Management Accounting Terms- Page 62
10 Adapted from CAS 1_ Para 6.7.5
11 Adopted from Glossary of Management Accounting Terms page 70

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

6.5.1 ***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.***

6.5.2 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.

6.5.3 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[12] 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.*

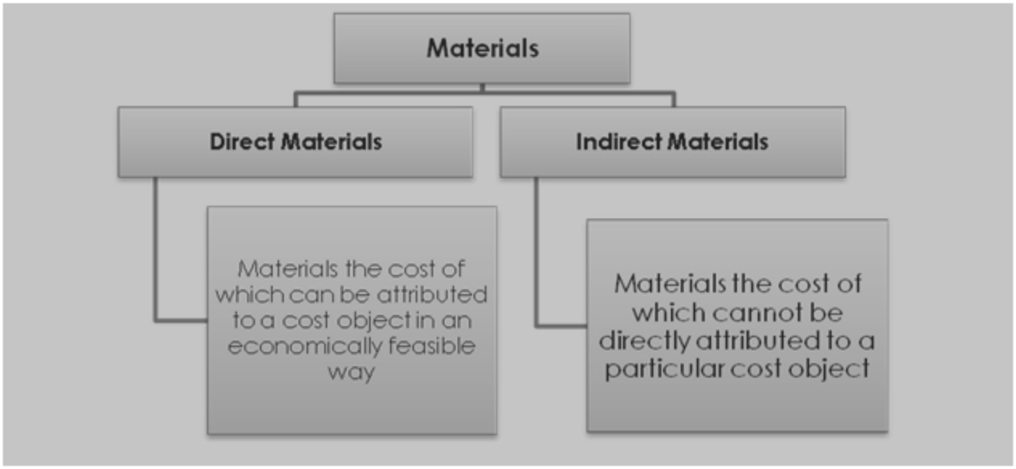
8.10 *Disclosures may be made in the body of the Cost statement or as a footnote or as a separate schedule.*

<u>Cost Accounting Standard-6:</u> <u>Material Cost</u>:

***"Material cost is defined as cost of material of any nature used for the purpose of production of a product or a service"*.**

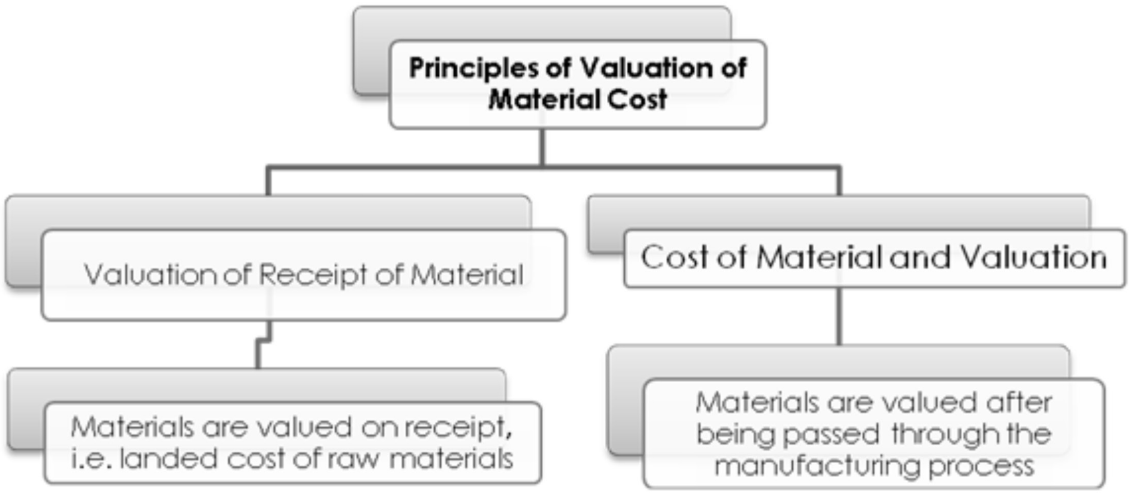
<u>Cost Accounting Standard-6:</u> <u>Material Cost</u>:

***"Material cost is defined as cost of material of any nature used for the purpose of production of a product or a service"*.**



12 Related party as per the applicable legal requirements relating to the cost statement as on the date of statements

Principles of Valuation of Material Cost: The principles to be followed for valuation of materials are:



Valuation of Receipts of Materials: Inclusions and Exclusions:

The following items are to be **'included'** for the purpose of determining valuation of receipt of materials:

- Purchase price;
- Duties and Taxes ;
- Freight Inwards ;
- Insurance ;
- Other expenditure directly attributable to procurement and can be quantified with reasonable accuracy at the time of procurement ;
- Self-manufactured packing materials shall be valued including direct material cost, direct employee cost, direct expenses, job charges, factory overheads and other directly related overheads.

The following items are to be **'excluded'** for the purpose of determining valuation of receipt of materials:

- Trade Discounts (Cash Discount being a financial income is not to be netted off against cost of materials)
- Rebates
- Taxes and duties refundable or credited by tax authorities

  (CENVAT Credits, Credit for countervailing customs duty, sales tax set off, VAT Credits and other similar items)

Note:

(1) The items specified as 'include' should be considered only if it is not included earlier in the material cost. If those items are already included earlier, then those may be ignored for the purpose of computation of material cost.

(2) The items specified as 'exclude' should be excluded only if it is already included in material cost. If those items are not included earlier, then those may be ignored for the purpose of computation of material cost.

Illustration 1: Valuation of Receipt of Material

Purchase of Materials ₹ 2,00,000 (inclusive of Trade Discount ₹ 3,000); Fee on Board ₹ 10,000; Import Duty paid ₹ 15,000; Freight inward ₹ 20,000 ; Insurance paid for import by sea ₹12,000; Rebates allowed ₹ 4,000; Cash discount ₹ 3,000; CENVAT Credit refundable ₹ 7,000; Subsidy received from the Government for importation of these materials ₹ 18,000. Compute the landed cost of material (i.e. value of receipt of material).

Computation of Material Cost Sheet

	Particulars	**Amount (₹)**
	Purchase price of Material	2,00,000
Add	Fee on Board	10,000
Add	Import Duties of purchasing the material	15,000
Add	Freight Inward during the procurement of material	20,000
Add	Insurance paid	12,000
	Total	**2,45,000**
Less	Trade Discount	3,000
Less	Rebates	4,000
Less	CENVAT Credit refundable	7,000
Less	Subsidy received from the Government for importation of materials	18,000
	Value of Receipt of Material	**2,13,000**

Note:

(i) Cash discount is not allowed, as it is a financial item.

(ii) Subsidy received, rebates and CENVAT Credit refundable are to be deducted for the purpose of computing the material cost.

Illustration 2: Valuation of Receipt of Material (special treatment related of losses)

Purchase of Materials ₹ 5,00,000 (inclusive of Trade Discount ₹ 8,000); Import Duty paid ₹ 45,000; Freight inward ₹ 62,000 ; Insurance paid for import by air ₹ 28,000; Rebates allowed ₹ 10,000; Cash discount ₹ 3,000; CENVAT Credit refundable ₹ 7,000; Abnormal Loss of Materials ₹14,000; Price variation due to computation of cost under standard rates ₹ 1,500. Compute the landed cost of material.

Solution:

Computation of Landed Cost of Material

	Particulars	**Amount (₹)**
	Purchase price of Material	5,00,000
Add	Import Duties of purchasing the material	45,000
Add	Freight Inward during the procurement of material	62,000
Add	Price Variation due to computation of cost under standard rates	1,500
	Total	**6,08,500**
Less	Trade Discount	8,000
Less	Abnormal Loss of materials	14,000
Less	Rebates	10,000
	Value of Receipt of Material	**5,76,500**

Note:

(i) Normal loss is not deducted

(ii) Price variation is allowable inclusion as the cost was maintained on standard cost.

Valuation and Cost of Materials: Inclusions and Exclusions:

The following items are to be **'included'** for the purpose of determining valuation of materials:

- Normal loss or spoilage prior to receipt at factory gate net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal
- Normal losses due to shrinkage or evaporation or gain due to elongation or absorption of moisture before receipt of material
- Foreign exchange component of material cost converted at the rate on the date of transaction
- Subsidy/Grant/Incentive and any similar payments received or receivable which can be ascertained with certainty shall be reduced.
- Price Variances when materials are accounted for at standard cost
- Self-manufactured components and sub-assemblies to be valued inclusive of direct material cost, direct employee cost, direct expenses, factory overheads and share of administrative overheads relating to production
- Material cost of normal scrap/defectives to be included in the material cost of manufactured goods

The following items are to be **'excluded'** for the purpose of determining valuation of receipt of materials:

- Finance costs
- Abnormal losses due to shrinkage or evaporation or gain due to elongation or absorption of moisture before receipt of material
- Changes in foreign exchange rate from the rate on date of transaction till date of payment
- Demurrage or detention charges or penalty levied by transport or other authorities
- Imputed costs
- Cost of self-manufactured components and sub-assemblies shall not include share of other administrative overheads, finance cost and marketing overheads
- Material cost of abnormal scrap/defectives not to be included

Illustration 3: Valuation of Receipt of Material (special treatment related to exchange rate difference)

Purchase of Materials $ 50,000 [Forward contract rate $ = 54.40 but $ = 54,60 on the date of importation] ; Import Duty paid ₹5,65,000; Freight inward ₹1,62,000 ; Insurance paid for import by road ₹48,000; Cash discount ₹33,000; CENVAT Credit refundable ₹37,000; Payment made to the foreign vendor after a month, on that date the rate of exchange was $ = 55,20. Compute the landed cost of material.

Solution:

Computation of Landed Cost of Material

	Particulars	**Amount (₹)**
	Purchase price of Material [50,000 x 54.60]	27,30,000
Add	Import Duties of purchasing the material	5,65,000
Add	Any taxes paid during the purchase of material	1,62,000
Add	Freight Inward during the procurement of material	48,000
Add	Insurance of the material (In case of import of material by Road / Sea)	28,000
	Total	**35,33,000**
Less	CENVAT Credit refundable	37,000
	Value of Receipt of Material	**34,96,000**

Note:

(i) Excess payment made to the vendor due to exchange fluctuation is not an includible cost, hence not considered.

(ii) Though the forward contract rate was $ = 54.40, but the exchange rate on the date of importation is considered. Hence, included in the cost of materials. Accordingly, the purchase cost is computed considering the $ = 54.60.

Illustration 4: Valuation of closing stock of raw materials:

Opening stock of raw materials (10,000 units) ₹ 1,80,000; Purchase of Raw Materials (35,000 units) ₹ 7,00,000; Closing Stock of Raw Materials 7,000 units; Freight Inward ₹ 85,000; Self-manufactured packing material for purchased raw materials only ₹60,000 (including share of administrative overheads related to marketing sales ₹ 8,000); Demurrage charges levied by transporter for delay in collection ₹ 11,000; Normal Loss due to shrinkage 1% of materials ; Abnormal Loss due to absorption of moisture before receipt of materials 100 units.

Solution:

Computation of value of closing stock of raw materials [Average Cost Method]

	Particulars	**Quantity (Units)**	**Amount (₹)**
	Opening Stock of Raw Materials	10,000	1,80,000
Add	Purchase of raw materials	35,000	7,00,000
Add	Freight inwards		85,000
Add	Demurrage Charges levied by transporter for delay in collection		11,000
			9,76,000
Less	Abnormal Loss of raw materials (due to absorption of moisture before receipt of materials) = [(7,00,000 + 85,000 + 11000) x 100]/35,000	(100)	(2,274)
Less	Normal loss of materials due to shrinkage during transit [1% of 35,000 units]	(350)	-----
Add	Cost of self-manufactured packing materials for purchased raw materials only (60,000 – 8,000)		52,000
	Cost of raw materials	**44,450**	**10,25,726**
Less:	Value of Closing Stock = Total Cost / (Total units – Units of Normal Loss) [10,25,726/(10,000+35,000 – 350)]x 7,000	(7,000)	(1,61,169)
	Cost of Raw Materials Consumed	**37,450**	**8,64,557**

Note:

(i) Units of normal loss adjusted in quantity only and not in cost, as it is an includible item

(ii) Cost of self-manufactured packing materials does not include any share of administrative overheads or finance cost or marketing overheads. Hence, marketing overheads excluded.

(iii) Abnormal loss of materials arised before the receipt of the raw materials, hence, valuation done on the basis of costs related to purchases only. Value of opening stock is not considered for arriving at the valuation of abnormal loss.

(iv) Demurrage charges paid to transporter is an includible item. Since this was paid to the transporter, hence considered before estimating the value of abnormal loss

ALTERNATIVELY, SOLVING THE ABOVE ILLUSTRATION BASED ON FIFO METHOD

Computation of value of closing stock of raw materials [FIFO Method]

	Particulars	**Quantity (Units)**	**Amount (₹)**
	Opening Stock of Raw Materials	10,000	1,80,000
Add	Purchase of raw materials	35,000	7,00,000
Add	Freight inwards		85,000
Add	Demurrage Charges levied by transporter for delay in collection		11,000
			9,76,000
Less	Abnormal Loss of raw materials (due to absorption of moisture before receipt of materials) = [(7,00,000 + 85,000 + 11000) x 100]/35,000	(100)	(2,274)
Less	Normal loss of materials due to shrinkage during transit = [1% of 35,000 units]	(350)	-----
Add	Cost of self-manufactured packing materials for purchased raw materials only (60,000 – 8,000)		52,000
	Cost of Raw Materials	**44,550**	**10,25,726**
Less:	Value of Closing Stock = Total Cost / (Total units – Units of Normal Loss) Where Total Cost = = [7,00,000 + 85,000 + 11,000 -2,274 + 52,000] = 8,45,726 And Total Units = [35,000 – 1% of 35,000] = 34,650 units Value of Closing Stock = [8,45,726 x 7,000]/ 34,650	(7,000)	(1,70,854)
	Cost of Raw Materials Consumed	**37,550**	**8,54,872**

Note:

(i) Since FIFO method is followed, hence for the purpose of estimating the units sold/used/consumed, it is presumed that there is no units left out of units in opening stock.

(ii) Since normal loss is in transit, hence it is calculated on units purchased only.

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.***

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.***

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.***

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.***

4.7 **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.

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.

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.***

4.10 Indirect Employee Cost: ***The cost which can not be directly attributed to a particular cost object.***

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.***

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.***

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.***

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.*
7. *Employee cost incurred in foreign exchange.*

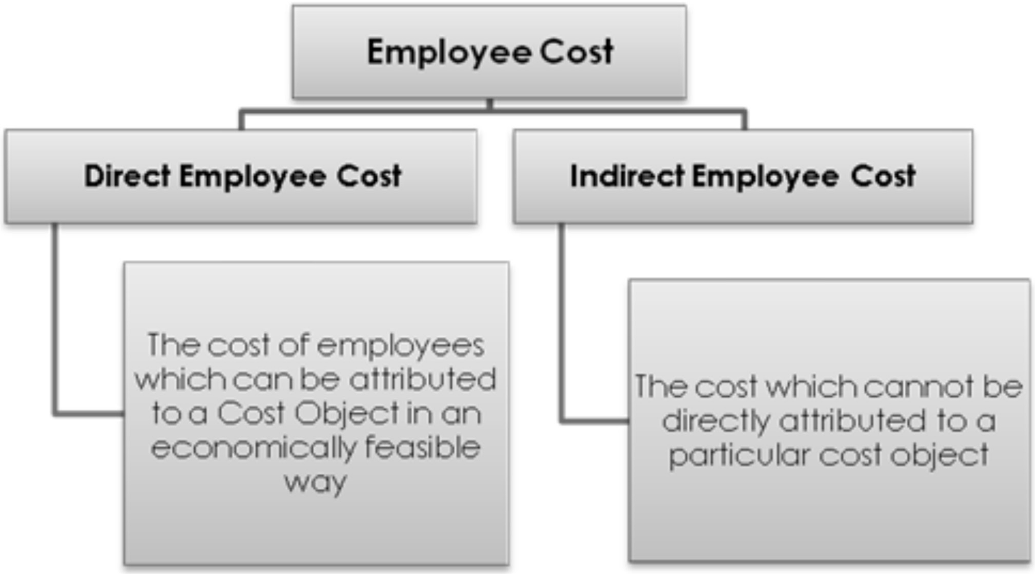
8.2 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the Employee Cost during the period covered by the cost statement which has a material effect on the Employee Cost. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

8.3 *Disclosures shall be made only where material, significant and quantifiable.*

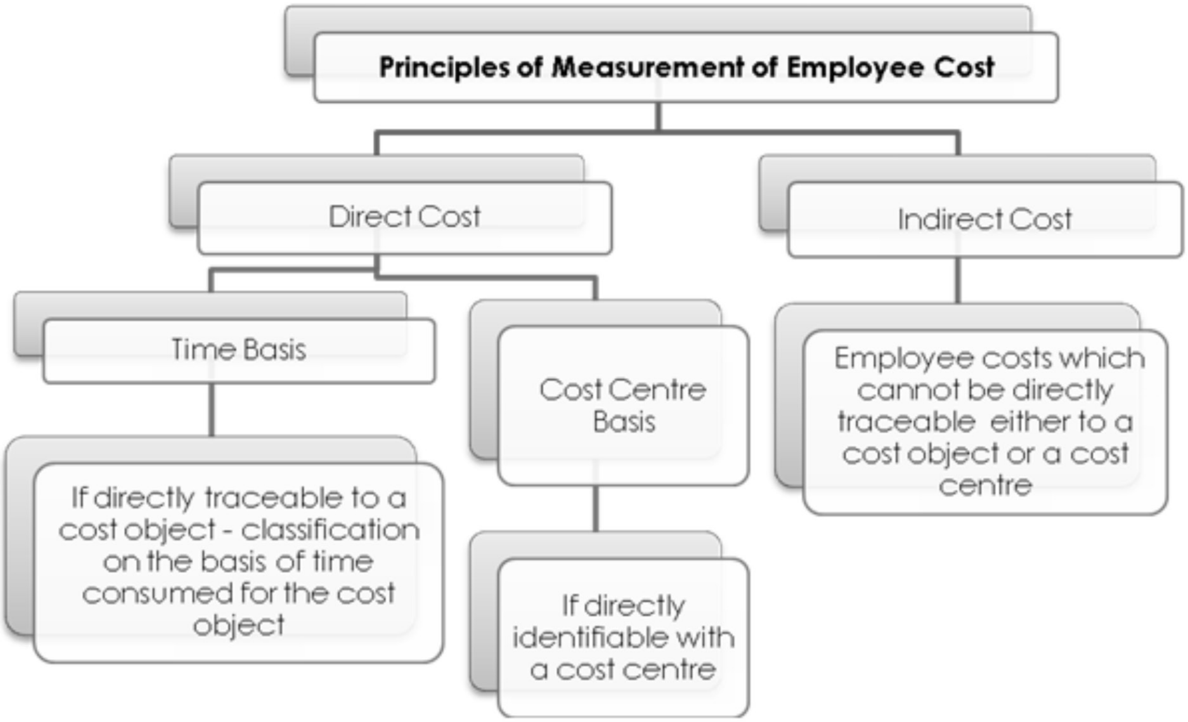
8.4 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.*

Cost Accounting Standard-7: Employee Cost:

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.



Principles of Measurement of Employee Cost: The principles to be followed for measurement of employee cost are:



Measurement of Employee Cost: Inclusions and Exclusions:

The following items are to be **'included'** for the purpose of measuring employee cost:

- Any payment made to an employee either in cash or kind
- Gross payments including all allowances payable and includes all benefits
- Bonus, ex-gratia, sharing of surplus, remuneration payable to Managerial personnel including Executive Directors and other officers
- Any amount of amortization arising out of voluntary retirement, retrenchment, termination, etc
- Variance in employee payments/costs, due to normal reasons (if standard costing system is followed)
- Any perquisites provided to an employee by the employer

The following items are to be **'excluded'** for the purpose of measuring employee cost:

- Remuneration paid to Non-Executive Director
- Cost of idle time [= Hours spent as idle time x hourly rate]
- Variance in employee payments/costs, due to abnormal reasons (if standard costing system is followed)
- Any abnormal payment to an employee – which are material and quantifiable
- Penalties, damages paid to statutory authorities or third parties
- Recoveries from employees towards benefits provided – this should be adjusted/reduced from the employee cost
- Cost related to labour turnover – recruitment cost, training cost and etc
- Unamortized amount related to discontinued operations.

Illustration 5: Measurement of Employee Cost

Basic pay ₹5,00,000; Lease rent paid for accommodation provided to an employee ₹2,00,000, amount recovered from employee ₹40,000, Employer's Contribution to P.F. ₹75,000, Employee's Contribution to P.F. ₹75,000; Reimbursement of Medical expenses ₹67,000, Hospitalisation expenses of employee's family member borne by the employer ₹19,000, Festival Bonus ₹20,000, Festival Advance ₹30,000. Compute the Employee cost.

Solution:

Computation of Employee Cost

Particulars		**Amount (₹)**
	Basic Pay	5,00,000
Add	Net cost to employer towards lease rent paid for accommodation provided to an employee [= lease rent paid less amount recovered from employee] = [2,00,000 (-) 40,000]	1,60,000
Add	Employer's Contribution to PF	75,000
Add	Reimbursement of Medical Expenses	67,000
Add	Hospitalisation expenses of employee's family member paid by the employer	19,000
Add	Festival Bonus	20,000
	Employee Cost	**8,41,000**

Note:

(i) Festival advance is a recoverable amount, hence not included in employee cost.

(ii) Employee's contribution to PF is not a cost to the employer, hence not considered.

Illustration 6: Measurement of Employee Cost (with special items)

Gross pay ₹10,30,000 (including cost of idle time hours paid to employee ₹25,000); Accommodation provided to employee free of cost [this accommodation is owned by employer, depreciation of accommodation ₹1,00,000, maintenance charges of the accommodation ₹90,000, municipal tax paid for this accommodation ₹3,000], Employer's Contribution to P.F. ₹1,00,000 (including a penalty of ₹2,000 for violation of PF rules), Employee's Contribution to P.F. ₹75,000. Compute the Employee cost.

Solution:

Computation of Employee Cost

	Particulars	Amount (₹)
	Gross Pay (net of cost of idle time) =[10,30,000 (-) 25,000]	9,95,000
Add	Cost of accommodation provided by employer = Depreciation (+) Municipal Tax paid (+) maintenance charges = 1,00,000 + 90,000 + 3,000 = 1,93,000	1,93,000
Add	Employer's Contribution to PF excluding penalty paid to PF authorities [= 1,00,000 (-) 2,000]	98,000
	Employee Cost	**12,86,000**

Note:

(i) Assumed that the entire accommodation is exclusively used by the employee. Hence, cost of accommodation provided includes all related expenses/costs, since these are identifiable/traceable to the cost centre.

(ii) Cost of idle time hours is an excludible item. Since it is already included in the gross pay, hence excluded.

(iii) Penalty paid to PF authorities is not a normal cost. Since, it is included in the amount of contribution, it is excluded.

Illustration 7: Measurement of Employee Cost (with special items)

Trial Balance as on 31.3.2013 *(relevant extracts only)*

Particulars	Amount (₹)	Particulars	Amount (₹)
Materials consumed	25,00,000		
Salaries	15,00,000	Special Subsidy received from Government towards Employee salary	2,75,000
Employee Training Cost	2,00,000	Recoverable amount from Employee out of perquisites extended	35,000
Perquisites to Employees	4,50,000		
Contribution to Gratuity Fund	4,00,000		
Lease rent for accommodation provided to employees	3,00,000		
Festival Bonus	50,000		
Unamortised amount of Employee cost related to a discontinued operation	90,000		

Solution:

Computation of Employee Cost

	Particulars	**Amount (₹)**
	Salaries	15,00,000
Add	Net Cost of Perquisites to Employees = Cost of Perquisites (-) amount recoverable from employee = 4,50,000 (-) 35,000	4,15,000
Add	Lease rent paid for accommodation provided to employee	3,00,000
Add	Festival Bonus	50,000
Add	Contribution to Gratuity Fund	4,00,000
Less	Special subsidy received from Government towards employee salary	(2,75,000)
	Employee Cost	**23,90,000**

Note:

(i) Recoverable amount from employee is excluded from the cost of perquisites.

(ii) Employee training cost is not an employee cost. It is to be treated as an Overhead, hence, not included.

(iii) Special subsidy received is to be excluded, as it reduces the cost of the employer.

(iv) Unamortized amount of employee cost related to a discontinued operation is not an includible item of cost.

(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

5.1 ***This standard shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of cost of utilities including those requiring attestation.***

5.2 ***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.***

5.3 ***This standard shall not be applicable to the organizations primarily engaged in generation and sale of utilities.***

5.4 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.***

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. 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.***

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.***

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.

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

5.5.2 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 5.5.1.

5.5.3 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.

5.5.4 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. 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:*

8. *The basis of distribution of Cost of Utility to the consuming centres.*

9. *The cost of purchase, production, distribution, marketing and price with reference to sales to outside parties.*

10. *Where cost of utilities is disclosed at standard cost, the price and usage variances.*

11. *The cost and price of Utility received from/supplied to related parties.*

12. *The cost and price of Utility received from/supplied as inter unit transfers and inter-company transfers*

13. *Cost of utilities incurred in foreign exchange.*

14. *Any Subsidy/Grant/Incentive and any such payment reduced from Cost of utilities.*

15. *Credits/recoveries relating to the Cost of utilities.*

16. *Any abnormal cost excluded from Cost of utilities.*

17. *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.***

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.***

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.*** 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.***

4.7 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.***

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. 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.***

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.

4.11.1Defectives: ***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.***

Rework includes repairs, reconditioning and refurbishing.

4.11.1.2 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.

4.11.2 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.***

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, feedback, and final evaluation cost.***

4.13 Production overheads: ***Indirect costs involved in the production process or in rendering service.***

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.***

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 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.

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.***
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.***

(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.

5. 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.***

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.***

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.*** 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.***

4.6 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. The terms Finance costs and Borrowing costs are used interchangeably.

4.7 Imputed Costs: ***Hypothetical or notional costs, not involving cash outlay, computed for any purpose.***

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.***

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.***

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.***
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.***

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.***

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 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. 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.***

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.***

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.***

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.

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.***
- ***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.***

(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. 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.***

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.

4.6 Production overheads: ***Indirect costs involved in the production process or in rendering service.***

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.

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 – 5.***

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.***
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.***

5.15.5 High value spare when replaced by a new spare and if it is reconditioned, which is expected to result in future economic benefits, the same should be taken into stock. Major overhaul is a periodic (generally more than one year) repair work carried out to substantially restore the asset to intended working condition and the cost of such repair work is expensed off in the year of incurrence and would form part of Repairs & Maintenance Cost. The principle is explained with the help of the example below.

Cost of equipment	₹10.00 crores
Cost of a major spare	₹ 1.00 crore

When the major spare is issued as a replacement, it will be taken to maintenance cost (debit). At this time, the old (replaced) spare is taken for reconditioning.

Let us assume that the original spare will have a life of five years and the reconditioned spare a life of one year. The value of the service potential of the reconditioned spare can therefore be put as ₹ 20 lakhs.

Let us further assume that the cost of reconditioning is ₹15 lakhs. This will also be taken to maintenance cost (debit).

The reconditioned spare will be taken to inventory (debit) and relieved from maintenance cost (credit). The amount to be taken should be the measure of the service potential of the reconditioned spare which is ₹20 lakhs. However, accounting to CAS-12 the amount to be taken to inventory (debit) and relieved from maintenance cost (Credit) should not exceed the cost of reconditioning viz. ₹ 15 lakhs.

The accounting entries would be as below:

Repairs & Maintenance Dr.	100.00 lakhs	
Inventory (Spares) Cr.		100.00 lakhs
(Being spare part issued replacing the old spare)		
Repairs & Maintenance Dr.	15.00 lakhs	
Cash Cr.		15.00 lakhs
(Being cost of repair & reconditioning of old spare)		
Inventory (Spares) Dr.	15.00 lakhs	
Repairs & Maintenance Cr.		15.00 lakhs
(Being Reconditioned Spare taken to stock)		

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.***

4.2 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 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.***

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. 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.***

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.***

4.9 Production Overheads: ***Indirect costs involved in the production process or in rendering service.***

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.***

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.***

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.

4.13 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. 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.*

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.***
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.***

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.

4.2 Air Pollution: Air pollution means the presence in the atmosphere of any air pollutant.

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.

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.

4.6 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.

4.7 Environment Pollution: Environmental pollution means the presence in the environment of any environmental pollutant.

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. 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.

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.

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. 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.

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.

Section 2 (e) of The Water (Prevention and Control of Pollution) Act, 1974

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 – 5.*

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.

5. Pollution Control cost of Jobs done in-house and outsourced separately.

4. Pollution Control cost paid/ payable to related parties15.

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.

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]

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[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

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. 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.

[6] CAS 3 (Revised 2011) Para 4.15

[7] CAS 3 (Revised 2011) Para 4.11

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.

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.

[8] Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement

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.

Study Note - 5

COST BUILDING PROCESS, COMPLIANCE REPORT

This Study Note includes

5.1 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.

5.2 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.

5.3 THE SYSTEM - BASIC PARAMETERS

The objective of the statutory maintenance of cost accounting records as stipulated under section 209(1)(d) of the Companies Act 1956 reflected in any of the Cost Accounting Records Rules, applicable to every company engaged in production, processing, manufacturing and mining activity, require a company to maintain its cost accounting records in accordance with the Generally Accepted Cost Accounting Principles and the Cost Accounting Standards issued by the Institute of Cost Accountants of India.

The said Rules have not specified any specific methodology for maintenance of cost accounting records so long as there is adherence to the cost accounting standards and principles and a true and fair view of cost is determined of the products manufactured by the company. The information which are to be focussed by these records are required to be determined as per generally accepted cost accounting principles and the control aspects have been left with the company to install. The cost accounting system should incorporate these control measures and maintain such records as would serve the purpose of maintenance of the statutory cost accounting records as well.

The Central Government has also introduced the concept of industry specific cost audit. The specific requirements of a cost audit and the report of cost audit is as stipulated in the Companies (Cost Audit Report) Rules 2011. The requirements of the cost audit report also gives a guideline regarding the methodology and different cost elements that are required to be maintained.

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.

5.4 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.

5.5 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.

5.6 COMPLIANCE REPORT

5.1 Introduction:

The new cost accounting records rules have provided for submission of a Compliance Report in respect of every company that are required to maintain any of the cost accounting records under the applicable rules. The Compliance Report introduced in the Rules is a simple format of certification with 2 Annexures that would ensure proper maintenance of the cost accounting records by the companies. This mechanism of ensuring compliance is a new measure introduced by the Ministry of Corporate Affairs.

5.2 Definition of Compliance Report and specific provisions therefor

5.2.1 Rule 2(b): Definition of Compliance Report:

"Compliance Report means compliance report duly authenticated and signed by a cost accountant in the prescribed form of compliance report".

5.2.2 Rule 5: Form of the Compliance Report:

Every company to which the Companies (Cost Accounting Records) Rules 2011 apply shall submit a compliance report, in respect of each of its financial year commencing on or after the 1st day of April, 2011, duly certified by a cost accountant, along with the Annexure to the Central Government, in the prescribed form.

5.2.3 Rule 6: Time limit for submission of Compliance Report:

Every company shall submit the compliance report referred to in rule 5 to the Central Government within one hundred and eighty days from the close of the company's financial year to which the compliance report relates.

5.2.4 Rule 7: Authentication of Annexure to the Compliance Report:

"The Annexure prescribed with the compliance report, as certified by the cost accountant, shall be approved by the Board of Directors before submitting the same to the Central Government by the company".

5.2.5 In respect of the 6 Industry specific Rules, the following provision of Rule 5 is different from the Companies (Cost Accounting Records) Rules 2011 -

Every company to which any of the 6 regulated Industry Rules are applicable are required to submit a compliance report in respect of each of its financial year commencing on or after the date of publication of the Rules, i.e., December 7, 2011.

5.3 In respect of companies to which Companies (Cost Accounting Records) Rules 2011 apply, filing of compliance report is to be done in respect of every financial year commencing on or after April 1, 2011. In respect of companies to which any of the 6 Regulated Industries cost accounting records rules apply (viz., companies engaged in Pharmaceuticals, Fertilizers, Telecommunication, Sugar, Electricity or Petroleum) filing of compliance report is to be done in respect of every financial year commencing on or after December 7, 2011.

5.4 The Compliance Report shall be as per the notified Form-B and no other details of cost records are required to be filed with the Central Government.

5.5 If all the products/activities of a company, excluding the exempted categories, are covered under cost audit, then the company will not be required to separately file the compliance report.

5.6 As per Rule 5, the Compliance Report and annexure thereto in Form B is required to be certified by a "cost accountant" as defined under Rule 2(c). As per Rule 7, the annexure to the Compliance Report is to be duly approved by the Board of Directors. Cost accountant has been defined in the Rules as below.

> "Cost Accountant" for the purpose of these rules 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) and who is either a permanent employee of the company or holds a valid certificate of practice under sub-section (1) of section 6 and who is deemed to be in practice under sub-section (2) of section 2 of that Act and includes a firm of cost accountants".

5.7 The Council of the Institute of Cost Accountants of India has further clarified that "cost accountant" within the definition of these Rules does not include:

a) A member holding a part-time certificate of practice; or

b) A member who is in full time employment whose membership fees are in arrears;

c) A member of the Institute who has been admitted as a member through reciprocal arrangement of membership by virtue of being a member of Institute of Management Accountants USA.

5.8 A question may arise whether a partner of a professional firm, ***which is not a firm of cost accountants***, where the partner is also a member of the Institute of Cost Accountants of India would qualify for authenticating the Compliance Report.

5.8.1 In case the person concerned is a permanent employee of the company, he would be qualified to certify the Compliance Report as a "permanent employee" of the company.

5.8.2 However, being a partner of a firm which is not a firm of cost accountants, the person cannot be holding a full-time Certificate of Practice of the Institute of Cost Accountants of India as well. Hence, the person will not be qualified to authenticate a Compliance Report as a member of the Institute who is in full-time practice.

5.9 **Authentication of Compliance Report by the preparer of the records:**

A member of the Institute of Cost Accountants of India as per the Cost and Works Accountants Act 1959 & Regulations framed there under who is working as permanent employee of a company and responsible for maintenance of cost records therein can also authenticate Compliance Report of the same company.

5.10 **Cost Accountant holding part-time certificate of practice:**

A cost accountant is in full time employment and is also holding a part-time certificate of practice. A question may arise whether he can authenticate the Compliance Report of the company he is employed in as also Compliance Report of other group companies.

As per Rule 5, a cost accountant can authenticate the Compliance Report of the company where he is in full time employment in his capacity as a permanent employee and not in his capacity as a holder of part time certificate of practice. He is not eligible to authenticate Compliance Report of other group companies in his capacity of either being in full time employment or holding part time certificate of practice.

5.11 **Authentication of Compliance Report by a LLP Firm of Cost Accountants:**

Cost and Works Accountants Act 1959 (as amended) has now allowed Cost Accountants in practice to form Limited Liability Partnership Firms (LLP). In case a LLP is constituted for rendering "cost accounting" services as defined under Section 2 of the Cost and Works Accountants Act 1959 (as amended), in that case partners of the firm holding full-time certificate of practice can authenticate the Compliance Report.

5.12 **Authentication of Compliance Report by Cost Auditor:**

A cost accountant in full time practice or a firm of cost accountants appointed for conducting cost audit of a product/activity of a company is eligible to also authenticate the Compliance Report of the Company in respect of any of the Cost Accounting Records Rules, as applicable.

5.13 **Procedure of appointment of cost accountant for authentication of Compliance Report:**

No procedure has been prescribed in the Rules for appointment of a "cost accountant" to certify the Compliance Report.

An employee cost accountant is also permitted to certify the Compliance Report.

In case where a company appoints a Practicing Cost Accountant to certify the Compliance Report, it would be advisable to appoint the cost accountant by the Board since the Board is responsible to approve the Compliance Report.

In case a company decides to get it certified by a permanent employee of the organization, nominating/authorizing the employee cost accountant would be an internal matter of the company.

5.14 **Ceiling on Number of Compliance Report:**

There is no ceiling on the number of Compliance Reports that can be certified by a cost accountant in whole-time practice as of now. A cost accountant working as permanent employee can certify the Compliance Report of the company where he is employed but he cannot certify Compliance Report of any other company even under the same group.

5.15 **Requirement of filing Compliance Report if the company is also under cost audit.**

(a) If all the products/activities of a company, excluding the exempted categories, are covered under cost audit, then the company will not be required to separately file the compliance report.

(b) If one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products covered under Companies (Cost Accounting Records) Rules, 2011 but not covered under Cost Audit as per company-wise or industry specific Cost Audit Orders dated 2nd May, 2011, 30th June, 2011 and 24th January 2012, the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

(c) If one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products not covered under Companies (Cost Accounting Records) Rules 2011, then the company will not be required to file a Compliance Report since the product(s)/activity(s) other than product(s)/ activity(s) under Cost Audit are in the exempted category.

5.16 **Requirement of filing Compliance Report by companies engaged in Pharmaceuticals, Telecommunication, Petroleum, Sugar, Fertilizer and Electricity, which are not covered under Rule 3(a) to 3(h) of Companies (Cost Accounting Records) Rules 2011:**

Companies engaged in the above activities or products are not covered under **Companies (Cost Accounting Records) Rules 2011**. However, the industry specific rules for these products/activities require filing of a Compliance Report.

Further, in case of the above 6 industry specific products/activities:

a) If one or more product(s)/activity(s) of a company is covered under cost audit and there are other products that are not covered under Cost Audit as per company-wise cost audit orders issued in the past or industry specific cost audit orders dated 2nd May, 2011 and 30th June, 2011, the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

b) If one or more product(s)/activity(s) of a company are covered under Cost Audit and the other product(s)/activity(s) belong to the exempted category, then the company will not be required to file a Compliance Report.

c) If a company is having multiple production units and one or more of the units are situated in EPZ or SEZ where the unit is exempted from cost audit, then the company would be required to get cost audit conducted for the units located outside EPZ or SEZ and also file a Compliance Report for the company as a whole including the exempted units.

5.17 **The threshold limit for applicability of any of the Cost Accounting Records Rules is Rs. 20 crore. In respect of companies coming under the purview of Companies (Cost Accounting Records) Rules 2011, the threshold limit for application of cost audit for specific industries is Rs. 100 crore. Hence, any company having a turnover between Rs. 20 crore and Rs. 100 crore would have to file a Compliance Report. Further, companies engaged in such products/activities not covered under cost audit would also be required to file a compliance report.**

In case of 6 Regulated Industries, the threshold limit for applicability of cost accounting records rules as well as cost audit is Rs. 20 crore. Further, every company engaged in any of the specified Regulated Industries are already covered under cost audit by cost audit order dated May 2, 2011. *Hence, a question arises as to why a provision of Compliance Report is required in the 6 Regulated Industry Rules when the activities are already under cost audit.*

The Companies (Cost Accounting Records) Rules 2011 and the 6 Industry Specific Rules have been notified in the same manner and having the same provisions barring prescription of Formats for the 6 Regulated Industries.

Before the notification of 6 Regulated Industry Rules, a company engaged in any of the activities referred to under these Rules were not covered under Compliance Report mechanism. Hence, a company engaged in any of these activities and also in some other activities covered under the Companies (Cost Accounting Records) Rules 2011 would have been required to file Compliance Report only for those activities covered under Companies (Cost Accounting Records) Rules 2011 to the exclusion of these regulated activities.

Since the 6 regulated Industry Rules have been made effective from the date of notification of the Rules, viz., December 7, 2011, this position would prevail for companies having financial year commencing on or after April 1, 2011 and engaged in both types of activities and as a result, the entire company position would not be reflected in the Compliance Report for the financial year commencing on April 1, 2011.

Example:

A Pharmaceutical Company is also engaged in manufacture of Toiletries. The company would not be covered for cost audit of Toiletries since this is not one of the products/activities covered under cost audit orders dated May 2, 2011, or June 30, 2011 or January 24, 2012. The exemption for filing a compliance report is applicable only when all the products/activities of a company are under cost audit. In the absence of a provision for filing of Compliance Report for the Regulated Industry Rules, this company would have been required to file a Compliance Report for Toiletries only and a cost audit report for Pharmaceuticals. The compliance report for Toiletries would not have included details regarding Pharmaceuticals since Pharmaceutical activity fall under industry specific record rules. As a result, the entire position of the company would not have been available being reported partly under cost audit and partly under compliance report.

Example:

A Pharmaceutical Company is having 4 production units out of which one unit is located in SEZ. As per clarification issued by the MCA [vide MCA General Circular Nos. 67/2011 dated November 30, 2011 and 11/2012 dated May 25, 2012], the company can avail of exemption from cost audit in respect of the unit located in SEZ. In such a situation, the company would file cost audit report in respect of the three units located outside SEZ and would also be required to file a Compliance Report for the company as a whole including the unit located in SEZ.

It may be noted that for companies engaged in any of the activities covered under the 6 Industry Specific Rules, such companies would not be required to file a Compliance Report provided they do not have any other activity besides these activities which are already covered under cost audit by cost audit order dated May 2, 2011 or they do not have unit located in an area where it is specifically exempted from cost audit in respect of such units (e.g., located in EPZ or SEZ). But they would be required to file a Compliance Report if additionally they are engaged in one or more other activities if such activities are not covered under cost audit under cost audit orders dated June 30, 2011 or January 24, 2012 or having units in exempted locations.

5.18 **Responsibility of preparing Annexure to the Compliance Report: Whether the Annexure is to be prepared by the company or by the Cost Accountant?**

The Company is responsible for maintenance of cost accounting records. Hence the preparation of the Annexures is the responsibility of the Company.

The "cost accountant" authenticating the Compliance Report is required to certify and state whether the same has been maintained in accordance with the Rules.

5.19 **Duties of Board of Directors regarding Compliance Report:**

The Compliance Report as prescribed in the Rules is divided into different parts.

Form A, Part I contains general information regarding the company and details of cost accountant.

Form A, Part II contains attachment of Compliance Report including annexure and verification by the company.

Form B contains the Compliance Report to be certified by the cost accountant and annexure to Compliance Report to be authenticated by the cost accountant.

As per the Rules, the Annexure to the Compliance Report is to be approved by the Board of Directors. However, the Compliance Report, being a report of the cost accountant, is not to be approved by the Board of Directors.

5.20 **Role of Audit Committee vis-a-vis Compliance Report:**

A question arises whether the Audit Committee has any role in approval of the Annexure to the Compliance Report. In this connection, the requirements of the cost audit report rules may be noted.

Cost accounting records lay emphasis on performance measurement by bringing out product profitability and efficiency measurement. Cost accounting is a continuous process and cost accounting records enable a comparative analysis of expenses, variations and changes, both with reference to actual costs and standard costs.

Sub-section (6) of section 292A of the Companies Act, 1956 states that the Audit Committee should have discussions with the auditors periodically about internal control systems and cost accounting records are an integral part of this.

Hence, consideration of the cost accounting records in a summarised manner, which leads to preparation of the Annexure to the Compliance Report, should be considered by the Audit Committee, if any. The Annexure should be approved by the Audit Committee before being placed before the Board of Directors for approval.

5.21 **Ceiling on a cost accountant in full-time practice on number of Compliance Report that he can authenticate:**

There is no ceiling on the number of Compliance Reports that can be authenticated by a cost accountant in full-time practice.

A cost accountant working as permanent employee can authenticate the Compliance Report of the company where he is employed provided his membership dues are not in arrears. He cannot authenticate Compliance Report of any other company even under the same group.

5.22 **Authentication of Compliance Report and Annexure thereto by a cost accountant who is responsible for maintenance of the cost records:**

A cost accountant who is working as permanent employee of a company and responsible for maintenance of cost records therein can also authenticate Compliance Report of the same company. He has to meet the other qualification criteria as prescribed in the Rules and clarified by the Institute of Cost Accountants of India.

5.23 **Applicability of Compliance Report on company covered under earlier cost accounting records rules but not covered under cost audit under present cost audit orders.**

A company with multiple product range was under cost audit for some of its products under the erstwhile cost accounting records rules. The products that were covered under cost audit are not included under any of the cost audit orders dated 2nd May 2011, 30th June 2011 or 24th January 2012. In such a situation, the company will be covered under cost audit for these products till the financial year ending on or before 31st March 2012. The company will be required to file Compliance Report for the company as a whole from financial year commencing on or after 1st April, 2012.

In this connection, the following situations may be envisaged:

(a) If all the products/activities of a company, excluding the exempted categories, are covered under cost audit, then the company will not be required to separately file the compliance report.

(b) If one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products covered under any of the Cost Accounting Records Rules but not covered under Cost Audit as per company-wise or industry specific Cost Audit Orders dated 2nd May, 2011 and 30th June, 2011 or 24th January 2012, the Company will be required to file a Compliance Report (Company as a whole) covering products under cost audit and products not under cost audit.

(c) If one or more product(s)/activity(s) of a company is covered under Cost Audit and there are other products not covered under any of the Cost Accounting Records Rules, then the company will not be required to file a Compliance Report since the product(s)/activity(s) other than product(s)/ activity(s) under Cost Audit are in the exempted category.

5.7 GUIDANCE FOR PREPARATION OF COMPLIANCE REPORT

1. The Companies (Cost Accounting Records) Rules 2011 as well as the 6 Industry specific Cost Accounting Records Rules has prescribed the format and structure of Compliance Report.
2. The explanation provided below is in line with the Costing Taxonomy issued by the Ministry of Corporate Affairs.
3. FORM-A – Form for filing Compliance Report and other documents with the Central Government [Pursuant to section 209(1)(d), 600(3)(b) of the Companies Act, 1956 and rule 2 of the Companies (Cost Accounting Records) Rules, 2011]

   Form A is divided into two parts - Part I containing General Information; and Part II containing attachments and Verification of the signatory to the Form.
4. Most of the information contained in the Form A - General Information as has been notified by the MCA along with the Companies (Cost Accounting Records) Rules 2011 as well as the 6 Industry specific Cost Accounting Records Rules has now been shifted to the main Compliance Report under General Information. These details are discussed below.

Form A

General Information

General information compliance	**Information to be provided. All fields are mandatory**
Corporate identity number or foreign company registration number	Enter valid CIN/FCRN Number of the Company. Should be same as entered in the form.
Name of company	Enter the name of the Company. Name should be based on CIN or FCRN as applicable.
Address of registered office or of principal place of business in India of company	Enter registered office address. In case of a foreign company, enter address of principal place of business
Address of corporate office of company	Enter corporate office address. In case it is the same as registered office, enter registered office address
Email address of company	Enter email address of the company
Current financial year	
Date of start of reporting period	Should be greater than or equal to date of incorporation in case of Indian company or date of establishment of place of business in case of foreign company. Should be less than or equal to system date. Should be same as entered in the Form.
Date of end of reporting period	Should be less than or equal to system date. Should be greater than or equal to Start Date Of Reporting Period. Difference between start date and end date should not be greater than 18 months. Should be same as entered in the Form.
Level of rounding used in cost statements	Select the basis of reporting of the figures in the report
Reporting currency of entity	The currency of reporting is INR
Date of board of directors' meeting in which annexure to compliance report was approved	Enter date of meeting of Board of Directors approving the annexure to cost audit report

General information compliance	Information to be provided. All fields are mandatory
Details of cost accountant	
Nature of employment of cost accountant	State whether cost accountant is in employment or in Practice
Category of cost accountant	Enter whether the cost auditor is a firm or a sole proprietor. An individual practising in individual name is to be considered under the Sole Proprietorship category
Firm's registration number	Enter registration number of the firm allotted by the Institute. Mandatory in case 'Firm' is selected in field 'Category Of Cost Accountant'
Name of cost accountant or cost accountant's firm who has certified compliance report of company	Enter Name of cost accountant who has certified the Compliance Report. In case of a firm has been appointed, enter name of the partner certifying the Compliance Report
Permanent account number of cost accountant or cost accountant's firm	Enter PAN of firm in case the cost accountant is a Firm. In case of a sole proprietor or an individual, enter the PAN of the individual member. In case of an employee certifying the compliance report enter PAN of the employee member.
Address of cost accountant or cost accountant's firm	Enter address
Email id of cost accountant or cost accountant's firm	Enter email id
Membership number of member signing report	Enter membership number
Name of member signing report	Enter name of member certifying the report
Date of signing compliance report by cost accountant	Enter Date
Place of signing compliance report by cost accountant	Enter Place
Whether compliance report has been qualified or has any reservations or contains adverse remarks	State whether the compliance report is qualified or has any reservations or adverse remarks

FORM B

COMPLIANCE REPORT

The cost accountant is required to complete the report in the format provided. Strike off the portions not applicable.

In case a Firm of Cost Accountants is appointed to authenticate the Compliance Report, a Partner of the Firm must sign the report on behalf of the Firm and put his membership number.

ANNEXURE TO THE COMPLIANCE REPORT

2	**Quantitative Information:**		
1	Name of Product of Activity Group	Check the "Product Group" under which the product(s) of the company belongs to. This is to be done by comparing the 4 digit HSN Code of the product against the notified "Product Groups". If the products of the company fall under multiple Product Groups, then each of the Product Groups is to be mentioned serially. The name of Product Group should be as per Product Group Classification notification issued by MCA on 7th August 2012	Mandatory
2	Product or Activity Group Code	Enter the Product Group Code as per the Product Group Classification notification of MCA dated 7th August 2012	Mandatory
3	Unit of Measurement	Enter the UOM of the Product Group. In case products are having different UOM but falls under the same Product Group, then the same Product Group is to be mentioned according to the different UOMs.	Mandatory
4	Quantity Produced	Enter the production quantity separately against each Product Group and according to the UOM.	Mandatory
5	Quantity Sold	Enter the quantity sold separately against each Product Group and according to the UOM.	Mandatory
6	Net Operational Revenue	Enter the net operational revenue separately against each Product Group and according to the UOM. The value should be net of taxes and duties.	Mandatory
7	Whether Product Group covered under cost audit	State Yes/No against each of the Product Groups.	Mandatory
8	Other Income	All other non-operational Incomes not considered against individual Product Groups category to be shown here.	Mandatory

9	Total Revenue as per Financial Accounts	The total amount shown here should be equal to the Income shown in the Profit & Loss Account, net of Excise Duty and Taxes.	Mandatory
3	**Reconciliation Statement:**		
1	Profit (loss) from product or activity groups covered under cost audit	This amount would be the sum total Margin of all the Products of the company that are covered under cost audit. In case none of the products of the company are covered under cost audit, this amount would be zero.	Mandatory
2	Profit (loss) from product or activity groups covered under cost accounting records rules but not covered under cost audit	This amount would be the sum total Margin of all the products of the company that are covered under any of the Cost Accounting Records Rules but not covered under cost audit.	Mandatory
3	Profit (loss) from activities not covered under cost accounting records rules	The margin arrived at in respect of all such activities that are not covered under any of the cost accounting records rules.	Mandatory
4	Total Profit/(Loss) as per cost accounts	The total of all the above margins	Mandatory
5	Amount of incomes not considered in cost accounts	All non-operating incomes of the Company that are not considered in cost accounts	Mandatory
6	Amount of expenses not considered in cost accounts	Expenses not considered in cost accounts would arise only in case of activities that are covered under the cost accounting records. These would include expenses such as demurrage, donations, foreign exchange loss/gain, loss on sale of fixed assets. Unabsorbed Overheads due to under-utilization of capacity would not have been charged to cost of production/sales and the same would be reflected here. In case of such activities which are not covered under the cost accounting records (e.g., exempted services, trading etc.) the expenses pertaining to these activities would already be a part of the total expenses of these activities and the margin of these activities would have been derived after considering these.	Mandatory

7	Difference in stock valuation as per cost and financial records	Difference in valuation of stocks between financial accounts and cost accounts to be furnished here. Difference due to Excise Duty component included in value of stock of finished goods as per financial accounts and value of stock as per cost accounts (excluding excise duty component) should be mentioned with amount in the note below the statement.	Mandatory
8	Profit (loss) as per financial accounts	Total Profit/(Loss) as per financial accounts	Mandatory

In respect of Incomes not considered in cost accounts and Expenses not considered in cost accounts, details of these Incomes and Expenses is required to be provided in a table giving the different income and expense heads and the corresponding amounts.

Study Note - 6

COMPANIES (COST AUDIT REPORT) RULES, 2011, COST AUDITOR AND COST AUDIT PROGRAMME

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

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.

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 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.

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

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.

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

6.1 COST AUDIT REPORT - DISCLOSURES

Cost Accounting Policy covering, 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 etc., 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, 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) In case the Company has adopted IFRS, variations (if any) in treatment of cost accounting arising out of adoption of IFRS in Financial Accounting.

(j) Other relevant cost accounting policy adopted by the Company

6.2 COMPANIES (COST AUDIT REPORT) RULES, 2011 (Provided for basic information only)

G.S.R. 430(E) dated 3rd June,2011	**Companies (Cost Audit Report) Rules,2011**
Form I	**Form for filling Cost Audit Report and other documents with the Central Government** (Pursuant to section 233B(4), 600(3)(b) of the Companies Act,1956 and rule 2 of the Companies (Cost Audit Report) Rules,2011
	Part I – General Information
	Part II - Attachments
Form II	**FORM OF THE COST AUDIT REPORT**
	ANNEXURE TO THE COST AUDIT REPORT (Rule 2 and Rule 6)
	Para 1 : General Information
	Para 2 : Cost Accounting Policy
	Para 3 : Product Group Details (for the company as a whole)
	Para 4 : Quantitative Information (for each product group separately)
	Para 5: Abridged Cost Statement (for each product group separately)
	Para 6 : Operating Ratio Analysis (for each product group separately)
	Para 7 : Profit Reconciliation (for the company as a whole)
	Para 8 : Value Addition and Distribution of Earnings (for the company as a whole)
	Para 9 : Financial Position and Ratio Analysis (for the company as a whole)
	Para 10 : Related Party Transactions (for the company as a whole)
	Para 11 : Reconciliation of Indirect Taxes (for the company as a whole)
Form III	**FORM OF THE PERFORMANCE APPRAISAL REPORT**
	1. Capacity Utilization Analysis
	2. Productivity/ Efficiency Analysis
	3. Utilities/ Energy Efficiency Analysis
	4. Key-Costs & Contribution Analysis
	5. Product / Service Profitability Analysis
	6. Market/Consumer Profitability Analysis
	7. Working Capital & Inventory Management Analysis
	8. Manpower Analysis
	9. Impact of IFRS on the Cost Structure, Cash Flows and Profitability
	10. Application of Management Accounting Tools

Supplementary Study Material on relevant Rules of 2014 would be provided in due course pursuant to final notification by the Ministry of Corporate Affairs, Government of India.

Study Note - 7

COST AUDIT AND ASSURANCE STANDARDS (CAAS)

This Study Note includes

7.1 Cost Audit and Assurance Standard

7.1 COST AUDIT AND ASSURANCE STANDARD (CAAS)

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.

Standards issued by the Cost Audit and Assurance Standards Board under the authority of the Council of the Institute of Cost Accountants of India

The CAASB issues the following Standards under the authority of the Council of the Institute of Cost Accountants of India:

(a) Standards on Quality Control – to be applied for all services rendered by the Cost Accountants.

(b) Standards on Auditing – to be applied in the audit of historical cost statements.

(c) Standards on Review Assignments – to be applied in the review of historical cost statements.

(d) Standards on Assurance Assignments – to be applied in assurance assignments rendered by the Cost Accountants.

(e) Standards on Related Services – to be applied in such other related service assignments rendered by the Cost Accountants as may be specified by the Institute of Cost Accountants of India.

While formulating the Standards, the CAASB takes into consideration the applicable laws, usage and business environment prevailing in India. CAASB also takes into account the relevant provisions of Cost and Works Accountants Act, Rules and Regulations, Code of Professional Ethics, Cost Accounting Standards and other Statements issued by the Institute. The Standards issued by the CAASB are aligned, to the extent possible, with other recognised Standards issued in India and prevailing International Practices.

Standards formulated by the CAASB include paragraphs in ***bold italic*** type and plain type, which have equal authority. Paragraphs in ***bold italic*** type indicate the main principles. Each Standard should be read in the context of the objective stated in that Standard and this Preface. Any limitation of the applicability of a specific Standard is made clear in the Standard itself.

Pending development of the Standards on Quality Control, the Guidance Manual for Audit Quality issued by the Institute prevails in respect of all services rendered by the Cost Accountants.

Pending development of the Standards on Auditing, Review Assignments and Assurance Assignments, the Statement on Generally Accepted Cost Audit and Assurance Practices issued by the CAASB under the authority of the Council of the Institute prevails.

The CAASB considers issues requiring interpretation of any Standard. Interpretations or General Clarifications are issued under the authority of the Council. The authority of interpretation is the same as that of the Standard to which it relates.

Compliance with the Standards

The Standards on Quality Control, Standards on Auditing, Assignment Standards, and Standards on Related Services, issued by and under the authority of the Council of the Institute, are required to be complied with by the members of the Institute, wherever applicable.

If a particular Standard or any part thereof is inconsistent with any law in force, the provisions of the said law prevails.

Guidance Notes

Guidance Notes are issued to assist the professional cost accountants in implementing the Standards on Quality Control, Standards on Auditing, Assignment Standards, and Standards on Related Services issued by the CAASB under the authority of the Council of the Institute. Guidance Notes are also issued to provide guidance on other generic or industry specific issues, not necessarily arising out of a Standard. Professional cost accountants should be aware of and consider Guidance Notes applicable to the assignment. A professional cost accountant who does not consider and apply the guidance included in the relevant Guidance Note should justify the appropriateness and completeness of the alternate procedures adopted by him to deal with the objectives and basic principles set out in the Guidance Note.

Technical Guides, Practice Manuals and other Papers

The CAASB may also publish Technical Guides, Practice Manuals and other Papers. Technical Guides are generally aimed at imparting broad knowledge to the professional cost accountants about a particular aspect of an industry. Practice Manuals are aimed at providing additional guidance to the professional cost accountants in performing audit and other related assignments. Other Papers are aimed at promoting discussion or debate or creating awareness on issues relating to quality control, auditing, assurance and related services affecting the profession. Such publications of the CAASB do not establish any basic principles or essential procedures to be followed in audit, review, assurance or related services assignments and accordingly, have no authority of the Council of the Institute attached to them.

Constitution of the Cost Audit and Assurance Standards Board

The Council of the Institute of Cost Accountants of India constituted the Cost Audit and Assurance Standards Board (CAASB) in 2007 entrusting the responsibility to formulate Standards and develop Guidance Notes in the areas of auditing, review, assurance, related services and quality control.

Composition of the CAASB

The composition of the CAASB is fairly broad based to ensure participation of all interest groups in the standard setting process. Apart from six members of the Council of the Institute nominated in the CAASB, the following are represented on the CAASB:

1. Head, Cost Audit Branch, Ministry of Corporate Affairs, Government of India

2. One member to be nominated by the Comptroller & Auditor General of India

3. Two members to be nominated by the Regulatory bodies

4. Two eminent members of the Institute in Public Practice

5. Two members representing Industry / Industry Associations / Professional Institutes

Members mentioned at (4) & (5) above are decided in consultation with the President. In addition, the President is authorised to include a maximum of two eminent persons having relevant knowledge and expertise not falling under the categories mentioned above.

The Chairman of the CAASB is nominated by the Council of the Institute.

The quorum of the CAASB is five members.

The terms and period of appointment of the chairman and other members, excluding the nominee members, is decided by the Council of the Institute. This is, however, restricted to the term of the Council.

Objectives and Functions

The following are the objectives and functions of the Cost Audit and Assurance Standards

Board:

a) To identify areas in which Standards on Quality Control, Assignment Standards, Standards on Auditing and Standards on Related Services need to be developed.

b) To develop Standards on Quality Control, Assignment Standards, Standards on Auditing and Standards on Related Services so that they may be issued under the authority of the Council of the Institute.

c) To develop Guidance Notes on issues arising out of any Standard or on auditing issues pertaining to any specific industry or on generic issues so that they may be issued under the authority of the Council of the Institute.

d) To formulate and issue Technical Guides, Practice Manuals and other Papers under its own authority for guidance of Cost Accountants in the cases felt appropriate by the Board.

e) To review the existing Standards, Guidance Notes, Technical Guides, Practice Manuals and other Papers to assess their relevance in the changed conditions and to undertake their revision, if necessary.

f) To provide Interpretations or formulate General Clarifications, where necessary, on issues arising from the Standards.

Procedure for issuing the Standards

The following procedure is adopted for formulating and issuing the Standards:

I. Proposals to develop new Standards or revise the existing ones, are identified by the CAASB based on the national and international developments, inputs from members of the Council of the Institute, CAASB members, members of other committees of the Institute, members of the Institute and/or recommendations received from the Government, regulators, industry associations, or other interest groups.

II. CAASB determines the priorities of various proposals on hand for the development of the Standards.

III. CAASB constitutes separate Task Force or Study Group to develop preliminary draft of each Standard based on appropriate research and consultation with all interest groups, other professionals and regulators. The Task Force / Study Group also consider relevant pronouncements issued by the IFAC, if any.

IV. The preliminary draft Standard prepared by the Task Force / Study Group is considered by the CAASB with inputs from the Technical Directorate. After a para by para discussion, CAASB either clears the draft Standard, with or without any modifications or refers the same to the Task Force / Study Group for revision based on the deliberations of the CAASB.

V. In case the preliminary draft Standard is re-drafted by the Task Force / Study Group, the revised draft is again considered by the CAASB with inputs from the Technical Directorate. Based on the discussions held, CAASB clears the draft Standard. This is then issued as an Exposure Draft under the authority of the CAASB.

VI. Each Standard generally follows the following structure. In case of deviation, suitable explanation is provided by the Task Force / Study Group preparing the Standard.

1. Introduction
2. Objectives of issuing the standard
3. Scope of the standard
4. Definitions and explanations of the terms used in the standard
5. Requirements
6. Application and other explanatory material
7. Effective date

VII. Exposure draft of the Standard is hosted on the website of the Institute and published in Management Accountant journal for comments of stakeholders and public at large Copies of the Exposure Draft are sent to the members of the Central Council, Past Presidents, members of the Regional Councils & Chapters and circulated among other bodies for their comments. Exposure Draft is also sent to the following bodies:

i. Ministry of Corporate Affairs, Government of India
ii. Comptroller and Auditor General of India
iii. Reserve Bank of India
iv. Central Board of Direct Taxes
v. Central Board of Excise and Customs
vi. Securities and Exchange Board of India
vii. Institute of Chartered Accountants of India
viii. Institute of Company Secretaries of India
ix. Industry Associations such as CII, FICCI, ASSOCHAM and PHDCCI
x. Concerned regulators or any other body considered relevant by the CAASB keeping in view the nature and requirements of the Standard.

VIII. To allow adequate time for due consideration and comment from all interested parties, exposure period is of minimum 45 days or higher as decided by the CAASB.

IX. The comments and suggestions received within the exposure draft period are read and considered by the CAASB. Outcome of each comment / suggestion is recorded in the minutes of the relevant CAASB meeting.

X. After taking into consideration the comments received, the draft of the proposed Standard is finalised by the CAASB and submitted to the Council of the Institute for its consideration and approval.

XI. The Council of the Institute considers the final draft of the proposed Standard, and if found necessary, modifies the same in consultation with the CAASB. The concerned Standard is then issued under the authority of the Council of the Institute.

XII. The effective date of implementation of the Standard is decided by the Council of the Institute in consultation with the CAASB. No Standard will have retrospective application unless otherwise stated.

Procedure for issuing Guidance Notes

The following procedure is adopted for formulating and issuing the Guidance Notes:

I. CAASB identifies the issues on which Guidance Notes need to be formulated. CAASB also determines the priorities of various proposals on hand for commencement.

II. CAASB constitutes separate Guidance Notes Committee (GNC) to develop draft of each Guidance Note. Each Committee has a minimum of three members, of which at least one is a member of the CAASB and others with backgrounds as preparers of cost statements, auditors and regulators. One of the members of CAASB is the Chairman of the said Committee. He is authorised to co-opt maximum two members with the consent of the Chairman, CAASB.

III. The draft Guidance Note prepared by the GNC is considered by the CAASB with inputs from the Technical Directorate. After a para by para discussion, CAASB either clears the draft Guidance Note, with or without any modifications or refers the same to the GNC for revision based on the deliberations of the CAASB.

IV. In case the draft Guidance Note is re-drafted by the GNC, the revised draft is again considered by the CAASB with inputs from the Technical Directorate. Based on the discussions held, CAASB clears the draft Guidance Note. This is then issued as an Exposure Draft under the authority of the CAASB.

V. Exposure draft of the Guidance Note is hosted on the website of the Institute for comments of stakeholders and public at large. Copies of the Exposure Draft are sent to the members of the Central Council, Past Presidents, members of the Regional Councils & Chapters and circulated among other bodies for their comments.

VI. To allow adequate time for due consideration and comment from all interested parties, exposure period is of minimum 45 days or higher as decided by the CAASB.

VII. The comments and suggestions received within the exposure draft period are read and considered by the CAASB. Outcome of each comment / suggestion is recorded in the minutes of the relevant CAASB meeting.

VIII. After taking into consideration the comments received, the draft of the proposed Guidance Note is finalised by the CAASB and submitted to the Council of the Institute for its consideration and approval.

IX. The Council of the Institute considers the final draft of the proposed Guidance Note, and if found necessary, modifies the same in consultation with the CAASB. The concerned Guidance Note is then issued under the authority of the Council of the Institute.

X. The Guidance Note of a Standard is explanatory to the corresponding Standard and will not override the same.

Procedure for issuing Technical Guides, Practice Manuals and other Papers

For issuance of a Technical Guide, Practice Manual etc., the procedure followed by the CAASB is generally the same as in case of a Guidance Note except that the draft Technical Guide, Practice Manual etc. is never exposed for public comments. Also since Technical Guide, Practice Manual etc.

do not have any authority attached to them, those are not required to be placed for consideration and approval by the Council of the Institute; rather they are issued by the CAASB under its own authority.

Procedure for Revision of the Standards, Guidance Notes, Technical Guides, Practice Manuals and other Papers

The CAASB undertakes revision of the Standards, Guidance Notes, Technical Guides, and Practice Manuals etc. based on the subsequent legal or professional requirements or any other national or international developments in the field of auditing. The procedure followed for revision is the same as that followed for formulation of a new Standard, Guidance Note, Technical Guide, or Practice Manual etc., as the case may be, as detailed above.

CAAS – 101

Cost Audit and Assurance Standard on Planning an Audit of Cost Statements

Already discussed in Study Note 6 Companies (Cost Audit Report) Rules, 2011, Cost Auditor and Cost Audit Programme

CAAS – 102

Cost Audit and Assurance Standard on

Cost Audit Documentation

The following is the **Cost Audit and Assurance Standard** (CAAS 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 and other cost related information.

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 CAASs 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 and other cost related information. The specific documentation requirements of other CAAS's do not limit the application of this CAAS. 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: ***An 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 material 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 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 Audit and Assurance Standards.***

4.5 Cost Auditor: ***"Cost Auditor" means an auditor appointed to conduct an audit of cost records, under sub-section (2) of section 233B of the Companies Act 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 Assignment or audit Partner: ***Assignment or audit partner means the partner or other person 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 Assignment or 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.***

4.7 Assignment or audit Team: ***Assignment or audit team means all personnel performing an Assignment or audit, including any experts contracted by the firm in connection with that Assignment or audit.***

4.8 Firm: *Firm means a sole practitioner, partnership including LLP 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.

5.2 In documenting the nature and extent of audit procedures performed, the Cost Auditor shall record the characteristics of the specific items or matters tested the responsibility for performing and reviewing such procedures and the relevant dates.

5.3 The Cost Auditor shall prepare audit documentation that is sufficient to enable another Cost Auditor undertaking a peer review to understand:

- Conformance of audit procedures performed with legal and regulatory requirements;
- Conformance to cost audit and assurance standards
- The results of audit procedures performed
- The audit evidence obtained
- Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

5.4 The Cost Auditor shall prepare audit documentation on a timely basis.

5.5 The Cost Auditor shall record any departure from the standard requirement in a Cost Audit Assurance Standard.

5.6 The Cost Auditor shall record the discussions with client personnel and outsiders.

5.7 The Cost Auditor shall record any audit procedures performed in exceptional circumstances after the Cost Audit Report or new conclusions reached after that date.

6. Application Guidance

1. The Cost Audit documentation will usually contain

- Checklists

Example: Checklist of compliance with industry specific Record Rules, Checklist of compliance with Measurement Principles in CAS, Checklist of Disclosure requirements as per CAS

- Audit programs

  Example: Audit Program for Material Cost, Employee Cost and others

- 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.

- Audit Query List

  Contains a log of audit queries raised and their resolution

- 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

- Letters of confirmation

  Example: Stock of materials with subcontractors.

- Letter of Representation from Management
- Correspondence (including e-mail) concerning significant matters.

  Example: Correspondence regarding terms of supply of goods and services.

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.
3. The content and form of audit documentation will depend on a number of factors

   Such as:

   - the size and complexity of the operations,
   - the extent of computerization of cost records,
   - The assessed risks of misstatement of cost, the cost audit methodology and tools used. E.g. whether automated queries were used to get audit evidence from cost records.
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 product from technical norms, normal price for a related party contract from Cost Auditor's own sources of data of the industry.
5. Audit documentation must be sufficient and oral explanations by the Cost Auditor cannot substitute for such documentation.
6. Audit documentation must contain evidence of conformance to requirements of Cost Audit and Assurance Standards in respect of this Standard and other standards. Typical of such evidence are:
   - an adequately documented audit plan
   - the signed appointment letter from the client containing in particular the terms of coverage for the Performance appraisal in a cost audit
   - Minutes of discussion with client personnel with names of members of audit team present particularly of the audit partner when he is present

- Minutes of team discussions with names of members of audit team present particularly of the audit partner when he is present.

7. If, in exceptional circumstances, the Cost Auditor finds it necessary to perform alternative audit procedures different from a corresponding requirement in a Cost Audit and Assurance Standards, the Cost Auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure.

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.

9. 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.

10. 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.

11. 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.

12. Reference was made earlier to Minutes of discussion with client personnel but audit documentation may also include Minutes of Discussion with third parties seeking information or confirmation.

13. 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 description of the entity, the products produced and other activities.
    - An organization Chart showing the responsibility centres and the person responsible
    - A description, preferably a flow chart of the manufacturing process
    - The product structure with product groups for cost reporting identified
    - Internal controls over material cost, labour cost and expenses
    - The risks of material misstatement assessed, for example, in respect of scrap recovery and disposal
    - Tests of materiality used
    - The overall audit strategy and audit plan,
    - Significant matters noted during the audit, and conclusions reached.

14. The Cost Audit Documentation must be assembled as the audit goes on and the final assembly required of audited documentation must be limited. It should be completed within a reasonable time after the completion of the audit.

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.

16. 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

17. 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 to be applied for the period commencing on or after 1st April 2012.

CAAS - 103

Cost Audit and Assurance Standard on Overall Objectives of the Independent Cost Auditor and the Conduct of an Audit in Accordance with Standards on Auditing

The following is the **Cost Audit and Assurance Standard** (CAAS 103) on **"Overall Objectives of the Independent Cost Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".** 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 CAASs. It also explains the scope, authority and structure of the CAASs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the CAASs.

The independent auditor is referred to as "the Cost auditor" hereafter.

2. Objectives

The objective of issuing this Standard is to lay down the principles governing the Audit of Cost Statements.

The objective of an audit of Cost Statements is to enable the auditor to express an opinion whether the Cost Statements are prepared, in all material respects, in accordance with an applicable Cost reporting framework 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 Cost Audit Report Rules in India, 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.

It is the responsibility of the management and where required of the governing body e.g. Board of Directors to maintain the cost records, prepare the cost statements and the abridged Cost Statement and other information contained in the Annexure to the Cost Audit Report prescribed by law in India. The Cost Auditor expresses an opinion on them. The CAASs do not in any way alter this responsibility of the management or the governing body.

As part of their responsibility for the preparation and presentation of the cost statements, management and, where appropriate, those charged with governance are responsible for:

- The identification of the applicable cost reporting framework, in the context of any relevant laws or regulations.

- The preparation and presentation of the cost statements in accordance with that framework.
- An adequate description of that framework in the cost statements.

To be in a position to express an opinion, the Cost auditor's objectives are:

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
2. to report on the cost statements in the form required by law or by the CAAS.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 objective may extend to making observations and suggestions where required by regulations e.g. Cost Audit Report Rules.

3. Scope

This Standard should be applied while undertaking audit of Cost Statements that require attestation. 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.

The cost reporting framework may be laid down by law e.g. the Cost Audit Report Rules under the Companies Act in India or by the intended user e.g Excise Department in the case of a Section 14AA audit or by a professional body having jurisdiction over the area of reporting.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Audit: ***An 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 Auditee: ***Auditee means a company or any other entity for which cost audit and/ or certification is carried out.***

4.3 Auditor: ***Auditor is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable the firm. Auditor includes Cost Auditor***

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. The risk of material misstatement has two components viz. Inherent Risk and Control risk.***

d. **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.***

e. **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.***

f. **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 Assurance engagement: An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the

outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria.

There are two types of assurance engagements a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

4.5.1 Reasonable assurance engagement: The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.

4.5.2 Limited assurance engagement: The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

4.6 Assurance Engagement Risk: The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

4.7 Audit Strategy: Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

4.8 Cost Audit: 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.

4.9 Cost Auditor: "Cost Auditor" means an auditor appointed to conduct an audit of cost records, under sub-section (2) of section 233B of the Companies Act 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.

4.10 Engagement Partner: Engagement partner means the partner or other person 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 engagement 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.

4.11 Engagement Team: Engagement team means all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

4.12 Firm: Firm means a sole practitioner, partnership including LLP or any other entity of professional cost accountants as may be permitted by law and constituted under The Cost and Works Accountants Act & Regulations.

4.13 Misstatement: A difference between the amount, 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.

4.14 Risk Assessment: Risk Assessment is the overall process of risk analysis and risk evaluation.

4.15 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 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.

5. Requirements

5.1 The cost auditor should comply with the relevant ethical requirements including those pertaining to independence in respect of cost audit engagements.(refer 6.1)

5.2 The cost auditor should comply with Cost Audit and Assurance Standards and Statement on Generally Accepted Cost Audit and Assurance Principles and Practices (GACAAP) while conducting an audit. (refer 6.2)

5.3 In determining the audit procedures to be performed in conducting an audit the cost auditor should comply with each of the Cost Audit and Assurance Standards and also with the Statement on Generally Accepted Cost Audit and Assurance Principles and Practices (GACAAP) relevant to the audit. (refer 6.2) A CAAS is relevant to the audit when the CAAS is in effect and the circumstances addressed by the CAAS exist.

5.4 The cost auditor should not represent compliance unless the auditor has complied fully with all of the Cost Audit and Assurance Standards and Statement on Generally Accepted Cost Audit and Assurance Principles and Practices (GACAAP) relevant to the audit. (refer 6.2)

5.5 The cost auditor should 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)

5.6 The cost auditor should exercise professional judgment in planning and performing the audit. (refer 6.4)

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 should determine whether the Cost Reporting Framework followed by management in preparing the Cost Statements is acceptable. (refer 6.5)

5.9 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)

6. Application Guidance:

6.1 Audit and Ethics (refer 5.1): The cost auditor should comply with relevant ethical requirements as per Code of Ethics of the Institute of Cost Accountants of India. This code establishes fundamental principles of professional ethics relevant to the auditor when conducting an audit and provides a conceptual framework for applying these principles. The fundamental principles with which the auditor is required to comply are Integrity, Objectivity, Professional competence and due care, Confidentiality, and Professional behavior. In case an audit engagement is in public interest, then 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.

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, 5.3 and 5.4)

6.2.1 The Cost Audit and Assurance Standards and Statement on Generally Accepted Cost Audit and Assurance Principles and Practices provide the standards for the cost auditor's work in fulfilling the overall objectives of the cost auditor. The CAAS AND GACAAP 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. In performing an audit, the cost auditor may be required to comply with legal or regulatory requirements in addition to CAAS AND GACAAPs.

6.2.2 The CAAS AND GACAAPs do not override law or regulations that govern audit process. The cost auditor may also conduct the audit in accordance with both CAAS AND GACAAPs and legislative and regulatory requirements. In such cases in addition to complying with each of the CAAS and GACAAP 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 form of the cost auditor's opinion will depend upon the applicable cost reporting framework and any applicable laws or regulations e.g. Cost Audit Report Rules..

6.2.3 The cost auditor is not expected to represent compliance with Cost Audit and Assurance Standard and Statement on Generally Accepted Cost Audit and Assurance Principles and Practices unless the cost auditor has complied fully with all of the Cost Audit and Assurance Standards and Statement on Generally Accepted Cost Audit and Assurance Principles and Practices.

6.3 Professional skepticism: (refer 5.5) 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 professionalism 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 is not 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.

6.3.1A cost auditor conducting an audit in accordance with CAAS AND GACAAP 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:

- The use of sample testing.
- The inherent limitations of internal control (for example, the possibility of management override or collusion).
- 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:

a) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and

b) 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.

6.3.2 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 CAAS AND GACAAPs identify specified audit procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:

a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or

b) 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: (refer 5.6 and 5.7) 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.

6.4.1 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.

6.4.2 Audit risk is a function of the risk of material misstatement of 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.

6.4.3 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:

- the overall cost statement level and
- in relation to cost heads, items of cost and disclosures and the related assertions.

6.4.4 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;

6.4.5 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.

6.4.6 The risk of material misstatement at the assertion level consists of two components as follows:

- "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.
- "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 CAAS AND GACAAPs 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 CAAS AND GACAAPs 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.
- "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 engagement 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 (refer 5.8) the cost auditor is responsible for forming and expressing an opinion on the Cost Statements.

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.

6.5.1 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.

6.5.2 The Cost auditor is not responsible for preparing and presenting the cost statements in accordance with the applicable Cost reporting framework including inter-alia:

- 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;
- Selecting and applying appropriate Cost accounting policies; and
- Making cost estimates that are reasonable in the circumstances.

6.6 Non-compliance (refer 5.9) 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 effect the nature and extent of other audit evidence that is to be obtained by the cost auditor.

7. Effective Date

This standard is to be applied for the period commencing on or after 1st April 2013.

CAAS 104

Cost Audit and Assurance Standard on

Knowledge of Business, its Processes and the Business Environment

The following is the ***Cost Audit and Assurance Standard*** **(CAAS 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.

❖ **Introduction:**

1. In performing an audit of cost statements and other related information, 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.

2. The cost auditor's level of knowledge for an 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.

❖ **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.

❖ **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 staff working on an engagement.

❖ **Definitions:**

The following terms are being used in this standard with the meaning specified.

4.1 Audit: ***An 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. Audit includes cost audit.***

4.2 Auditee: Auditee means a company or any other entity for which audit and or certification is carried out.

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. The risk of material misstatement has two components viz. Inherent Risk and Control risk.***

a) **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.***

b) **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.***

c) **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 Assurance engagement: An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the

outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria.

There are two types of assurance engagements a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

4.4.1 Reasonable assurance engagement: The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.

4.4.2 Limited assurance engagement: The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

4.5 Assurance Engagement Risk: "The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated".

4.6 Audit Strategy: Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

4.7 Cost auditor: "Cost auditor" means an auditor appointed to conduct audit of cost records, under sub-section (2) of section 233B of the Companies Act and should be 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. Cost Auditor includes Audit Partner.

❖ **Requirements:**

1. It is essential that the Cost Auditor should 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.

2. The Entity and Its Environment: The cost auditor should obtain an understanding of the following:

1. The nature of the entity, including its operations covering Business processes, major inputs, Joint & By-Products and Wastages and major outputs etc.
2. The entity's ownership and governance structure, relevant industry, regulatory, and other external factors including the applicable cost and financial reporting framework.
3. The entity's selection and application of cost accounting policies.
4. The measurement and review of the entity's performance.

3. The Entity's Internal Control:

1. The cost auditor should obtain an understanding of internal controls relevant to the audit.
2. The cost auditor should evaluate whether management has created and maintained a culture of honesty and ethical behaviour.
3. The cost auditor should evaluate the adequacy of the internal audit function in relation to cost records.

4. IT Environment and Control: The cost auditor should evaluate and assess:

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; and
4. Integrity of information and security of the data.

5. ***The entity's risk assessment process: The cost auditor should obtain an understanding of whether the entity has a process for:***
   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.
6. ***Cost Information System/ Management Information System: The cost auditor should obtain an understanding of the management information system, relevant to cost reporting, including the following areas:***
   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.***
7. Identifying and Assessing the Risks of Material Misstatement: The cost auditor should identify and assess the risks of material misstatement at the cost statement level; and at the assertion level for classes of transactions and disclosures. For this purpose, the cost auditor should:
   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.***

❖ **Application Guidance:**

1. Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous & 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:
   - Assessing risks of material misstatement of the cost statements;
   - Considering the appropriateness of the selection and application of cost accounting policies, and the adequacy of cost statement disclosures;
   - Identifying areas where special audit consideration may be necessary, for example, abnormal losses, lower yields, higher wastages, higher utilities consumption, related party transactions etc.
   - Developing Models for use in performing analytical procedures;
   - Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
   - Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

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:
   - The market and competition
   - Cyclical or seasonal activity
   - Changes in product technology
   - Business risk (for example, high technology, high fashion, ease of entry for competition)
   - Declining or expanding operations
   - Adverse conditions (for example, declining demand, excess capacity, serious price competition)
   - Key ratios and operating statistics
   - Specific cost accounting practices and problems
   - Specific or unique practices (for example, relating to labor contracts, financing methods, accounting methods).
   - Energy supply sources and cost
   - Environmental requirements and problems
3. An understanding of the entity's selection and application of cost accounting policies may encompass matters such as:
   - The methods the entity uses to account for significant and unusual transactions (abnormal events).
   - The effect of significant cost accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
   - Changes in the entity's cost accounting policies.
   - Cost reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.
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:
   - Key performance indicators and key ratios (financial and non-financial).
   - Key trends and operating statistics.
   - Period-on-period financial performance analyses.
   - Budgets, forecasts, variance analyses, segment information and divisional, departmental or other unit level performance reports.
   - Employee performance measures and incentive compensation policies.
   - Comparisons of an entity's performance with that of competitors.
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.
6. 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.

7. The cost auditor should assess the following with regard to IT environment and controls.
   - Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
   - 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.
   - The possibility of IT personnel gaining access to privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
   - Unauthorized changes to data in master files.
   - Unauthorized changes to systems or programs.
   - Failure to make necessary changes to systems or programs.
   - Inappropriate manual interventions.
   - Potential loss of data or inability to access data as required.
8. If the entity has established such a 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.
9. 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.
10. 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.
11. 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.
12. 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.
13. 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.
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.

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.

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

❖ **Effective Date**

This standard is to be applied for the period commencing on or after 1st April 2013.

Study Note - 8

GUIDANCE NOTE ON PEROFRAMANCE APPRAISAL REPORT

This Study Note includes

8.1. PREFACE

8.1.1 The Ministry of Corporate Affairs vide Companies (Cost Audit Report) Rules, 2011 notified by GSR 430(E) dated 3rd June 2011 introduced "Performance Appraisal Report". The Government has prescribed that Cost Auditors are required to prepare and submit a Performance Appraisal Report in Form III of the said notification, to the company. This is a landmark in the history of companies in India, as this is the first time that a regulatory mechanism has been notified which enables an external Auditor to prepare and submit a Performance Appraisal Report to the Company Management in addition to the assurance report. The Institute has brought out the present guidance note on Performance Appraisal Report, as required in Part III of the Cost Audit Notification dated June 3, 2011.

8.1.2 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. Since the Performance Appraisal Report is to 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 under Cost Audit provisions of the Companies Act, 1956. The guidance note is also not a prescriptive but a suggestive mode for performance analysis.

This guidance is about some of the theoretical perceptions on Strategies formulation and implementation, centering on cost implications. Understanding the theory without understanding the ground reality is dangerous.

8.1.3 The users of this guidance note may come across three types of companies. In the First category are those companies who operate at the global level with a robust system of strategic management processes, including detailed cost management mechanisms. In such companies, the utility of this guidance note may be limited and it would be the ingenuity of the Cost Auditor to locate areas of value-addition through the performance analysis. For such companies, most of the performance analysis parameters are already in the purview of a structured management culture and the cost auditor may additionally provide an effective assurance service on selected performance indicators as desired by the management.

The Second category of companies is the group consisting of leading domestic companies with a sight on the global market. Such companies would be receptive to any positive and meaningful recommendations from the Cost Auditor in the Performance Analysis Report. This guidance note would supplement the efforts of the Auditor in such situations, notwithstanding the fact that in ultimate analysis it is the ingenuity of the Cost Auditor to bring out the important parameters of performance that may be of interest and use to the management of the company in effectively entering/operating in global markets.

The Third category of companies is the group of domestic companies that are confined to domestic market, or even only a part of it, and includes small and medium sized companies. This guidance note largely addresses such a situation confronted by the cost auditors. The value addition provided by the profession in such a situation would strengthen the statutory role which it normally plays under the legal framework by the government.

8.1.4 This guidance note would supplement the efforts of the Cost Auditor in all the three situations categorized above, and is the first version of guidance note on this subject. It is proposed to constantly update the guidance note on the basis of responses from the users of this guidance notes and further exposures in this area. The users are earnestly requested to send their responses, to the Institute for larger benefits.

8.2 PERFORMANCE ANALYSIS

The rationale of Performance Appraisal Report (PAR)

8.2.1 The basic objective of Performance Appraisal Report 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

8.2.2 The Performance Appraisal Report is to be provided only to the company under cost audit. The form III is NOT to be submitted to anyone else. In that sense, this report is a confidential and not public document. According to the rule 4 (5) of the Companies (Cost Audit Report) Rules 2011, the Performance Appraisal Report should be submitted to the Board or Audit Committee of the Board of the company.

8.2.3 The objective is to provide the management objective 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.

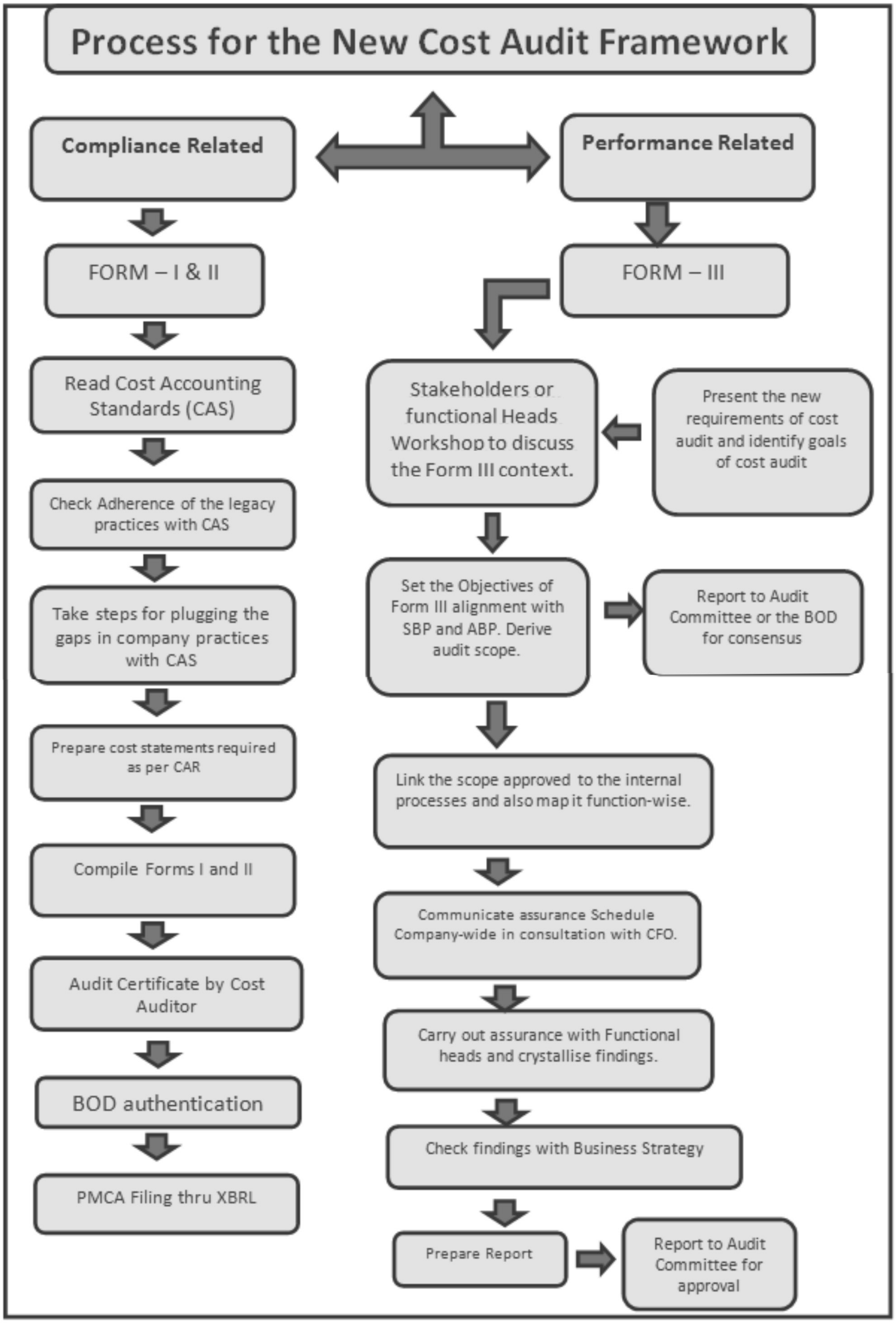
8.2.4 The Performance Appraisal Report is more on principle based than format-driven. It is clear that the contents of the report are to be mutually agreed between the company management and the cost auditor. Although some indicative areas have been specified in Form III to the Companies (Cost Audit Report) Rules 2011, the cost auditor is expected to verify the suitability for the company and then add other relevant areas or delete those not relevant to the Company.

8.2.5 It is also clarified that the frequency of the Performance Appraisal Report is to be mutually agreed between the company management and the cost auditor. The frequency of Performance Appraisal Report should be commensurate with the nature, size and complexity of the business of the company. Usually under the present form of corporate reporting, the BOARD OF DIRECTORS has to make an interim limited review of financial performance on a quarterly basis, immediately after the quarter is over. Ideally, the cost auditor can also consult the management and submit a quarterly Performance Appraisal Report. This will enable identification of business risks faced by the company in the immediate past and evaluate the risk mitigation measures that are planned by the Company in the subsequent period.

8.2.6 It has been clarified that there cannot be a "nil" performance appraisal report. This means that if the report is not issued or if the report is issued as "nil", the cost audit report will be incomplete. The cost auditor must certify in the main body of Certificate to the cost audit report (form II) that the Performance Appraisal Report has been submitted to the management. (Refer to item number (viii) of form II – Companies (Cost Audit Report) Rules 2011.

8.2.7 The Performance Appraisal Report should uncover the opportunities for improvement of performance and creation/enhancement of value of the business. The distinction between Forms I and II as a block in contrast with Form III to Cost Audit Report is presented in the form of a Process Flow below:

8.3 PROCESS FLOW CHART



8.4 CHARACTERISTICS OF A GOOD PERFORMANCE APPRAISAL REPORT

8.4.1 It should be remembered that the Performance Appraisal Report is meant to be used by the company and this report is confidential.

8.4.2 The report, being an annexure to the cost audit report, should basically lay more thrust on the cost management aspect of the business and should effectively bring out comments on how the business performance could be improved by elevating the cost performance.

8.4.3 When commenting on or analyzing the cost performance, the cost auditor could assess the impact of changes in the costs on the profitability of the products, profitability by customers or market segments.

8.4.4 The cost drivers that are the fulcrum of the cause and effect relationship in the cost statement, are the ones which form the first level of KPIs that are easily understood and actionable for the operational executives. The cost auditor while evaluating the KPIs can also look at the efficacy of the cost drivers. This evaluation will also enable the operational executives to relate what is being done at the shop floor to the cost statements that are the end product of the cost accounting system.

8.4.5 It would be necessary to analyze the use of various resources to boost economy, efficiency and effectiveness of the operations. Economy indicates incurring of the least possible cost for acquiring and/or utilizing the resources, without compromising the quality. Efficiency denotes maximization of the output-input ratio. Effectiveness means achieving the desired goals. The Performance Appraisal Report should cover, at the minimum, all the three aspects of cost management.

8.4.6 For being a valuable report, Performance Appraisal Report should portray analysis of a range of performance measures. While selecting these measures, care should be taken to include those having a material impact on the past or future performance of an organisation. These measures could change over period of time and may require to be reconsidered for inclusion to or exclusion from the Performance Appraisal Report.

8.4.7 The following criteria may help the cost auditor to select and include the various performance measurement criteria in the Performance Appraisal Report:

- 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.

8.4.8 The Performance Appraisal Report should include non-financial performance indicators in addition to the use of traditional financial ratio analysis. The non-financial measures provide useful information about the probable future of performance of the company. E.g. a consistently good customer satisfaction index would guarantee a certain growth in business.

8.4.9 An ideal Performance Appraisal Report 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

8.5 SUGGESTED MECHANISM FOR PERFORMANCE ANALYSIS

8.5.1 After analyzing the activities within each process, we come to the operational part of Form III of the Companies (Cost Audit Report) Rules 2011. We give below the suggested mechanism for performance analysis as follows:

8.5.2 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.

8.5.3 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?

Narrowing the list of measures requires judgment and knowledge about the organization's systems and customers. Keep in mind that the audience who receives the information set the standard for what is relevant and important. Typically, internal audiences are interested in process-level measures and production outputs. Surveys may be measurement tools of last resort for qualitative subjects that defy attempts to measure them quantitatively, such as customer satisfaction. Survey scores can be useful to internal audiences, but usually mean little to external audiences. External audiences involved in budget and policy development are more interested in efficiency and outcome (results) measures. Because ultimate outcomes are often influenced by many factors besides a company's work, the most meaningful measures for judging effectiveness may be immediate outcomes.

8.5.4 Try to avoid common mistakes in writing about selected performance measures:

- Should not include explanations of why the measure is important or how the data is collected. Those comments belong to in operational details, footnotes, or unpublished notes.
- Avoid jargon and acronyms in performance measure titles, so readers who are not subject matter experts can understand what is being measured.

Don't word performance measures as objectives. Objective statements include words such as "increase" or "decrease," which imply change. Objective statements are not performance measures, although performance measures can tell us whether we are meeting our objectives.

8.6 EIGHT STEPS APPROACH SUGGESTED FOR PERFORMANCE APPRAISAL REPORT- FORM III

In conclusion we present below eight steps involved in the preparation of the Performance Analysis Report for being submitted to the Board or Audit Committee of the company:

Preliminary discussion with the Management of the company to apprise them of the scope of Form III of the Companies (Cost Audit Report) Rules 2011, with specific reference to the company.

8.6.1 Identify and understand the key strategies of the company, both prescriptive and emergent strategies included.

8.6.2 Choose strategies that have more visible expressions in costs data maintained by the company.

8.6.3 Identify the activities that were impacted by the strategies selected and also implemented during the year of cost audit.

8.6.4 Analyze the cost implications of those activities and link it with the expected results of the strategies.

8.6.5 Present the evaluation, in a table or any other easily comprehensible format like histogram, chart, graph etc.

8.6.6 Give explanatory notes for the terms used, calculations made, and assumption behind the evaluations.

8.6.7 Finalize the finding after a discussion with the concerned operating executives and then with the management of the company.

8.7 GENERAL GUIDANCE ON THE FIRST TIME PREPARATION OF PERFORMANCE APPRAISAL REPORT

8.7.1 The Performance Appraisal Report being the part and parcel of the cost audit report, it would apply in all the cases where Companies (Cost Audit Report) Rules, 2011 apply with effect from 1st April 2011.

8.7.2 Before preparing the Performance Appraisal Report for the first relevant year, the following approach is recommended to be adopted by the cost auditor:

- The cost auditor first must clearly understand the nature of business operations of the company, its segmentation, the environment within which the company operates. It is essential to list the various business drivers and then prioritize according to the importance of each one of them. For this purpose, it will be useful to relate to the definitions of "manufacturing activity", "mining activity", "processing activity", "product" and "production activity" as mentioned in the rule 2 of the "Companies (Cost Accounting Records) Rules 2011. This will provide immense insight for the cost auditor to understand the nature of business and then build the Performance Appraisal Report around it.
- The organization's reporting structure is a crucial consideration. The responsibility centers recognised as investment centers, profit centers or cost centers should be correctly understood as the performance metrics for each of them would be different.
- The business drivers could, inter alia, include product life cycle stage, technology, customer preferences, market developments etc. This will enable the cost auditor to understand the variables that impact the performance of the company.

- It is recommended that the cost auditor collects and analyses the competitor information. Using this he could add value to the Performance Appraisal Report by clearly bringing out the comparative analysis of performance parameters.
- The cost auditor should, by having a series of discussions with the senior management, understand the existing MIS reports of the company and the objectives thereof. It is necessary understand how these reports help the management to make decisions for short term and long term.
- It is necessary to get agreed between the cost auditor and the company management the contents of the Performance Appraisal Report and the frequency of the issue which could be half-yearly or yearly depending upon the need. More frequent reporting may not be feasible. The cost auditor should concentrate on financial as well as non-financial performance indicators. The selection of Key performance indicators (KPIs) for a highly diversified company may be difficult and should be done based on the economic relevance of each business in the overall performance.
- It would be better to provide the comparative figures for the previous one or two years as may be required in consultation with the management. The preparation time for the first report may be a little longer as the information may have to be collected and analysed for more than one reporting period.
- The cost auditor could summarize the plan in order to have clarity. A suggestive format of the plan is given in the Appendix- A

8.7.3 Once the terms of Performance Appraisal Report are agreed upon as above, the cost auditor should ensure that the company has the underlying information system which could throw up the data required for the preparation of Performance Appraisal Report. In case, the existing system is insufficient, the cost auditor could hold discussions with the IT head of the company.

8.7.4 The cost auditor is recommended to have a personal hearing from the head or member of the audit company and discuss the Performance Appraisal Report templates with them. The templates of Performance Appraisal Report could then be finalised.

8.7.5 The cost auditor should make a presentation to the general management team and the members of audit committee. This presentation should highlight the performance metrics selected for the Performance Appraisal Report, the logic of selecting them, and the way they would help the company to review its performance. The cost auditor should then present his independent evaluation of performance of the company. It should not only be diagnostic assessment, but should also include suggestions for improvements.

8.7.6 The suggestions for improvement could stem from comparing the performance vis-à-vis competition or any other benchmark selected (whether internal or external).

8.7.7 The Performance Appraisal Report should not contain only number crunching, but have meaningful conclusions drawn from the relationships that exist between various performance criteria.

8.7.8 The cost auditor must maintain proper record of all the information gathered from the company for the purpose of compiling the report. (Please note this information is required for carrying out the cost audit work as well).The record may be maintained to include:

- The company organisation structure with divisions, departments, SBUs, products and services handled etc.
- Details of information collected
- Source of the information – whether from the IT system or internal documents, board minutes, any other internal correspondence

- Basic assumptions like risk perception of the management, discount rates used in various calculations, the methods of inventory valuation, overheads allocation, absorption rate calculations etc.

8.8 GENERAL GUIDANCE ON PERFORMANCE APPRAISAL REPORT FOR SUBSEQUENT YEARS

8.8.1 Handling of the Performance Appraisal Report for subsequent years may seem to be simple. However, the cost auditor must exercise proper care to ensure that the Performance Appraisal Report is relevant and serves the objectives of the management and the audit committee. The cost auditor should revisit various aspects of the previous report and dwell upon the rationale thereof.

8.8.2 Depending upon the satisfaction of the Board or the members of Audit committee, the cost auditor should choose to continue reporting on the same parameters or may elect to alter some of them in consultation with the management.

8.8.3 For every subsequent year, it is necessary to question the basis of preparing and submitting the Performance Appraisal Report. If substantial changes have occurred in the business during the year (like merger or demerger, introduction of a new products, new markets, discontinuation of a product line, new technological development, or such other material changes), the cost auditor should make suitable changes in the contents and format of the Performance Appraisal Report.

8.8.4 It would be pertinent to highlight the effect of such changes on the overall performance of an organisation and also how these factors could potentially drive the future performance of the company.

8.8.5 The cost auditor should comment on the feedback on the previous year's Performance Appraisal Report. There may suggestion made in the previous year on which the management may have agreed to act upon. The Performance Appraisal Report should comment on the actions taken by the management and the outcome thereof. This is essential to ensure no issue remains open.

8.8.6 The Performance Appraisal Report would also highlight the success achieved as a result of suggestions made in the Performance Appraisal Report of the previous year/s. It is required to officially document the usefulness of the Performance Appraisal Report for the organisation.

8.9 GUIDANCE ON INDICATIVE CONTENTS OF THE PERFORMANCE APPRAISAL REPORT

8.9.1 The form III of the Companies (Cost Audit Report) Rules 2011 has provided an indicative list of the contents. The critical parameters that have to be concentrated upon may differ from industry to industry and within the business amongst the business segments. Some KPIs may also be not figuring in the indicative list also. The cost auditor has to use his judgment in shifting between the chaff and grain and arrive at Performance Appraisal Report indicators that add value to the Company. This guidance note aims at providing the approach for each of those areas.

8.9.2 This approach would enable the cost auditor to include in the report

- The opinions and observations and
- Suggestions for improvement

8.9.3 The word "opinion" denotes "a view point". The cost auditor is expected give his/her viewpoint about "how something or someone has performed" during the reporting period. In addition, the cost auditor is expected to put a remark as an observation. This needs to be based on a critical assessment of the performance metrics. This may include quantitative and/or qualitative assessment of various performance indicators chosen for reporting. It is recommended that the cost auditor should establish an observed relationship between two or more parameters and the outcome thereof. This may mean cause-effect observations.

8.9.4 Based on the view point and remarks, the cost auditor should put forward suggestions or recommendations for improvement. The cost auditor may develop certain ratios in relation to the chosen metrics and then elucidate the analysis by comparing these ratios with the set benchmarks.

8.9.5 For each of the indicative area given in the form III, the guidance aims at providing the following:

- Meaning and Coverage of the area
- Performance measures related to the area
- Cost auditor's checklist

8.9.6 The guidance note 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

8.9.7 For these and any other performance measures elected for inclusion in the Performance Appraisal Report, the cost 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

8.10 CAPACITY UTILISATION ANALYSIS

8.10.1 The basic quantitative information on capacity is covered in the Para 4 – Quantitative Information to the annexure to the cost audit report. 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.

8.10.2 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 cost auditor should assess this impact by analyzing and relating the impact of capacity costs on profitability.

8.10.3 The cost 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 cost auditor should identify the "constraint" that would limit the capacity of the entire organisation or product or a certain geographical area.

8.10.4 The cost 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

8.10.5 When comparing the actual production with the capacity, the cost 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.

8.10.6 Most of the capacity related information is available with the production and industrial engineering departments. The cost auditor should also refer to the CENVAT records for actual production data.

8.10.7 The cost 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.

8.10.8 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

8.10.9 The cost 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)

8.10.10 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)

8.11 PRODUCTIVITY AND EFFICIENCY ANALYSIS

8.11.1 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.

8.11.2 The cost auditor could understand and analyse the whole chain of input-processing-output. This analysis, while traditional and very basic, would help cost auditor to comment upon the performance of the organisation across products or product groups. It is necessary for the cost auditor to understand the input ingredients for each product, product group, customer etc.

8.11.3 Para 6 and Para 8 to the cost audit report provide some basic information about the input costs and their relation with the output. The cost auditor should further analyse these areas to identify causes of good performance and areas that need improvements.

8.11.4 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 cost 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 cost 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

8.11.5 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 cost auditor for analysis

8.11.6 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

8.12 UTILITIES AND ENERGY EFFICIENCY ANALYSIS

8.12.1 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.

8.12.2 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.

8.12.3 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 cost 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.

8.12.4 The cost 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.

8.12.5 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.

8.12.6 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

8.13 KEY COSTS AND CONTRIBUTION ANALYSIS

8.13.1 The thrust here should not be only on computation of numbers or percentages for various product groups under consideration. The cost auditor should check the reasonableness of the contribution by benchmarking with the industry average wherever applicable.

8.13.2 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. Para 6 -Annexure to 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.

8.13.3 The cost 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.

8.13.4 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 cost 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.

8.13.5 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 cost auditor can add value by pointing out contribution earned per unit of the key constraint resource.

8.13.6 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 cost 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.

8.13.7 The cost 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.

8.13.8 The checklist for the cost auditor could include reference to

- Sales and production records
- Reconciliation with CENVAT records
- Price lists and discount structure policy
- Product cost statements
- Operational budgets

8.14 PRODUCT/SERVICE PROFITABILITY ANALYSIS

8.14.1 The unit product or service profits are driven by two major components viz. cost per unit and selling price per unit. The cost 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 cost auditor must ensure that the basis use to allocate indirect costs is consistently adopted by the company.

8.14.2 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 cost auditor should bifurcate the sales and costs for each portion and then compute and comment on their respective profitability.

8.14.3 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.

8.14.4 It would help to separately identify the costs of production, selling & marketing and handling customer services.

8.14.5 The cost 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.

8.14.6 The analysis should separately appraise profitability of newly introduced products or services and also their proportion to the total profits of the organisation. The cost auditor should incorporate the profitability analysis of products discontinued during the period.

8.14.7 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.

8.14.8 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.

8.14.9 The checklist for the cost auditor could include reference to

- Sales and production records
- Reconciliation with CENVAT records
- Price lists and discount structure policy
- Product cost statements
- Operational budgets

8.15 MARKET / CUSTOMER PROFITABILITY

8.15.1 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.

8.15.2 The cost 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.

8.15.3 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.

8.15.4 The challenge in all the above named method of segmentation lies in the computation of costs for each of them. The cost auditor should carefully evaluate the allocation of costs to the different channels, especially marketing & campaigning costs.

8.15.5 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 cost auditor should perform trend analysis to judge the performance in such cases and recommend suitable measures.

8.15.6 A life cycle approach would provide better insight into the market or customer profitability analysis. Hence, the cost 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.

8.15.7 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.

8.15.8 In addition to the study of profitability, the cost 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.

8.15.9 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

8.16 WORKING CAPITAL AND INVENTORY MANAGEMENT ANALYSIS

8.16.1 This part of the report should point out the efficiencies in operations through management of different components of working capital. The cost auditor should identify all the elements of working capital for each product group and evaluate the adequacy or otherwise thereof.

8.16.2 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.

8.16.3 On the whole, the cost 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.

8.16.4 Working capital decision is handling of the conflict between liquidity and profitability. The cost auditor could provide an independent assessment of how it is being currently handled and how it can be improved.

8.16.5 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.

8.16.6 For manufacturing industries, inventory is the major portion of the current assets. The cost 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.

8.16.7 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 cost auditor should comment upon the quality of inventory asset using the inventory aging reports.

8.16.8 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 cost 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.

8.16.9 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 cost auditor could analyse the supplier-wise performance in respect of on time supply, quality issues, pricing, etc.

8.16.10 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.

8.16.11 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.

8.16.12 The cost 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.

8.17 MANPOWER ANALYSIS

8.17.1 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.

8.17.2 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.

8.17.3 The factor returns from the manpower is in terms of growth in production and productivity, enhancement of skills and knowledge of the organisation. The cost 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 Performance Appraisal Report.

8.17.4 The Performance Appraisal Report may include comments and observations about the employee learning and growth opportunities and their linkage with the improvement in overall performance of the organisation.

8.17.5 The cost 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

8.18 IMPACT OF IFRS ON THE COST STRUCTURE, CASH FLOWS AND PROFITABILITY

8.18.1 The new era of accounting standards has started in India after India committed to converge to the IFRS. The Ministry of Corporate Affairs had notified 35 new Ind AS in 2011. 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.

8.18.2 However, it will be useful for the cost auditor to run through the effects that the new standards may have on the organisations in the new era. The cost auditor should get acquainted with the requirements of the new standards and the differences as compared to the existing standards.

8.18.3 In the Performance Appraisal Report, the cost 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.

8.18.4 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.

8.18.5 The most important effect on valuation will happen through the adoption of "fair value" concept in measuring various assets and liabilities. The cost 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.

8.18.6 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.

8.18.7 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

8.18.8 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

8.18.9 The Performance Appraisal Report should include comments of the potential changes for the understanding of the Board and Audit Committee members. The cost 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.

8.19 OTHER AREAS THAT COULD BE COVERED IN THE PERFORMANCE APPRAISAL REPORT

8.19.1 As stated in the note to the form III, the above named areas are only indicative. It should, however, be noted that these are very comprehensive and could cover most of the aspects of enterprise performance. However, depending upon the specific characteristics of the industry within which a company operates, the performance criteria should be chosen and included in the Performance Appraisal Report. It may be necessary to drop one or more of the above on the basis of their relative importance (or the lack of it) for the organisation.

8.19.2 Some additional areas of performance assessment actually may not directly comment upon the current or past performance but the likely future performance. The cost 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 appendix B.

8.19.3 Another set of parameters could company specific. The companies may track performance using parameters such as EVA and therefore the assessment will have to be done to meet the specific requirement.

8.19.4 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 cost auditor should benchmark these with companies in the same industry and provide observation thereon.

8.19.5 Risk Management: The Performance Appraisal Report should include the risk analysis that may affect the future performance. These could be macro variables causing variations like the economic indicators of India such as industrial growth trends, Government policy on commerce and trade, interest rates, international growth etc. The risks facing the business could arise out of technological changes, entry of competition, stages of product life cycle, FOREX rate movements, shifts in customer preferences, credit risks, etc. The cost 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

8.19.6 Environment and Sustainability: The Performance Appraisal Report could provide insight into how effectively the company is following policies on CSR, environment and sustainability. The importance of economic, social and environmental performance hardly needs any justification. The CSR index could be formulated to reflect performance in respect of socially responsible products, socially responsible processes and socially responsible employee relationships. The index could comprise of spending by the company on these as a percentage of turnover. Similarly, the economic benefits from the environmental & sustainability initiatives could be indexed to the costs of such initiatives and reported.

8.19.7 Quality Performance: Quality is another important performance area. The cost auditor could include analysis of quality performance of the company. The 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. The quality costs should be reported as prevention costs, appraisal costs, internal failure costs and external failure costs. It will be useful to analyse the changes in the composition of total quality costs and their impact on the sales and profits, e.g. higher spending on prevention would mean less costs on external failures, which in turn would reduce customer complaints and could bring in higher sales. Such analysis would provide good value for the user of the Performance Appraisal Report.

8.19.8 R & D Performance: The future performance of companies would depend upon their success of the R & D initiatives. The cost auditor could provide a useful lead in this respect by including analysis of the R & D costs. The analysis may include, inter alia, the percentage of successful research initiatives, the turnaround time taken for development, the response time taken for changes in designs due to customer requirement etc. Total expenditure on R & D initiatives as a percentage of sales turnover may be a good indicator of the technology leadership status of the company.

8.19.9 Business Process Performance: The cost auditor could evaluate various processes followed by the company and incorporate valuable assessment in the Performance Appraisal Report. The processes could be evaluated on the criteria like speed, accuracy, empowerment, hurdles, facilitation etc. The process performance would have a bearing on costs and profitability of the organisation. Transparent and ethical business processes would enhance the corporate image of the company and hence the cost auditor could bring out clearly how far the exiting processes need to be modified. The cost auditor could suggest best practice adoption approach from the benchmarked processes of the industry. This data is usually available in the published case studies. It would be appropriate to highlight the processes that should be re-engineered.

8.19.10 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. This value of human capital is reflection of the enhanced value that an organisation could create by owning the human asset. The cost auditor could observe the value of human asset and link it to the returns. This is an upcoming performance measurement criterion.

8.19.11 Value Added Analysis: The performance of a company could be measured in terms of the value based approach. 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.

8.19.12 Performance of Intangible Assets: The business may have internally developed intangible assets. In financial accounting these are generally not capitalised. It is possible to use value based approach. 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.

8.19.13 Stakeholder Performance Analysis: This would mean analysing various performance parameters for the different stakeholders. 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 Performance Appraisal Report.

8.20 MANAGEMENT ACCOUNTING TOOLS

8.20.1 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.

8.20.2 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 cost auditor should identify such sources within and outside of the organisation and use information drawn from the same.

8.20.3 The management accounting tools could be used to analyse the performance with different purposes. The cost auditor should verify the tools and techniques used by the company and comment on appropriateness and adequacy thereof. The cost auditor could recommend more appropriate management accounting tool.

8.20.4 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

8.20.5 The cost 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 Performance Appraisal Report 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.

8.21 APPENDIX

Appendix A

Planning for the Performance Appraisal Report

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 Performance Appraisal Report:

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 cost 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 cost auditor gets the management's nod on these basic elements, the Performance Appraisal Report can certainly be a value adding proposition for the company.

Appendix 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

Appendix 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

1. Strategies can be seen as the process of building on or stretching a company's resources and competencies to create opportunities for the company to benefit from them. It means identifying existing resources and competencies and using them to create opportunities in the market. Strategies may require major and comprehensive resources changes for the company. This would be in terms of the extent to which resources can be obtained and controlled to develop strategies for the future.

   Strategies do affect operational decisions. Operational aspects of the company need to conform to the strategies to achieve the goals of the strategies. Also, only at the operational levels the strategic advantages are achieved. Performance Analysis report as discussed in this Guidance note, takes this view of linkage between strategy formulations and operational dimensions. Strategy will be affected by the values and perceptions of people around the company who have power in and around the company, like investors, shareholders, consumers, suppliers and the regulatory authorities.

   Strategies formulated in a company can be grouped into three levels: The Corporate Level, The Product Group Level and the operational level. All the three levels, it must be emphasized, are closely inter-related. In this guidance note we focus more on the Operational levels and Product group levels, notwithstanding the significance of the Corporate Level strategies on these two levels of strategies. While the Products group level strategies largely concentrate on gaining/maintaining Competitive advantages, the operational level strategies focus on processes and resources allocation. Strategies implemented, have a wide range of implications including cost implications. A Cost Auditor should focus on the cost implications of strategic decisions and their implementation, not losing the sight of other implications. Familiarity with the strategic management process will be an essential requisite for this focus .

2. **Strategic Management Process:**

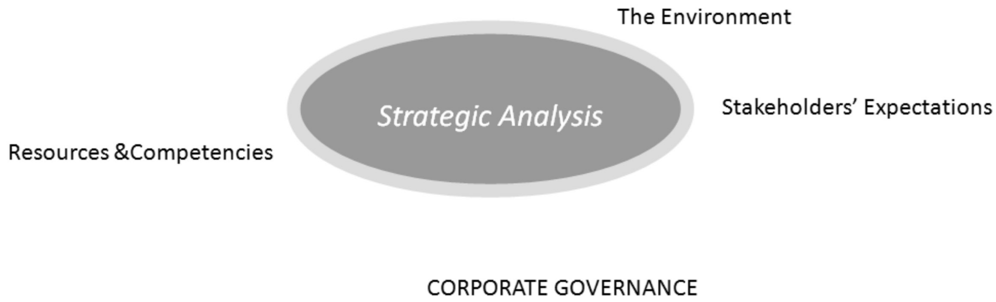
   Strategy and strategic management are significant aspects of company's decision making process in a specific political and cultural context and the performance analysis would include a rational assessment of the strategies and implementation thereof. However, the Para III of the Cost Audit Report Rules, 2011, would also deal with those aspects of company's performance which have cost implications in a strategic context. While it is true that the notifications of June 3, 2011, prescribing Para III, do not restrict to operational performance analysis with cost implications only, this guidance note is based on the premise that the Cost Auditor's role in performance appraisal report can be extended to strategic areas expressible in terms of cost impacts. There is a sufficient scope for reporting on overall performance, because of the recent thrusts in companies on resource-led strategies which tend to have significant cost implications.

3. **Strategic Management is concerned with:**

Strategic Analysis>Strategic choices>Strategic Implementation

All the above three segments are inter-related. Performance Analysis is evaluation of the results of the implemented strategies, in the context of strategies chosen after Strategic Analysis. Hence the Cost Auditor preparing the Performance Appraisal Report should be well versed with this cycle in the company under audit. The guidance note takes this perspective and presents a brief description of the Strategic Management process for the practicing members to appreciate the theoretical context behind the appraisal process.

Strategic Analysis:



4. The strategic management process is concerned with the issue of positioning the company in the context of its environment, competitive and others. For example, a small company may be engaged in finding a niche' in the emerging competitive market. The Strategic management process is also involved in finding ways to extend the company to a perceived future position with higher levels of competitive advantage. One of the important factors on which success of company is dependent, is the strategic capability of the company which is based on judicious use of resources to build competencies and achieve core competencies. We also know that the core area of analysis under Cost Audit is the study of the Resources of the company. The cost audit, in a way, attempts to assess the inherent strengths of the resources of the company in the contexts of the strategies of the company as well as in comparison to other users of similar resources. The appraisal of the resources of the company, in terms of its competencies and efficiency, will be a significant input for the Management. Hence, the Performance Appraisal, primarily, should focus on the resources of the company both in terms of usage in strategies' implementation as well as in terms of the outcomes of its usage. It would also include an appraisal as to the uniqueness of the resources of the company that adds to its competitive advantage.

5. Resources

Resources of any company may be grouped:

(a) Physical resources:

Queries should be raised as to the nature of these resources, such as age/condition/capabilities, and the location of the resources to the extent of their usefulness in contributing to the competitive advantage of the company. Capacity utilization, a performance indicator, analysis is a good example to appreciate the meaning of physical resources' performance. Input-output ratio, machine hour rate are some of the factors that may throw light on the usage of physical resources.

(b) Human Resources:

Skill base of this resource, under each category, its conformity with the strategies are important areas of analysis and evaluation. Similarly, the adaptability of the human resources to the strategies formulated, needs to be examined while evaluating the operational processes as well as their outcomes.

(c) Financial Resources:

Financial Resources are the money available to a business for spending in the form of cash, liquid securities and credit lines. Simply put Financial Resources represent the money that is available for a person or organization to spend. Before going into business, an entrepreneur needs to secure sufficient financial resources in order to be able to operate efficiently and sufficiently well to promote success

Companies often need funding for starting or continuing business operations. Small businesses typically need start-up funds, while medium and larger companies may need funding to expand operations or purchase competitors. Different types of funding are usually available based on the company's size and needs. Companies may choose to use traditional funding sources such as banks and equity investors or apply for government grants or venture capital funds. Each funding type offers different advantages to companies with different costs associated with them.

Corporate financial management plays a cardinal role in organizational decision-making processes, enabling companies to manage risks adeptly, administer liquidity ratios and increase profit indicators. Central to corporate strategies are management accounting procedures that organizations select in the short- and long-terms.

(d) Intangible Resources:

Performance analysis should also take into account the intangibles as this is gaining in importance in determining or shaping competitive advantage. For example, capacity utilization of machine and processes are increased often to improve the brand image and not for any focused Sales growth. In such cases, the capacity utilization enhanced is a pointer to the brand image strategy in place and not to be confused with sales growth. The performance analysis should include audit of all the resources of the company that support its strategies, including resources like network of contacts or customers.

The cost auditor will do well to identify resources that are critical in underpinning the company's strategies. That is, which are the resources on which the successful performance of the strategies, implemented, depends?

6. Competencies

Difference in performance over time in the same company or differences in performances of different companies in same industry, cannot be explained only by the differences in their resources base, but also need to be examined in the manner in which the resources have been deployed. Resources deployed in various cost centres would indicate the competencies of the company in activities within a cost centre. These are the competencies that help the company in gaining or strengthening its competitive advantage. Competencies are those which are the strengths of the company in using its resources. They are difficult to be imitated by competitors. The bases of competencies of company could be any or all of the following:

a) Cost efficiency; b)Value addition:

The Performance Analysis process should examine the above factors in identifying the core competencies (those that are unique to the company) of the company and their comparisons through appropriate benchmarks. This is an area of professional expertise of the cost auditor.

Core competencies (cost efficiency being an important one) in different activities contribute to the competitive advantage of the company. Identifying the core competence of the company in various activities/cost centres and providing performance appraisal of them, periodically, is within the scope of the Performance Appraisal Report. Creating and managing these core competencies provides leverage and levels of performance that are difficult to imitate by competitors, and hence the competitive advantage to the company.

7. Value Chain:

It needs to be appreciated that many company attempts to gain competitive advantage by appropriately linking its own activities with those of the suppliers, channels or customers. Vertical-integration, quality controls on inputs from suppliers, total quality management strategies, controlling distributors' performance through training/financing etc., collaborative arrangements etc. are some of the ways in which company's own activities are beneficially linked to other organizations. This provides an avenue for reporting under performance analysis report. What has been the cost of such coordinating strategies and how much of competitive advantage of the company has improved or strengthened at present level? If such linkages with other companies are established as a matter policy, every year, then performance as to the cost efficiency in such coordinating/ cooperating linkages can be an area for appraisal for the Cost Auditor.

8. Benchmarking

A company's capabilities (resulting from core competencies) are to be assessed, ultimately, in relative terms. Items like capacity utilization at a given level Sales value, contribution ratio, investments in green initiatives, contributions to social responsibilities, are of no use unless juxtapositioning them with other companies' similar data. Such an attempt is usually known as Benchmarking. It is important to note that benchmarking technique, both internal and external to the company, would be an important tool for reporting on the performance appraisal by the Cost Auditor. While historical comparisons are important, they may be limited in their potential to draw conclusions. Hence, comparison with outside organizations for each or group of activities may be advantageous in analyzing the real performance. It is always a welcome input for the top management of the company, when an external assurance professional provides a comparative analysis of the company's performance with that of best practices in the Industry. Having mentioned the relevance of Benchmarking under Performance Appraisal Report, it must be stated in clear terms that it is a challenging task for the Cost Auditor and it would require good amount of hard work to get appropriate benchmarks and use them effectively. In the initial years, historical data comparisons, input-output data available in public domain may be used and slowly graduate to higher levels of benchmarks acquired through specific in-depth studies undertaken by the cost auditor. It must be mentioned that it is necessary for the Cost Auditor to identify areas for benchmarking, after a detailed consultation with the Management of the Company. Many companies do have a system of collating Benchmark data and using them for internal analysis. It is also important to note that benchmarks can be for individual activities, group of activities, processes, outcomes including final products/services.

8.23 PROCESS MAPPING AS A TOOL IN PERFORMANCE MANAGEMENT AND EVALUATION

1. Definition of "process": "A collection of interrelated work tasks, Initiated in response to an event." The objective of a process is to achieve the specific result as expected by its customer. A process can be made up of processes, often called sub-processes. Process mapping is to understand the activities of the company, in the background of strategies formulated and implemented by the company at all levels. To evaluate performance it is necessary to understand the processes in the company, as they constitute the area of performance analysis. Each process is understood by what is known as process mapping. Processes involve more than one person/equipment, coordinated effort is required. Tasks involve one person/equipment. Two versions of a process map are common:

> **As-is:** the current state of the process;

> **To-be:** the goal state of the process;

2. Likely results of process mapping:

Increased understanding of process, Increase consensus about the process, increased visibility into the process (Those who assume they know the process, without having mapped it, will probably find surprises when they map the process).

3. Steps-wise approach for Process Mapping:

1. Observe process
2. Document your observations
3. Identify all process steps & Align all the steps horizontally

4. **List the parameters that can change a product characteristic at each step (machine settings, supplies)**

5. **Identify VA and NVA steps:**

   5.1 Value Adding (VA) steps have the following characteristics:

   a. Something the customer would be willing to pay for

   b. Transforms the product or service (shape, smell, color)

   5.2 Non Value-Added (NVA) steps are classified as:

   a. NVA Necessary:

   - Activities that your customers do not want to pay for (it does not increase value in their eyes) but are required by the company for some reason: Accounting, legal, Rework, multiple signatures & copies, counting, handling, inspecting, set-up, downtime, transporting, moving, delaying, storage.
   - Is task required by law or regulation?
   - Does task reduce financial/liability risk?
   - Does task support financial requirements?
   - Does process break down if task is removed?

   b. NVA Unnecessary (waste): (rework, delays, idle)

6. **List Process Inputs and Outputs:** Each step in a process may be understood in terms of a common logic: INPUTS >>>>TASK >>>>>>OUTPUTS.

   Inputs: all necessary parameters to complete a step in a Process (Human Resources, Machine, Measurement, Method, Material including Utilities and Nature)

   Task: Activities converting inputs into outputs.

   Outputs: End-products; parameters that are measurable or assessable

7. **Inputs & outputs can be identified by:**

   Brainstorming; Work instructions; Operators experience; Industry standards; Engineering knowledge; scientific theory

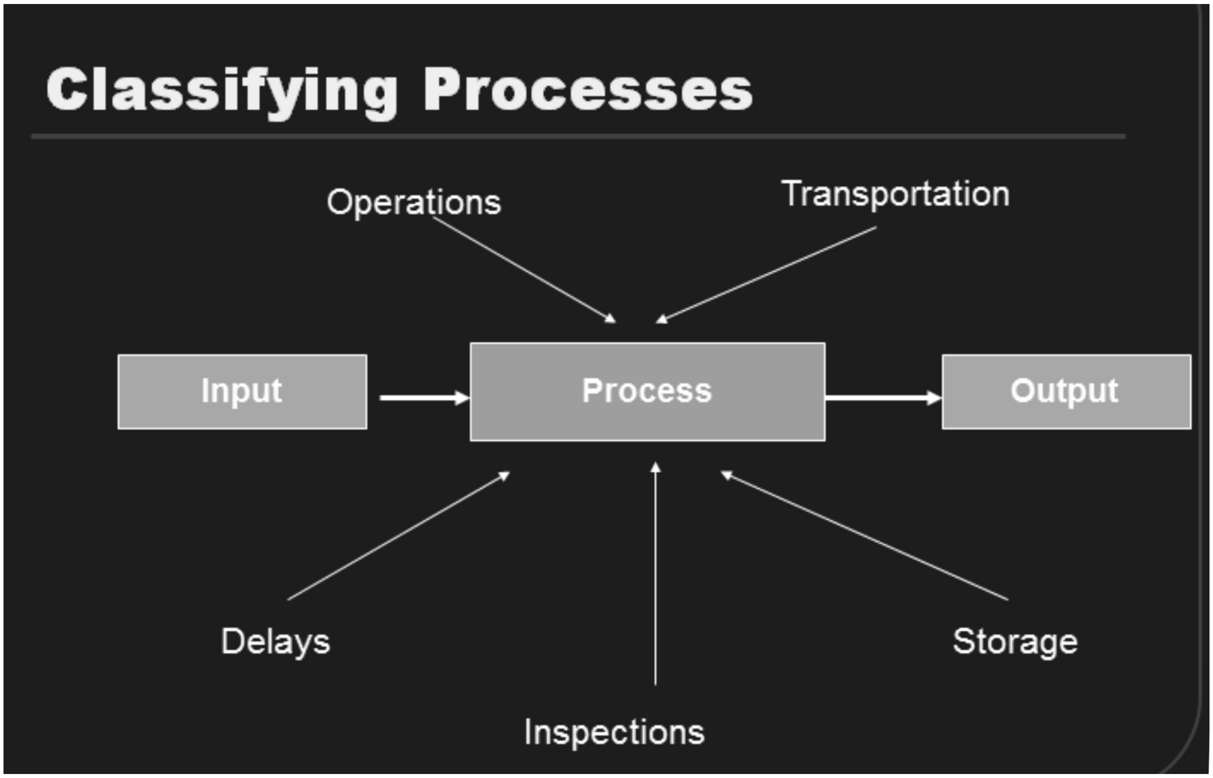
8. Classify inputs into the following categories:

   - Uncontrollable factors in the process
   - **Controllable Factors -** Process factors that can be changed to see the effect on product characteristics.
   - **Standard Operating Procedures -** A procedure is used to define and run those factors.
   - **Critical Factors** – Important factors that determines the outcome. (Availability of specific input, at times, become so critical that even product mix is determined by computing contributing per such input)

9. **Link desired customer value to process:** Time ; Cost; Quality; Flexibility; Sustainability;

10. **Measure The Process**

- Show total time as VA and NVA percentages for the entire process.
- Analyze the NVA steps, investigate time wasted.
- Calculate Cycle Time – total time elapsed to run all the steps in a process to complete a part and start the next one.
- ·Calculate Flow Time – total scheduled time to complete a part



For the benefit of the readers, we list out the possible benefits of process mapping:

- Understanding of the process flow
- Find where/what/when/who/how waste is being created
- Define elements of cycle time
- Eliminate or combine steps
- Improve process flow
- Re-layout the process
- Reduce variation, cycle times, rework, waste and manpower
- Allocate resources better
- Process Mapping may also help in focusing to eliminate waste, like:
  a. Unnecessary motions, steps
  b. High volume of inventory, overstock

c. Overproduction

d. Transporting

e. Waiting, idle, queuing

f. Defects, scrap

g. Under-utilization of resources (people, equipment)

It is important to point out here that Process flow as mapped in the above Ten steps, may undergo change due to:

- Raw materials
- Product (output) design
- Job design
- Processing steps used
- Management control information
- Equipment or tools
- Suppliers

The above elaborate articulation of Process Mapping is to enable the Cost Auditors familiarize themselves with the role of process mapping as a vital tool in the performance analysis.

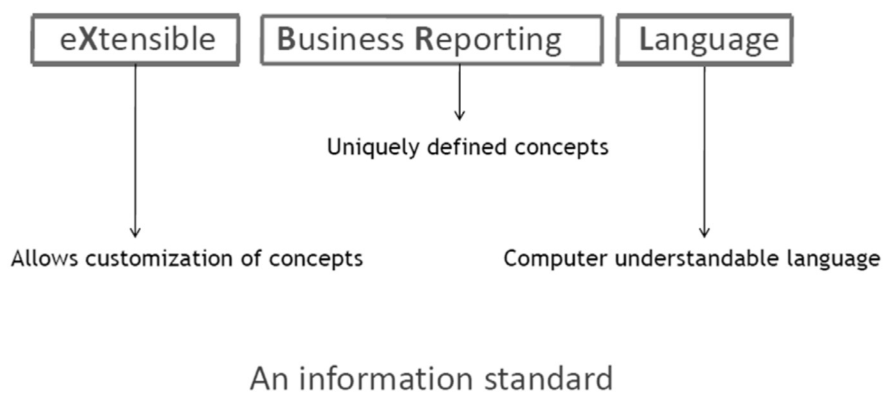
Study Note - 9

EXPOSURE DRAFT TRAINING & GUIDANCE MANUAL FOR COST AUDIT REPORT & COMPLIANCE REPORT IN XBRL FORMAT

This Study Note includes

9.1 INTRODUCTION TO XBRL

XBRL stands for eXtensible Business Reporting Language. It belongs to the XML (the eXtensible Markup Language) family of languages. An extensible language means one that is designed to easily allow addition of new features at a later date. It is an open standards-based reporting system that is built to accommodate the electronic preparation and exchange of business reports around the world. XBRL is all about the electronic tagging of data.



Source: IRIS

The initial goal of XBRL was to provide an XML-based framework that the global business information supply chain will use to create, exchange, and analyze business reporting information including, but not limited to, regulatory filings such as annual and quarterly financial statements, general ledger information, and audit schedules.

XBRL is freely licensed and facilitates the automatic exchange and reliable extraction of business information among various software applications anywhere in the world.

A standard set of XML-type tags can be used to create instance documents that can then be presented in a variety of formats. XBRL is not trying to set new accounting standards; it is attempting to standardise the XML-based tags that are used in business reporting so that the business reports prepared by organisations can be more easily compared and collated for regulatory and other purposes.

The introduction of XBRL tags enables automated processing of business information by computer software, cutting out laborious and costly processes of manual re-entry and comparison. Computers can treat XBRL data "intelligently"; they can recognise the information in a XBRL document, select it, analyse it, store it, exchange it with other computers and present it automatically in a variety of ways as per the requirements of the users. XBRL greatly increases the speed of handling of business data, reduces the chance of error and permits automatic checking of information.

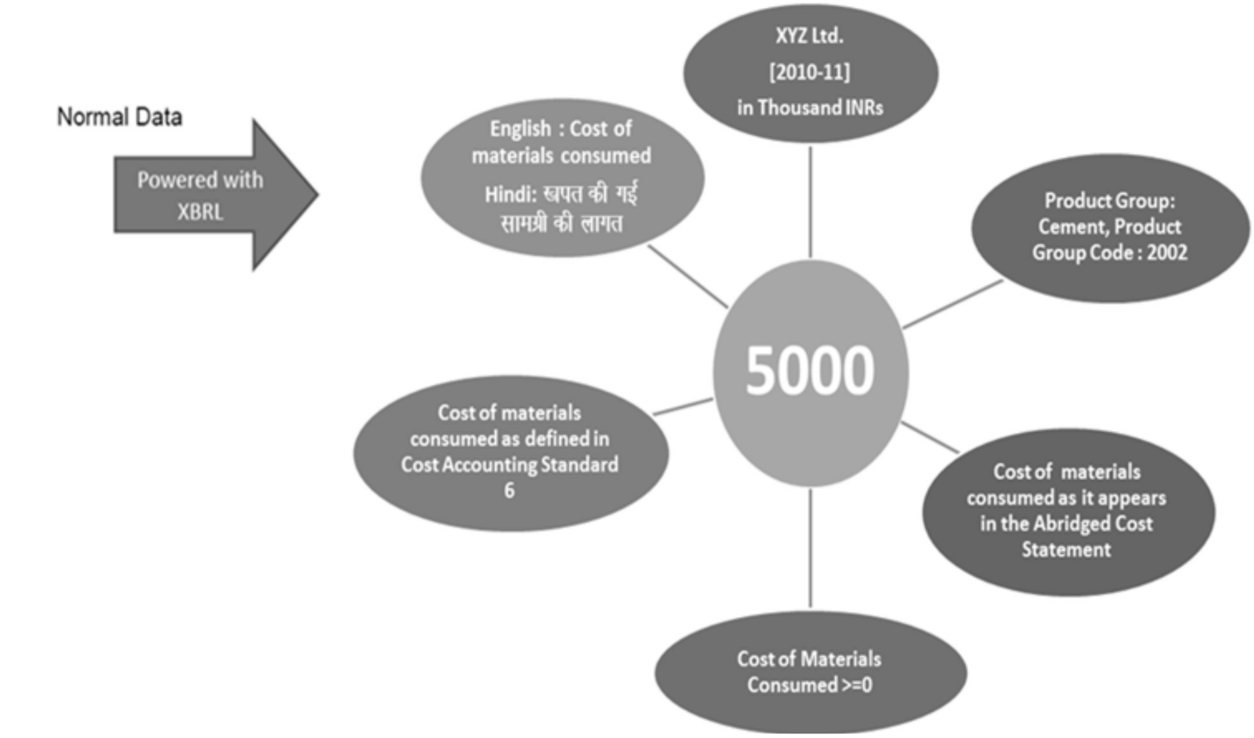
Companies can use XBRL to save costs and streamline their processes for collecting and reporting business information. Consumers of business data, including investors, analysts, financial institutions and regulators, can receive, find, compare and analyze data much more rapidly and efficiently if it is in XBRL format. XBRL can handle data in different languages and accounting standards. It can flexibly be adapted to meet different requirements and uses. Data can be transformed into XBRL by suitable mapping tools or it can be generated in XBRL by appropriate software. The main features of XBRL are:

- XBRL combines hierarchical xml data with relationships and references between the data points.
- It uses Xlink technology of linking xml files.
- It links the data xml files with various other files containing definitions, presentation, calculation, references relationships.
- XBRL data files are a set of xml and xsd files.

How XBRL Works

XBRL was developed with the objective of making the data, system understandable. XBRL is built around XML and is based on the concept of meta-data, which provides context to the information, making the data almost self-explanatory. Wherever the XBRL data moves, it carries along with it the context, which makes it intelligent and thus any software application can interpret and process the data. Information attributes like the period of the information, data structure it will hold (monetary, percentage, text etc.) are attached to the data.

xyz Ltd Abridged Cost Statement of the Peroduct Group : Cement, Produt Group Code : 2002	For the period 2011-11 (₹ In Thousands)
Cost of Materials Consumed	5000
Cost of Direct Expenses	3500
Cost of Administrative Overheads	1000
Cost of Production	9500



In addition, labels in any language can be applied to information and also references to the legal or authoritative literature can be added. Along with the basic attributes, interrelationships amongst the data can also be stored in system readable manner. Thus XBRL can hold the calculations amongst the various data points or the manner in which it should be displayed and so on. One of the primary features of XBRL is extensibility and thus adapting XBRL to cater to the reporting requirements makes it more attractive and handy. Any type of unstructured information, which is collected from multiple formats and sources, can be made structured using XBRL.

XBRL: Key Benefits

In a nutshell, XBRL significantly increases the quality and efficiency of the information supply chain. This is achieved through the principle of assigning XBRL "bar codes" or tags to each information element that enables standardization and transparency to the data while offering tremendous ease of use through interoperability, with data flowing into analyst's proprietary applications.

Every fact that is disclosed has a unique XBRL tag associated to it, which acts like a barcode. This XBRL tag explains the nature of data, the context of data and its relationships with other data. The advantage XBRL data has over other reporting formats is

- It is system-understandable
- Data becomes platform independent
- Flows smoothly across the software applications.

XBRL is rapidly being adopted worldwide as a de facto business reporting standard. Following are some of the key benefits of XBRL -

1. ***Accurate and Quality Data –*** XBRL validates the data based on the rules and relationships defined amongst the data elements, which results in obtaining clean and valid data.
2. ***Seamless Integration –*** The XBRL data carries along with it, the additional attributes and facts, which makes the data self-explanatory. And thus the data remains no longer dependent on any

application or platform for interpretation and processing. The XBRL data can be easily integrated into any other software system.

3. ***Efficient Business Processing –*** As XBRL cuts down the time spent on less efficient processes like re-keying and re-arranging data, the entire business process now becomes more efficient and productive. XBRL streamlines the preparation of business reports for internal and external decision making.

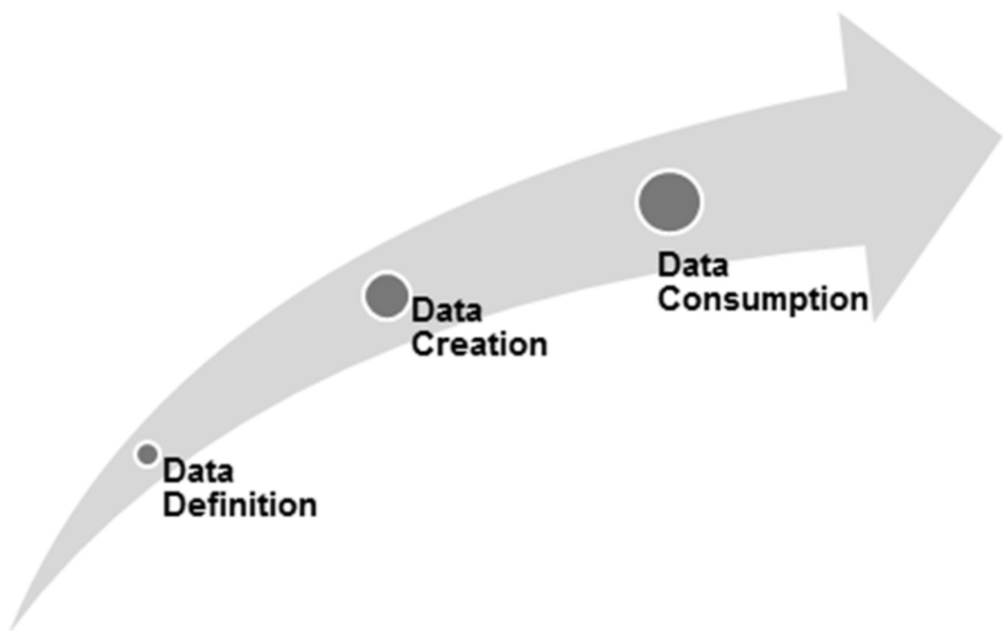
4. ***Easy location of data –*** All the information is identified with a unique XBRL tag and this makes locating the data from a vast information repository or from a voluminous report very easy and quick. Since related information is linked (like facts and relevant footnotes), retrieving of information is very easy.

5. ***Real-time data –*** Because of automation and creation of accurate and valid data, the processing of data becomes much faster and so does its dissemination. Thus the information seekers can access the data in real-time.

6. ***Better Coverage by Analyst community –*** The time required for analysis is quite high because the data is first rekeyed, validated and arranged according to the needs. Since all these activities are no longer required in XBRL based framework and hence the analyst have time to focus on the analysis of data.

Stages in XBRL supply chain

There are three main stages in XBRL cycle –

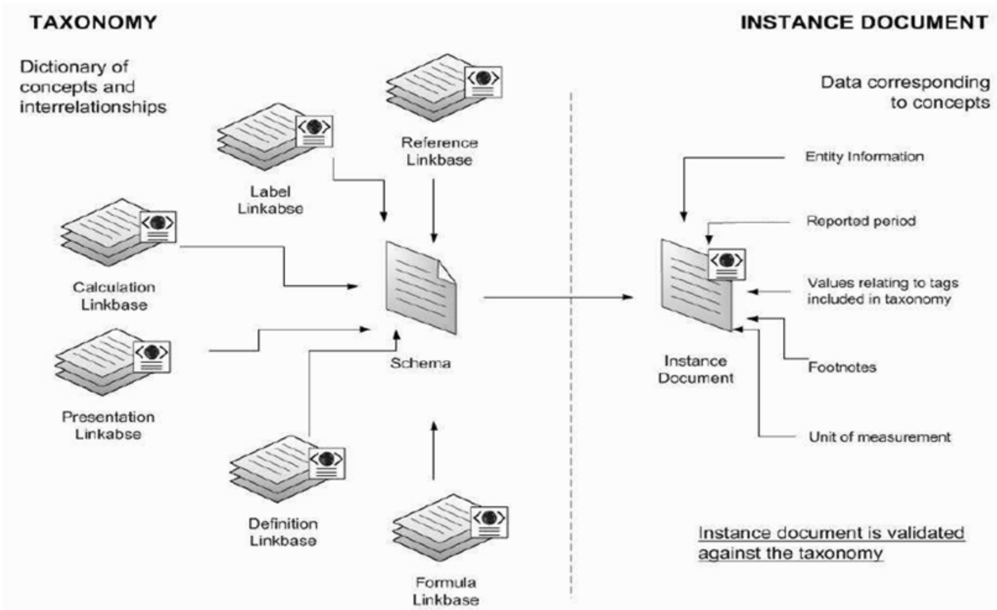


1. **Data definition**: Defines the standards and describes how a certain set of data is structured. This is mainly concerned with the creation of the taxonomy.

2. **Data creation**: This involves the generation of data files based on taxonomy and is mainly concerned with creation of instance documents

3. **Data consumption**: This involves viewing and using the XBRL data.

XBRL Documents

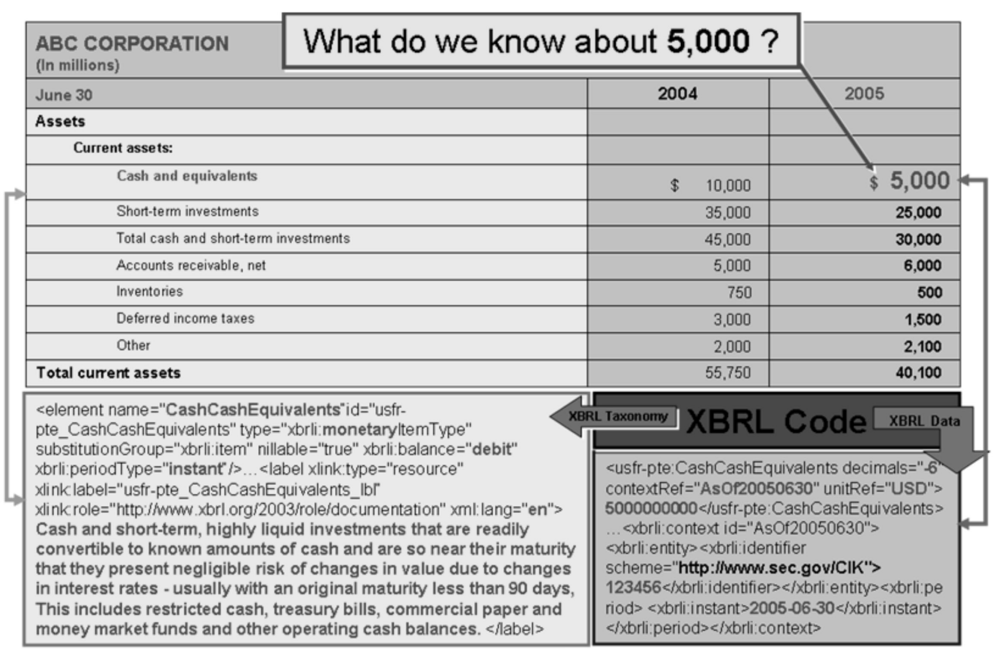


XBRL documents are made up two parts:

1. **Taxonomy:** Taxonomy is the core parts of XBRL which sets up standard structures and definitions for reporting requirements. Taxonomy is defined as vocabulary of all the business and costing concepts, along with their properties and interrelationships. Taxonomies are based on the reporting framework as applicable to the companies in a region or a country.

2. **Instance document:** Instance document contains the facts and related information corresponding to the concepts defined in the taxonomy.

Sample XBRL



Source: IRIS

Understanding XBRL Taxonomy

Taxonomy further can be divided into two components:

1. Schema
2. Link bases.

Schema

The purpose of XBRL schemas is to define taxonomy elements (concepts) and give each concept a name and define its characteristics. For every concept to be included in the schema, the following attributes are to be defined –

Element Name: It specifies the name of the concept which is defined.

Element ID: This attribute makes the concept defined unique. To make it unique, a prefix is attached to the element name which creates a reference point for the concept, for example, 'in-cost_ QuantitySoldOfProductOrActivityGroup ', which shows that the item 'QuantitySoldOfProductOrActivityGroup ' is from the in-cost taxonomy. It is not necessary to present this attribute explicitly in the taxonomy.

Data Type: This attribute defines the type of the fact that will be reported against the specified element. The most common data types that appear in costing statements are

1. Monetary
2. String
3. Date
4. Decimal
5. Pure
6. Percent
7. Textblock

Abstract: It helps to determine if the element carries any value against it. The abstract attribute can be either true or false. Abstract elements (the elements for which abstract=true), do not hold any value but are used as a place holders to bind the elements. The elements which have abstract=false, will hold a value in instance document.

Period Type: This helps in determining the nature of the element and defines the flow and stock concept of accounting with regard to every element in the taxonomy. Here the elements are distinguished into _Instant & _Duration where _Instant refers to the stock concept (E.g.: Assets & Liabilities as on a particular date) and _Duration refers to the flow concept (E.g.: Cost of Production, Revenue from Operations etc are from reporting period start date to reporting period end date).

Substitution Group: It defines the association of elements with other elements in the schema. For substitution group set to item, it means that the element is not associated to any other item in the schema and is not grouped with other elements in any way.

Balance Type: This attribute states the balance type of the concept that is being defined in the schema. The elements which are monetary item types are given a balance type of debit or credit depending on the nature of the concept.

These are the basic attributes that needs to be defined. In addition if there are any user-specific attributes or other XML attributes, they can also be used for the concepts. This is the extensible part of XBRL.

Linkbases

The purpose of XBRL linkbases is to combine labels and references to the concepts as well as define relationships between those concepts. The different kinds of linkbases (each having a special purpose) are:

Presentation linkbase: Business reports are in general organized into identifiable data structures e.g. Cost Audit Report and Compliance Report. The presentation linkbase stores information about relationships between elements in order to properly organize the taxonomy content. This enables a taxonomy user to view a representation or the display format of the elements.

Calculation linkbase: The calculation linkbase defines basic calculation validation rules (addition/ subtraction), which must apply for all instances of the taxonomy.

Label linkbase: This linkbase defines all the labels for the various elements in the taxonomy as they appear in the presentation format. This linkbase enables business data labels to be defined in multiple languages. The labels are stored and linked to their respective elements in a label linkbase.

Reference linkbase: Most of the elements appearing in taxonomies refer to particular concepts defined by various authorities / boards. The reference linkbase stores the relationships between elements and the references e.g. Cost Audit Report, Form II, Para 5.

Definition linkbase: The definition linkbase stores other pre-defined or self-defined relationships between elements.

Formula linkbase: One of the latest specifications developed by XBRL International. This linkbase can be used to build any kind of advanced and user defined mathematical and logical relationships between concepts.

Instance documents

The second part of XBRL document is an instance document. The XBRL instance document consists of the actual facts, values and information pertaining to the entity along with the contextual details like period, unit of measurement, footnotes etc. An instance document can have data for multiple periods or for multiple entities. An instance document contains the "code" for the tags and the structure that belongs to the tagged data. Instance documents are built from a combination of XML specifications and XBRL, structured to produce Cost statements. The document provides data plus structure for machine recognition, and human readability.

Sample Instance Document


```
<in-cost:OtherIncomesOfCompany decimals="2" contextRef="D2012" unitRef="INR">3278.31</in-cost:OtherIncomesOfCompany>
<in-cost:EarningsAvailableForDistribution decimals="2" contextRef="D2012" unitRef="INR">17170.16</in-cost:EarningsAvailableForDistribution>
<in-cost:ToEmployeesAsSalariesWagesRetirementBenefitsAndOthers decimals="2" contextRef="D2012" unitRef="INR">3057.03</in-cost:ToEmployeesAsSalariesWagesRe
<in-cost:ToShareholdersAsDividend decimals="2" contextRef="D2012" unitRef="INR">1646.16</in-cost:ToShareholdersAsDividend>
<in-cost:ToGovernmentAsTaxes decimals="2" contextRef="D2012" unitRef="INR">2443.02</in-cost:ToGovernmentAsTaxes>
<in-cost:OtherDistributionOfEarnings decimals="2" contextRef="D2012" unitRef="INR">725.67</in-cost:OtherDistributionOfEarnings>
<in-cost:DistributionOfEarnings decimals="2" contextRef="D2012" unitRef="INR">17170.16</in-cost:DistributionOfEarnings>
<in-cost:WhetherCostAuditorsReportHasBeenQualifiedOrHasAnyReservationsOrContainsAdverseRemarks contextRef="D2012">false</in-cost:WhetherCostAuditorsReport
<in-cost:CostOfSalesOfCompany decimals="2" contextRef="D2012" unitRef="INR">92414.04</in-cost:CostOfSalesOfCompany>
<in-cost:NetRevenueFromOperationsOfCompany decimals="2" contextRef="D2012" unitRef="INR">101920.06</in-cost:NetRevenueFromOperationsOfCompany>
<in-cost:ProfitBeforeTax decimals="2" contextRef="D2012" unitRef="INR">11278.44</in-cost:ProfitBeforeTax>
<in-cost:ProfitBeforeTaxToCapitalEmployed decimals="4" contextRef="D2012" unitRef="INR">0.1239</in-cost:ProfitBeforeTaxToCapitalEmployed>
<in-cost:ProfitBeforeTaxToNetWorth decimals="4" contextRef="D2012" unitRef="INR">0.2373</in-cost:ProfitBeforeTaxToNetWorth>
<in-cost:ProfitBeforeTaxToNetRevenueFromOperationsOfCompany decimals="4" contextRef="D2012" unitRef="INR">0.1107</in-cost:ProfitBeforeTaxToNetRevenueFromO
<in-cost:ProfitBeforeTaxToValueAddedOfCompany decimals="4" contextRef="D2012" unitRef="INR">0.8119</in-cost:ProfitBeforeTaxToValueAddedOfCompany>
<in-cost:DebtEquityRatio decimals="4" contextRef="D2012" unitRef="INR">0.2803</in-cost:DebtEquityRatio>
<in-cost:CurrentAssetsToCurrentLiabilities decimals="4" contextRef="D2012" unitRef="INR">1.4573</in-cost:CurrentAssetsToCurrentLiabilities>
<in-cost:ValueAddedToNetRevenueFromOperationsOfCompany decimals="4" contextRef="D2012" unitRef="INR">0.1363</in-cost:ValueAddedToNetRevenueFromOperationsO
<in-cost:ProfitLossForAuditedProductOrActivityGroups decimals="0" contextRef="D2012" unitRef="INR">562241021</in-cost:ProfitLossForAuditedProductOrActivit
<in-cost:ProfitLossForUnauditedProductOrActivityGroups decimals="0" contextRef="D2012" unitRef="INR">278633430</in-cost:ProfitLossForUnauditedProductOrAct
<in-cost:OvervaluationOfClosingStockInFinancialAccounts decimals="0" contextRef="D2012" unitRef="INR">50434810</in-cost:OvervaluationOfClosingStockInFinan
<in-cost:ProfitLossAsPerFinancialAccounts decimals="0" contextRef="D2012" unitRef="INR">1127844495</in-cost:ProfitLossAsPerFinancialAccounts>
<in-cost:NameOfProductOrActivityGroup contextRef="D2012_P1">Iron &amp; Non-Alloy Steel</in-cost:NameOfProductOrActivityGroup>
<in-cost:ProductOrActivityGroupCode contextRef="D2012_P1">4002</in-cost:ProductOrActivityGroupCode>
```


The process of creating instance document would be based on whether the data is in structured or unstructured format.

The structured data already being in a fixed format, the conversion process can be automated by using applications which can read the structured data and convert them into XBRL instances. In addition, XBRL applications can read the raw output from accounting systems, which can then be integrated with the application to directly create XBRL documents.

However, for unstructured data, the approach would be different. There would be a need for XBRL authoring tool and an XBRL specialist, who can analyse the unstructured documents, use an appropriate taxonomy and customize the same if required and generate the instance document

Rendering

Rendering refers to viewing and consuming the XBRL data and is the last mile in the XBRL implementation life cycle. XBRL data, being system readable and platform independent, can be viewed in any application, be it Word, Spreadsheet, PDF, Web or proprietary tools. Recently, XBRL International has released new specification for rendering on web, which is called as Inline XBRL or iXBRL.

Apart from viewing the data, the intuitive nature of XBRL data, makes it amenable for further processing and analytics. XBRL data can be easily integrated and populated into valuation models and be used for external and internal reporting. Business rules around XBRL data can be built, which can be then used for compliance checks, MIS, monitoring & control, audit trails etc.

XBRL: Future

Machine-readable XBRL files are currently used to submit operational, tax and risk reporting to regulators in dozens of jurisdictions around the world. And the range of information delivered in XBRL formats is growing every year. But the future of XBRL reporting is about much more than just compliance – it's about new ways of managing transaction data, new types of holistic reporting and new kinds of DataStream analytics.

XBRL has a bright future ahead of it that goes way beyond the current focus on regulatory reporting and compliance. By tagging data at the account/transaction level using XBRL every business can power its own journey towards financial transformation.

XBRL adoption in India

In India, the Ministry of Corporate Affairs is leading the XBRL initiative. The MCA has mandated the filings in XBRL format for the Cost Audit Report, Compliance Report, Profit & Loss Account & Balance Sheet by all the companies (wherever applicable). The Ministry of Corporate Affairs (MCA) mandate for submitting XBRL data has been so far the largest in terms of coverage. With XBRL data, MCA is looking forward to receive cleaner, accurate and timely data, which can be used for compliance checks and data mining.

The Reserve Bank of India, India's central bank, is implementing XBRL in a phased manner. In October 2008, RBI launched XBRL-based reporting framework designed for the capital adequacy returns.

The Securities Exchange Board of India (SEBI) has mandated the top 100 companies listed on the two major exchanges viz. the Bombay Stock Exchange and the National Stock Exchange, to file their disclosures through XBRL-based Corp filing. In addition to the mandated companies, many companies are filing voluntarily their financial in XBRL. SEBI is also looking forward for mutual fund reporting in XBRL.

XBRL: Global adoption

XBRL is quickly spreading across the world, by way of increasing participation from individual countries and international organizations. It is now preferred as a standard for business and financial reporting worldwide.

The US Securities and Exchange Commission has played a vital role in accelerating adoption of XBRL in the US. In December 2008, Securities and Exchange Commission made it mandatory for companies in a phased manner to file the returns in XBRL format.

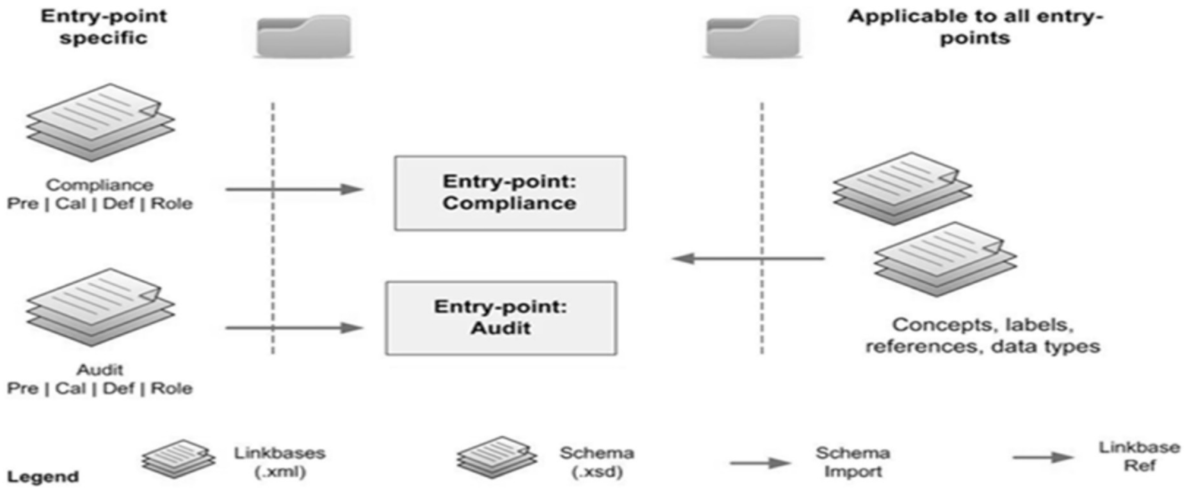
In the UK, HM Revenue and Customs (HMRC) statutory accounts and business tax returns are using iXBRL from April 2011 onwards. The mandate for full tagging requirement by all companies in the UK is expected to take off in 2013.

Japan also is one of the early adopters of XBRL and had started voluntary XBRL reporting program for financial services institutions gradually expanding the range of reports since 2005.

Many other countries are planning to adopt such simplified and one-point reporting process using XBRL, to name a few New Zealand, the United States, the United Kingdom, Japan, Spain, China, Belgium and Canada.

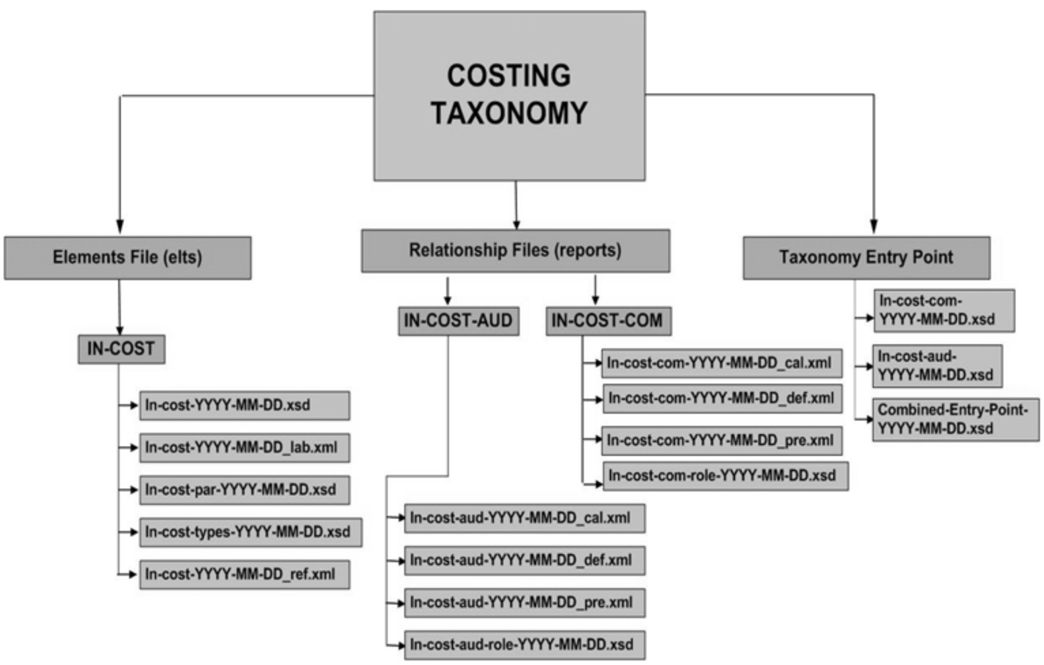
9.2 UNDERSTANDING COSTING TAXONOMY

Physical structure: Physical structure refers to inter-linkages between the various files. The physical structure is depicted in figure below:



Physical taxonomy structure

Folder and file structure: The structure of the general composition of the files and folders within taxonomy is given in the figure below:



The main folder of the costing taxonomy contains the following files:

- **In-cost-aud-2012-09-07.xsd:** is the entry point for the Cost Audit Report containing the schema file wherein all the elements relating to Cost Audit Report and the relationships among them are given.
- **In-cost-com-2012-09-07.xsd:** is the entry point for the Compliance Report containing the schema file wherein all the elements relating to Compliance Report and the relationships among them are given.
- **Combined-entrypoint-2012-09-07.xsd:** is the entry point schema that combines all of the files for the Cost Audit Report and Compliance Report.

In addition following subfolders are there in the main folder:

elts Folder: This contain the In-cost sub folder, which is the core schema containing reportable concepts based on the requirements of the reports and regulator. The contents of folder are:

i. *In-cost_YYYY-MM-DD.xsd:* is the core schema which contains Cost Audit and Compliance Report specific elements along with MCA specific elements.

ii. *In-cost_YYYY-MM-DD_lab.xml:* contains the labels in English language for the reportable concepts based on the requirements of the reports and regulator.

iii. *In-cost-par_YYYY-MM-DD.xsd*: is the core schema which contains the typed domain references defined for Costing taxonomy.

iv. *In-cost-types_YYYY-MM-DD.xsd:* is the core schema which contains custom data types defined for Costing taxonomy.

v. *In-cost_YYYY-MM-DD_ref.xml:* contains the references for the reportable concepts based on Cost Accounting Standards, GACAP and notification by MCA.

reports folder

This folder contains the relationships between the elements that are defined in the 'elts' folder as described above in the form of linkbases along with the information about the extended links used in the taxonomy as given in ' in-cost-aud-role-2012-09-07.xsd' and 'in-cost-com-role-2012-09-07.xsd'.Extended links are the logical grouping of elements.

There are two sub-folders inside this folder. Every sub-folder contains the linkbase files for presentation, calculation, definition and schema containing extended link role declaration. The following suffixes/ prefixes are used to identify each type of file:

- pre : presentation linkbase
- def : definition linkbase
- cal : calculation linkbase
- role : extended link role declaration

The Excel Worksheet

The excel sheets made available along with the taxonomy is for reference and easy understanding of various components of taxonomy in a human readable form.

The excel workbook contains the following worksheets:-

a. **Elements:** This worksheet contains all the concepts that form the costing taxonomy. The concepts are defined as elements/tags along with their characteristics such as data type, balance type, Nillable etc. For example, Cost of sales of product or activity group is an element defined as:

Characteristic	Property	Meaning
Element Name	CostofSalesofProductorActivityGroup	Name of the Element / Tag
Preferred Label	Cost of sales of product or activity group	Label that would appear in the rendered report
Label Role	Standard label	It is a standard label
Abstract	False	Abstract is False implies element can be used to tag data. Abstract set to True indicates that the element is only used in a hierarchy to group related elements together and cannot be used to tag data in an instance document.
Data Type	Monetary Item Type	It is monetary data type
Balance Type	Debit	The balance is debit balance
Period	Duration	The concept is reported for the period (financial year)
Substitution Group	Item	This tells whether the element is item, tuple, hypercube or dimension.
Nillable	True	Nillable set to true means the element can take empty values. If set to False it would means that the element in the instance should have non empty value.

b. **Labels:** This worksheet contains the 491 nos. of labels to be used as preferred labels in the final presentation (rendering) of the report in human readable format. A screenshot of the labels is given below:

c. **References:** This worksheet contains the relationships between elements and the references of the elements defined by authoritative literature. The reference parts used are listed below:

Reference part	Use
Name	CAS
Publisher	Institute of Cost Accountants of India
Section	Title of sections of standard or interpretation
Paragraph	Paragraph (number) in the standard
Subparagraph	Subparagraph (number) of a paragraph

An illustration is given below:

1	Prefix	Standard Label	Element Name	Publisher	Name	Section	Paragraph
56	in-cost	Sales of product or activity group	SalesOfProductOrActivityGroup	MCA	Cost Audit Report Rules	Annexure to Form II	4
57	in-cost	Self manufactured quantity	SelfManufacturedQuantity	MCA	Cost Audit Report Rules	Annexure to Form II	4

d. **Extended Link Cost Audit Report:** This worksheet contains the Extended Link Role definitions contained in the Cost Audit Report. Extended Link Roles represents a set of relationships between concepts and are the logical grouping of elements. The extended links are then used in link bases to build the relationships. The list of extended link roles in the Cost Audit Report are:

1	#	Extended Link Role definition	Used On
2	1	[100100] General information	presentationLinkbaseRef
3	2	[100300] Cost audit report (Form-II)	presentationLinkbaseRef , definitionLinkbaseRef
4	3	[100310] Cost accounting policy	presentationLinkbaseRef
5	4	[100320] Product or activity group	presentationLinkbaseRef , calculationLinkbaseRef , definitionLinkbaseRef
6	5	[100330] Quantitative information of product or activity group	presentationLinkbaseRef , calculationLinkbaseRef , definitionLinkbaseRef
7	6	[100340] Abridged cost statement of product or activity group	presentationLinkbaseRef , calculationLinkbaseRef , definitionLinkbaseRef
8	7	[100340a] Abridged cost statement-Details of material consumed	presentationLinkbaseRef , definitionLinkbaseRef
9	8	[100340b] Abridged cost statement-Details of utilities	presentationLinkbaseRef , definitionLinkbaseRef
10	9	[100340c] Abridged cost statement-Details of industry specific ope	presentationLinkbaseRef , definitionLinkbaseRef
11	10	[100350] Operating ratio analysis of product or activity group	presentationLinkbaseRef , calculationLinkbaseRef , definitionLinkbaseRef
12	11	[100360] Profit reconciliation	presentationLinkbaseRef , calculationLinkbaseRef
13	12	[100360a] Profit reconciliation-Details of incomes not considered	presentationLinkbaseRef , definitionLinkbaseRef
14	13	[100360b] Profit reconciliation-Details of expenses not considere	presentationLinkbaseRef , definitionLinkbaseRef
15	14	[100370] Value addition and distribution of earnings	presentationLinkbaseRef , calculationLinkbaseRef
16	15	[100400] Financial position and ratio analysis	presentationLinkbaseRef , calculationLinkbaseRef
17	16	[100410] Related party transactions	presentationLinkbaseRef , calculationLinkbaseRef , definitionLinkbaseRef
18	17	[100420] Reconciliation of indirect taxes	presentationLinkbaseRef , calculationLinkbaseRef , definitionLinkbaseRef
19	18	[100421] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
20	19	[100421a] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
21	20	[100421b] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
22	21	[100421c] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
23	22	[100421d] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
24	23	[900000] Typed default	definitionLinkbaseRef
25	24	[910000] Axis-Defaults	definitionLinkbaseRef

e. Presentation Cost Audit Report: This worksheet defines the structure of the Cost Audit Report for displaying the data along with preferred label attribute and the specific order in which they appear. This enables the taxonomy users to view the representation of elements in the human readable format. The illustration below shows the presentation of Product or Activity Group Details (Para 3 of the Annexure to Cost Audit Report):

1	Prefix	Preferred Label	Element Name	Label Role	Order
80	ELR	[100320] Product or activity group			
81	in-cost	Product or activity group [abstract]	ProductOrActivityGroupAbstract	standard label	
82	in-cost	Details of product or activity group [abstract]	DetailsOfProductOrActivityGroupAbstract	standard label	1
83	in-cost	Product or activity group [table]	ProductOrActivityGroupTable	standard label	1
84	in-cost	Identification of product or activity group [axis]	IdentificationOfProductOrActivityGroupAxis	standard label	1
85	in-cost	Whether previous year figures are reported	WhetherPreviousYearFiguresAreReported	standard label	2
86	in-cost	Details for not reporting previous year figures [text block]	DetailsForNotReportingPreviousYearFiguresExplanatory	standard label	3
87	in-cost	General information of product or activity group [abstract]	GeneralInformationOfProductOrActivityGroupAbstract	standard label	4
88	in-cost	Name of product or activity group	NameOfProductOrActivityGroup	standard label	1
89	in-cost	Product or activity group code	ProductOrActivityGroupCode	standard label	2
90	in-cost	Four digit CETA chapter headings included in product or activity grou	FourDigitCETAChapterHeadingsIncludedInProductOrActivit	standard label	3
91	in-cost	Net operational revenue of product or activity group	NetOperationalRevenueOfProductOrActivityGroup	standard label	4
92	in-cost	Whether product or activity group covered under cost audit	WhetherProductOrActivityGroupCoveredUnderCostAudit	standard label	5
93	in-cost	Other incomes of company	OtherIncomesOfCompany	standard label	2
94	in-cost	Total revenue as per financial accounts	TotalRevenueAsPerFinancialAccounts	standard label	3
95	in-cost	Notes to product or activity group [text block]	NotesToProductOrActivityGroupExplanatory	standard label	4

f. Calculation Cost Audit Report: This worksheet contains the Additive relationships between numeric items expressed as parent-child hierarchies in the Cost Audit Report. Each calculation child has a weight attribute (+1 or -1) based upon the natural balance of the parent and child items. Illustration below represents the calculation view of the Value addition and distribution of earnings of the

Annexure to Cost Audit Report (Para 8):

1	Prefix	Standard Label	Element Name	Order	Weight
131	ELR	[100370] Value addition and distribution of earnings			
132	in-cost	Distribution of earnings	DistributionOfEarnings		
133	in-cost	To employees as salaries, wages, retirement benefits and others	ToEmployeesAsSalariesWagesRetirementBenefitsAndOthers	1	1
134	in-cost	To shareholders as dividend	ToShareholdersAsDividend	2	1
135	in-cost	Funds retained by company	FundsRetainedByCompany	3	1
136	in-cost	To government as taxes	ToGovernmentAsTaxes	4	1
137	in-cost	Other distribution of earnings	OtherDistributionOfEarnings	5	1
138	in-cost	Earnings available for distribution	EarningsAvailableForDistribution		
139	in-cost	Other incomes of company	OtherIncomesOfCompany	1	1
140	in-cost	Value added of company	ValueAddedOfCompany	2	1
141	in-cost	Net revenue from operations of company for value addition	NetRevenueFromOperationsOfCompanyForValueAddition	1	1
142	in-cost	Gross revenue from operations of company	GrossRevenueFromOperationsOfCompany	1	1
143	in-cost	Excise and other duties of company	ExciseAndOtherDutiesOfCompany	2	-1
144	in-cost	Export incentives of company	ExportIncentivesOfCompany	2	1
145	in-cost	Adjustments in work-in-progress and finished stocks of company	AdjustmentsInWorkInProgressAndFinishedStocksOfCompany	3	1
146	in-cost	Cost of bought out inputs of company	CostOfBoughtOutInputsOfCompany	4	-1
147	in-cost	Cost of materials consumed of company	CostOfMaterialsConsumedOfCompany	1	1
148	in-cost	Cost of process materials or chemicals of company	CostOfProcessMaterialsOrChemicalsOfCompany	2	1
149	in-cost	Cost of stores and spares consumed of company	CostOfStoresAndSparesConsumedOfCompany	3	1
150	in-cost	Cost of utilities of company	CostOfUtilitiesOfCompany	4	1
151	in-cost	Cost of other bought out inputs of company	CostOfOtherBoughtOutInputsOfCompany	5	1
152					

g. **Definition Cost Audit Report:** It is used to express the dimensional relationship between elements of the Costing Taxonomy for the Cost Audit Report. An illustration of the definition linkbase for the Cost Audit Report showing elements of the Product or Activity Group Details is given below:

1	Prefix	Standard Label	Element Name	Order	Context Element	Closed
43	ELR	[100320] Product or activity group				
44	in-cost	Product or activity group [abstract]	ProductOrActivityGroupAbstract			
45	in-cost	Details of product or activity group [abstract]	DetailsOfProductOrActivityGroupAbstract	1		
46	in-cost	Product or activity group [table]	ProductOrActivityGroupTable	1	scenario	TRUE
47	in-cost	Identification of product or activity group [axis]	IdentificationOfProductOrActivityGroupAxis	1		
48	in-cost	Whether previous year figures are reported	WhetherPreviousYearFiguresAreReported	2		
49	in-cost	Details for not reporting previous year figures [text block]	DetailsForNotReportingPreviousYearFiguresExplanatory	3		
50	in-cost	General information of product or activity group [abstract]	GeneralInformationOfProductOrActivityGroupAbstract	4		
51	in-cost	Name of product or activity group	NameOfProductOrActivityGroup	1		
52	in-cost	Product or activity group code	ProductOrActivityGroupCode	2		
53	in-cost	Four digit CETA chapter headings included in product or activity grou	FourDigitCETAChapterHeadingsIncludedInProductOrActivity	3		
54	in-cost	Net operational revenue of product or activity group	NetOperationalRevenueOfProductOrActivityGroup	4		
55	in-cost	Whether product or activity group covered under cost audit	WhetherProductOrActivityGroupCoveredUnderCostAudit	5		

h. **Extended Link Compliance Report:** This worksheet contain the Extended Link Role definitions contained in the Compliance Report. Extended Link Roles represents a set of relationships between concepts and are the logical grouping of elements. The extended links are then used in link bases to build the relationships. The list of extended link roles in the Compliance Report are:

1	#	Extended Link Role definition	Used On
2	1	[200100] General information compliance	presentationLinkbaseRef
3	2	[200300] Quantitative information	presentationLinkbaseRef , calculationLinkbaseRef , definitionLinkbaseRef
4	3	[200400] Reconciliation statement	presentationLinkbaseRef , calculationLinkbaseRef
5	4	[200400a] Reconciliation statement-Details of incor	presentationLinkbaseRef , definitionLinkbaseRef
6	5	[200400b] Reconciliation statement-Details of expe	presentationLinkbaseRef , definitionLinkbaseRef
7	6	[200500] Compliance report (Form B)	presentationLinkbaseRef
8	7	[990000] Typed default	definitionLinkbaseRef
9			

i. **Presentation Compliance:** This worksheet defines the structure of the Compliance Report for displaying the data along with preferred label attribute and the specific order in which they appear. This enables the taxonomy users to view the representation of elements in the human readable format. The illustration below shows the presentation of Quantitative Information (Para 2 of the Annexure to Compliance Report):

1	Prefix	Preferred Label	Element Name	Label Role	Order
30	ELR	[200300] Quantitative information			
31	in-cost	Quantitative information [abstract]	QuantitativeInformationAbstract	standard label	
32	in-cost	Details of product or activity group [abstract]	DetailsOfProductOrActivityGroupAbstract	standard label	1
33	in-cost	Product or activity group [table]	ProductOrActivityGroupTable	standard label	1
34	in-cost	Identification of product or activity group [axis]	IdentificationOfProductOrActivityGroupAxis	standard label	1
35	in-cost	General information of product or activity [abstract]	GeneralInformationOfProductOrActivityAbstract	standard label	2
36	in-cost	Name of product or activity group	NameOfProductOrActivityGroup	standard label	1
37	in-cost	Product or activity group code	ProductOrActivityGroupCode	standard label	2
38	in-cost	Unit of measurement for product or activity group	UnitOfMeasurementForProductOrActivityGroup	standard label	3
39	in-cost	Quantity produced of product or activity group	QuantityProducedOfProductOrActivityGroup	standard label	4
40	in-cost	Net operational revenue of product or activity group [abstract]	NetOperationalRevenueOfProductOrActivityGroupAbstract	standard label	3
41	in-cost	Quantity sold of product or activity group	QuantitySoldOfProductOrActivityGroup	standard label	1
42	in-cost	Net operational revenue of product or activity group	NetOperationalRevenueOfProductOrActivityGroup	standard label	2
43	in-cost	Whether product or activity group covered under cost audit	WhetherProductOrActivityGroupCoveredUnderCostAudit	standard label	4
44	in-cost	Other incomes of company	OtherIncomesOfCompany	standard label	2
45	in-cost	Total revenue as per financial accounts	TotalRevenueAsPerFinancialAccounts	standard label	3

j. **Calculation Compliance Report:** This worksheet contains the Additive relationships between numeric items expressed as parent-child hierarchies in the Compliance Report. Each calculation child has a weight attribute (+1 or -1) based upon the natural balance of the parent and child items. Illustration below represents the calculation view of the Quantitative Information and Reconciliation Statement of the Annexure to Compliance report:

1	Prefix	Standard Label	Element Name	Order	Weight
2					
3	ELR	[200300] Quantitative information			
4	in-cost	Total revenue as per financial accounts	TotalRevenueAsPerFinancialAccounts		
5	in-cost	Other incomes of company	OtherIncomesOfCompany	1	1
6	in-cost	Net operational revenue of product or activity group	NetOperationalRevenueOfProductOrActivityGroup	2	1
7					
8	ELR	[200400] Reconciliation statement			
9	in-cost	Profit (loss) as per financial accounts	ProfitLossAsPerFinancialAccounts		
10	in-cost	Profit (loss) as per cost accounts	ProfitLossAsPerCostAccounts	1	1
11	in-cost	Profit (loss) from product or activity groups covered under cost audit	ProfitLossFromProductOrActivityGroupsUnderCostAudit	1	1
12	in-cost	Profit (loss) from product or activity groups covered under cost accou	ProfitLossFromProductOrActivityGroupsCoveredUnderCostAcc	2	1
13	in-cost	Profit (loss) from activities not covered under cost accounting record	ProfitLossFromActivitiesNotCoveredUnderCostAccountingRecc	3	1
14	in-cost	Difference in stock valuation as per cost and financial records	DifferenceInStockValuationAsPerCostAndFinancialRecords	2	1
15	in-cost	Amount of incomes not considered in cost accounts	AmountOfIncomesNotConsideredInCostAccounts	3	1
16	in-cost	Amount of expenses not considered in cost accounts	AmountOfExpensesnotConsideredInCostAccounts	4	-1
17					

k. **Definition Compliance Report:** It is used to express the dimensional relationship between elements of the Costing Taxonomy for the Cost Audit Report. An illustration of the definition linkbase for the Compliance Report showing elements of the Quantitative Information (Para 2) is given below:

1	Prefix	Standard Label	Element Name	Order	Context Element	Closed
2						
3	ELR	[200300] Quantitative information				
4	in-cost	Quantitative information [abstract]	QuantitativeInformationAbstract			
5	in-cost	Details of product or activity group [abstract]	DetailsOfProductOrActivityGroupAbstract	1		
6	in-cost	Product or activity group [table]	ProductOrActivityGroupTable	1	scenario	TRUE
7	in-cost	Identification of product or activity group [axis]	IdentificationOfProductOrActivityGroupAxis	1		
8	in-cost	General information of product or activity [abstract]	GeneralInformationOfProductOrActivityAbstract	2		
9	in-cost	Name of product or activity group	NameOfProductOrActivityGroup	1		
10	in-cost	Product or activity group code	ProductOrActivityGroupCode	2		
11	in-cost	Unit of measurement for product or activity group	UnitOfMeasurementForProductOrActivityGroup	3		
12	in-cost	Quantity produced of product or activity group	QuantityProducedOfProductOrActivityGroup	4		
13	in-cost	Net operational revenue of product or activity group [abstract]	NetOperationalRevenueOfProductOrActivityGroupAbstract	3		
14	in-cost	Quantity sold of product or activity group	QuantitySoldOfProductOrActivityGroup	1		
15	in-cost	Net operational revenue of product or activity group	NetOperationalRevenueOfProductOrActivityGroup	2		
16	in-cost	Whether product or activity group covered under cost audit	WhetherProductOrActivityGroupCoveredUnderCostAudit	4		
17						

Extended Link Roles:

The various elements in the taxonomy are grouped using extended link roles (ELR) or extended links as per the logical groupings of concepts defined in the Companies (Cost Audit Report) Rules 2011 and The Companies (Cost Accounting Records) Rules 2011. The list of ELR definitions in the Costing Taxonomy are:

ELRs (Cost Audit Report)

Extended Link Role definition	Used on
[100100] General information	presentationLinkbaseRef
[100300] Cost audit report (Form-II)	presentationLinkbaseRef, definitionLinkbaseRef
[100310] Cost accounting policy	presentationLinkbaseRef
[100320] Product or activity group	presentationLinkbaseRef, calculationLinkbaseRef, definitionLinkbaseRef
[100330] Quantitative information of product or activity group	presentationLinkbaseRef, calculationLinkbaseRef, definitionLinkbaseRef
[100340] Abridged cost statement of product or activity group	presentationLinkbaseRef, calculationLinkbaseRef, definitionLinkbaseRef
[100340a] Abridged cost statement-Details of material consumed	presentationLinkbaseRef definitionLinkbaseRef
[100340b] Abridged cost statement-Details of utilities	presentationLinkbaseRef, definitionLinkbaseRef
[100340c] Abridged cost statement-Details of industry specific operating expenses	presentationLinkbaseRef, definitionLinkbaseRef
[100350] Operating ratio analysis of product or activity group	presentationLinkbaseRef, calculationLinkbaseRef, definitionLinkbaseRef
[100360] Profit reconciliation	presentationLinkbaseRef, calculationLinkbaseRef
[100360a] Profit reconciliation-Details of incomes not considered	presentationLinkbaseRef, definitionLinkbaseRef
[100360b] Profit reconciliation-Details of expenses not considered	presentationLinkbaseRef, definitionLinkbaseRef
[100370] Value addition and distribution of earnings	presentationLinkbaseRef, calculationLinkbaseRef
[100400] Financial position and ratio analysis	presentationLinkbaseRef, calculationLinkbaseRef
[100410] Related party transactions	presentationLinkbaseRef, calculationLinkbaseRef, definitionLinkbaseRef
[100420] Reconciliation of indirect taxes	presentationLinkbaseRef, calculationLinkbaseRef, definitionLinkbaseRef
[100421] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef

[100421a] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
[100421b] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
[100421c] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
[100421d] Reconciliation of indirect taxes/not-all	definitionLinkbaseRef
[900000] Typed default	definitionLinkbaseRef
[910000] Axis-Defaults	definitionLinkbaseRef

ELRs Compliance Report

Extended Link Role definition	Used on
[200100] General information compliance	presentationLinkbaseRef
[200300] Quantitative information	presentationLinkbaseRef, calculationLinkbaseRef, definitionLinkbaseRef
[200400] Reconciliation statement	presentationLinkbaseRef, calculationLinkbaseRef
[200400a] Reconciliation statement-Details of incomes not considered	presentationLinkbaseRef, definitionLinkbaseRef
[200400b] Reconciliation statement-Details of expenses not considered	presentationLinkbaseRef, definitionLinkbaseRef
[200500] Compliance report (Form B)	presentationLinkbaseRef
[990000] Typed default	definitionLinkbaseRef

9.3 STEPS INVOLVED IN CREATING XBRL INSTANCE DOCUMENTS FOR THE COST AUDIT REPORT AND COMPLIANCE REPORT

Step 1: A user who wants to create XBRL documents need to understand the costing taxonomy and the tags available in the costing taxonomy. This understanding of costing taxonomy makes mapping process easy and efficient. The easiest way to learn about the structure and content of the costing taxonomy is to navigate the costing taxonomy.

Step 2: Mapping of organization's Cost Audit Report and Compliance Report to corresponding elements in the taxonomy. The process of mapping includes matching of information given in report to elements included in the taxonomy. Prepares should only consider taxonomy ELRs, relationships and concepts that are relevant to their specific reports.

Step 3: Once the elements of the report are mapped with the taxonomy elements or tags, the next step is to create the instance document. An instance document is a XML file that contains the actual facts, values and information pertaining to the organization along with the contextual details like period, unit of measurement; footnotes etc. generated using tags from the XBRL costing taxonomy. Separate instance documents need to be created for the following:

a. Cost Audit Report of the company

b. Compliance Report of the company

Step 4: Once the instance document has been prepared, it needs to be ensured that the instance document is a valid instance document and all the required information has been correctly captured in the instance document. The instance document needs to be validated against the taxonomy as well as the specified business rules for the taxonomy using the validation tool available on the website of MCA.

9.4 OBJECTIVE OF TRAINING & GUIDANCE MANUAL

1. Ministry of Corporate Affairs (MCA) vide General Circular No. 8/2012 dated May 10, 2012 has mandated filing of Cost Audit Reports and Compliance Reports in XBRL format from the financial year 2011-12 (including the overdue reports relating to any previous year).

2. The purpose and objective of this guidance note is to provide general guidance to members of the Institute and Industry for preparation of the Cost Audit Report and Compliance Report in XBRL format in accordance with the Costing Taxonomy as notified by the Ministry of Corporate Affairs and Business Rules thereof.

3. There is no change in the basic structure of the formats as notified in the Companies (Cost Audit Report) Rules 2011 and Annexure to the Compliance Report as notified by Companies (Cost Accounting Records) Rules 2011 dated 3rd June 2011 and the Industry specific Cost Accounting Records Rules 2011 dated 7th December 2011 notified by the Ministry of Corporate Affairs for six regulated industries viz. Telecommunication, Electricity, Petroleum, Sugar, Fertilizer and Pharmaceutical.

4. It is to be kept in mind that unlike earlier days when the cost audit report was required to be filed in PDF format as an attachment to the e-Form for filing, under the XBRL mode, a cost auditor and the company would be required to file the "data" contained in the reports in respect of the cost audit report and the compliance report. This data will be filed in XML format with proper tagging and the XML file will be attached to the e-Form. In other words, the cost audit report or the compliance report in the structure we are used to seeing it will not be filed but only the data as required by the Costing Taxonomy according to its defined labels and elements would be filed.

5. An important point that should be kept in mind by every user is that there are validation checks built into the taxonomy and validation tools. These tools check the correctness of computation of additions and subtractions within the tables. The costing taxonomy allows data with three decimal places. Care must be taken to round off every figure at the time of preparation of cost accounting records and cost audit report in any spread sheet format. Unless every data is rounded off properly, spread sheet like Excel will store data with maximum decimal places though due to the formatting of the cell, the user will see the figure in 2 or three places of decimal. This will lead to inaccurate calculation of sum total and give rise to rounding off errors and the data will not get validated.

6. This guide does not intend to educate the users on the basics of XBRL. Thus, the user is expected to be familiar with the basics of XBRL. While the costing taxonomy has specific elements relating to cost audit report and compliance report as given in the respective rules, the guide is not specific to the MCA filings and one needs to refer to other materials released/to be released specific to

MCA in order to file with them. Before starting preparation of the Instance document for Cost Audit Report and/or Compliance Report, the users are requested to read and understand the following documents:

a) *Costing taxonomy* issued by MCA for understanding each elements of taxonomy (particularly as contained in excel file).

b) Business Rules relating to costing taxonomy, issued by MCA for understanding the mandatory/ non-mandatory fields in the taxonomy.

c) Costing Taxonomy Architecture Guide 2012 for understanding basic structure of taxonomy.

d) Scope and Level of *tagging* for understanding the requirements of *tagging* issued by MCA.

e) Filing Manual for understanding the approach for *validation* and pre-scrutiny of *instance* documents issued by MCA.

f) Preparer's Guide for referring to the sample *instance* documents created for the better understanding of costing taxonomy.

g) General FAQs on Costing Taxonomy

h) Stakeholders' FAQs on Costing Taxonomy

9.5 GENERAL INSTRUCTIONS FOR CREATING THE XBRL INSTANCE DOCUMENTS FOR COST AUDIT REPORT AND COMPLIANCE REPORT

1. The Cost Audit Report and Compliance Report approved by the Board should be used as source for creation of the XBRL instances

2. It has to be ensured that the XBRL Cost Audit Report and Compliance Report instance documents generated are as per the costing taxonomy defined by MCA. Please ensure the following in the instance document:

   a. Completeness: All the required information is reported. Please refer to Business Rules to ensure that all mandatory items are reported.

   b. Mapping: The elements tagged should be consistent with the meaning of the associated cost concepts in the Cost Audit Report and Compliance Report.

   c. Accuracy: The amounts, dates, other attributes (for example, Monetary units), and relationships (order and calculations) in the instance document should be consistent with the Cost Audit Report and Compliance Report.

   d. Structure: XBRL instances are structured in accordance with the costing taxonomy.

3. 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.

4. If a company manufacture multiple product groups and has multiple units across the country and they have appointed multiple cost auditors, the Cost Audit Reports prepared by each individual cost auditor needs to be consolidated and only one XBRL instance document of the Cost Audit Report per company needs to be prepared. This is then filed with the Central Government

5. Though the XBRL instances of Cost Audit Report / Compliance Report are prepared on the basis of the Cost Statement of the company approved by the Board, they are not the exact replication of the statements. The process of conversion of approved cost statements into XBRL instances requires application of judgment, including, in matters of mapping the cost statement items to the appropriate tags in the costing taxonomy.

6. As of now the costing taxonomy does not permit any extensions. All the facts need to be reported with the help of elements defined in the taxonomy.

7. "Product or Activity Group classification" in the instance document should be strictly in accordance with the notification issued by the Ministry of Corporate Affairs vide S.O. No. 1747(E) dated 7th August 2012.

8. An instance must not have more than one fact having the same element name and equal contextRef attributes.

9. Facts appearing multiple times in the Cost Audit Report/Compliance Report are reported at one place using the same element throughout the instance document.

10. The amounts reported in instance document should have the appropriate sign based on the nature of the value in the Cost Audit Report/Compliance Report, balance attribute, etc. of the element.

11. The instance document prepared must conform to all the calculations included in the calculation linkbase.

12. The level of rounding off used in cost statements is to be defined at one place and it is applicable to all the Paras of the Cost Audit Report / Compliance Report.

13. The reporting currency is also defined at one place and is uniformly applicable to all the Paras of Cost Audit Report / Compliance Report

14. The financial year is required to be defined giving the start date and end date of the financial year.

15. The first previous year is also required to be defined by giving the start date and end date of the financial year. In case first previous year figures are not being given in the instance document, a valid reason for not providing the data needs to be specified.

16. The period information (for both instant and duration i.e. start Date/end Date) should follow the XBRL 2.1 Specification and should be expressed as YYYY-MM-DD. However, this would depend on the tool being used and the way the tool has been configured to capture the data.

17. Every fact where some detailed information or bifurcation needs to be given; a footnote can be attached to it. Every footnote element must be linked to at least one fact.

18. Language attribute should be "en" for textual information.

19. The valid CIN No (Corporate Identity Number) of the company issued by MCA needs to be provided as identifier for the company whose Cost Audit Report / Compliance Report XBRL instances are being created.

20. Only two financial years' data (Current Year & Previous Year) is to be provided in the Cost Audit Report. For Compliance Report, only the current year data is required to be provided.

9.6 PARA-WISE INSTRUCTIONS FOR CREATING XBRL INSTANCE DOCUMENTS FOR COST AUDIT REPORT AND COMPLIANCE REPORT

The Companies (Cost Audit Report) Rules 2011 as notified by the MCA contained the cost audit report format under Form II and Annexure to the Cost Audit Report. A number of information was contained in the e-Form of Form I. In the Costing Taxonomy, the information contained under "General Information" in Para 1 of Annexure to the Cost Audit Report and the other information contained in the Form I has been merged and the entire information has now been made a part of the information required to be filed in the cost audit report. The explanation of each of the elements is provided below.

A. General information

1 ***Corporate identity number or foreign company registration number:*** Provide valid CIN/FCRN Number of the Company which should be same as per MCA Database. This is a mandatory field.

2 ***Name of company:*** Enter the name of the Company which should be based on CIN or FCRN as applicable and as per MCA Database. This is a mandatory field.

3 ***Address of registered office or of principal place of business in India of company:*** Enter registered office address. In case of a foreign company, enter address of principal place of business as per MCA Database. This is a mandatory field.

4 ***Address of corporate office of company:*** Enter corporate office address. In case it is the same as registered office, enter registered office address as per MCA Database. This is a mandatory field.

5 ***Email address of company:*** Enter email address of the company as per MCA Database. This is a mandatory field.

6 ***Date of start of reporting period:*** Enter date of start of reporting period. The format would depend on the tool being used. The date should be greater than or equal to date of incorporation in case of Indian company or date of establishment of place of business in case of foreign company and should be less than or equal to system date. This is a mandatory field.

7 ***Date of end of reporting period:*** Enter date of end of reporting period. The format would depend on the tool being used. The date should be less than or equal to system date and greater than or equal to Start Date of Reporting Period. Difference between start date and end date should not be greater than 18 months. This is a mandatory field.

8 ***Date of start of first previous financial year:*** Enter beginning date of the immediately preceding financial year. The requirement of furnishing data of 2nd previous year in respect of certain paras has been dispensed with. This is a mandatory field.

9 ***Date of end of first previous financial year:*** Enter end date of the 1st previous year. This is a mandatory field.

10 ***Level of rounding used in cost statements:*** Enter level of rounding off used for the report, e.g., crores, lakhs, thousands, millions, etc. It is to be noted that the selected rounding off of figures must be adopted uniformly across the report for every para. This is a mandatory field.

11 ***Reporting currency of entity:*** The currency of reporting is INR. This is a mandatory field.

12 ***Number of cost auditor(s) for reporting period:*** Enter number of cost auditors. It is to be noted that only one cost audit report can be filed by a company irrespective of number of product-groups or cost auditors. The MCA General Circular No. 68/2011 dated 30/11/2011 had allowed submission of multiple reports in case there are multiple auditors for different products of a company. However, with the issue of Costing Taxonomy and requirements mentioned therein, it is to be noted that a Company would be able to file only a single report even in cases where it has appointed multiple cost auditors for different products. In other words, only the designated Lead Auditor is required to file the cost audit report for the company as a whole. This is a mandatory field.

13 ***Date of board of directors meeting in which annexure to cost audit report was approved:*** Enter date of meeting of Board of Directors approving the annexure to cost audit report. This is a mandatory field.

14 ***Whether cost auditors report has been qualified or has any reservations or contains adverse remarks:*** This element has to be seen from the perspective of the Lead auditor. The led auditor or the single auditor should mentioned "YES/NO" taking into consideration the reports of all the cost auditors. This is a mandatory field.

15 ***Consolidated qualifications, reservations or adverse remarks of all cost auditors:*** Enter summary of qualifications, reservations or adverse remarks of all cost auditors. In case of a single auditor, enter qualifications, reservations or adverse remarks of the single auditor. This is a mandatory field.

16 ***Consolidated observations or suggestions of all cost auditors:*** Enter summary of observations or suggestions of all cost auditors. In case of a single auditor, enter observations or suggestions of the single auditor. This is a mandatory field.

17 ***Whether company has related party transactions for sale or purchase of goods or services:*** Enter

YES/NO. If Yes is entered, then at least one member is mandatory in the relevant para for Related Party Transactions. This is a mandatory field.

B. Cost Audit Report (Form II)

1 ***Details of cost auditor:*** Details of all the cost auditors is required to be provided here in a table. The structure of the table has to be visualized where the first column contains the narration of the requirements and the data/information is to be provided against each element for each of the auditor(s). The number of columns for entering cost auditor details would depend on the number of cost auditors entered in the relevant field in the General Information.

2 ***Whether cost auditor is lead auditor:*** Enter/select "YES" or "NO". This field would always be YES since the cost auditor preparing the consolidated report for filing would either be the Lead Auditor or the single auditor of the company who would in any case be the only and Lead Auditor. This is a mandatory field.

3 ***Category of cost auditor:*** Enter whether the cost auditor is a firm or a sole proprietor. An individual practising in individual name is to be considered under the Sole Proprietorship category. This is a mandatory field.

4 ***Firm's registration number:*** Enter registration number of the firm allotted by the Institute. This is a mandatory field for all cost auditors.

5 ***Name of cost auditor or cost auditors firm:*** Enter name of the firm or trade name of the sole proprietor (including individual). This name must be same as per the Institute of Cost Accountants of India database. This is a mandatory field.

6 ***Permanent account number of cost auditor or cost auditors firm:*** Provide PAN of firm in case the cost auditor is a Firm. In case of a sole proprietor or an individual, enter the PAN of the individual member. The individual PAN of the Partner of the Firm is not to be provided here. This is a mandatory field.

7 ***Address of cost auditor or cost auditors firm:*** Enter address of the firm as registered with the Institute. This is a mandatory field.

8 ***Email id of cost auditor or cost auditors firm:*** Enter email id of the firm. This is a mandatory field.

9 ***Membership number of member signing report:*** Enter membership number of the signing Partner in case a Firm is appointed as the cost auditor. In case of Sole Proprietor or individual, enter membership number of Sole Proprietor or individual. It should be a valid membership number as per the Institute of Cost Accountants of India database. This is a mandatory field.

10 ***Name of member signing report:*** Enter name of the member signing the report. The name should be entered as appearing in the database of the Institute. This is a mandatory field.

11 ***Cost audit order date:*** Enter date of the cost audit order. In case the same cost auditor has been appointed for different products/activities of the company where different cost audit orders are applicable, the details of the same cost auditor is required to be repeated from serial 1 above and the number of cost auditors should be considered to be multiple and equal to the number of applicable cost audit orders. This is a mandatory field.

12 ***Cost audit order number:*** Enter cost audit order number. The format shall be 52/<Alpha numeric number>/CAB/<Calendar year in four digit format> and it must be a valid cost audit order number as per MCA database in case of company specific order. In case of industry wise general orders, should be a valid Industry wise general Cost Audit Order number. In case the same cost auditor has been appointed for different products/activities of the company where different cost audit orders are applicable, the details of the same cost auditor is required to be repeated from serial 1 above and the number of cost auditors should be considered to be multiple and equal to the number of applicable cost audit orders. This is a mandatory field.

It may be noted that for all cost audits from financial year commencing on or after 1st April 2012, only industry specific general orders would be applicable unless the report pertains to any financial year prior to financial year commencing on or after 1st April 2012.

13 ***Name of product or industry***: Enter name of the applicable product or industry in the same manner as available in the cost audit orders. This is a mandatory field.

14 ***SRN number of Form 23C***: Enter SRN number of Form 23C. Total 5 Rows for Form 23C have been provided. If multiple Form 23C has been filed for different products for the same cost auditor, then each of the SRN No. has to be entered. This is a mandatory field.

15 ***SRN number of Form 23D***: Enter SRN No. of Form 23D. Total 5 Rows for Form 23D have been provided. If multiple Form 23D has been filed against different SRN of Form 23C, then individual SRN Nos. of Form 23D corresponding to the SRN Nos. of Form 23C is to be entered in sequence of SRN No. of Form 23C in serial 14 above. This is a mandatory field.

16 ***Number of audit committee meeting attended by cost auditor during year***: Enter number of audit committee meetings attended during the reporting period. Number can be greater than or equal to zero. This is a mandatory field.

17 ***Date of signing cost audit report and annexure by cost auditor***: Enter date of signing of the report by the cost auditor. Date cannot be before date of Board meeting at which annexures to cost audit report is approved. This is a mandatory field.

18 ***Place of signing cost audit report and annexure by cost auditor***: Enter name of place where the report is signed. This is a mandatory field.

19 **Disclosure of cost auditors qualifications or adverse remarks in cost auditors report**

The disclosures in this para would be the same required to be provided by a cost auditor as per notified Form-II of the Companies (Cost Audit Report) Rules 2011. In case of multiple cost auditors where the report is being filed by the Lead cost auditor, the statements of individual cost auditors would be required to be provided here verbatim as given by the individual cost auditor. All the elements are mandatory and must be completed as per requirement of the certification portion of the cost audit report.

(i) ***Disclosure relating to availability of information and explanation for purpose of cost audit:***

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) ***Disclosure relating to maintenance of cost records as per applicable cost accounting records rules:***

In my/our opinion, proper cost records, as per the applicable Cost Accounting Records Rules, 2011 prescribed under clause (d) of sub-section (1) of section 209 of the Companies Act, 1956, have/have not been maintained by the company so as to give a true and fair view of the cost of production/operation, cost of sales and margin of the product/activity groups under reference.

(iii) ***Disclosure relating to availability of cost records of branches not visited:***

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) ***Disclosure regarding availability of information as per Companies Act 1956:***

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, 1956, in the manner so required.

(v) ***Disclosure regarding conformity of books and records with Cost Accounting Standards and GACAP:***

In my/our opinion, the said books and records are/are not in conformity with the Cost

Accounting Standards issued by The Institute of Cost Accountants of India, to the extent these are found to be relevant and applicable.

(vi) ***Disclosure relating to adequacy of internal audit of cost records:***

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

(vii) ***Disclosure relating to availability of audited and certified cost statements and schedules for each unit and each product or activity:***

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

(viii) ***Disclosure relating to submission of performance appraisal report:***

As required under the provisions of The Companies (Cost Audit Report) Rules, 2011, I/we have furnished Performance Appraisal Report, to the company, on the prescribed form.

(ix) ***Cost auditors observations or suggestions:*** Enter any observations or suggestions of the cost auditor.

C. <u>Cost Accounting Policy (Para 2 of Annexure to Cost Audit Report)</u>

All elements in this block are mandatory. The cost auditor is required to provide the policy of the cost accounting policy of the company in respect of each of the elements given below.

1 ***Cost accounting policy***

2 ***Disclosure regarding identification of cost centres, cost objects and cost drivers***

3 ***Disclosure regarding accounting for material cost including packing materials, stores and spares, employee cost, utilities and other relevant cost components***

4 ***Disclosure regarding accounting, allocation and absorption of overheads***

5 ***Disclosure regarding accounting for depreciation or amortization***

6 ***Disclosure regarding accounting for by products, joint products and scraps or wastage***

7 ***Disclosure regarding basis of inventory valuation***

8 ***Disclosure regarding valuation of inter unit or inter-company and related party transaction***

9 ***Disclosure regarding treatment of abnormal and non-recurring costs including classification of non-cost items***

10 ***Disclosure regarding other relevant cost accounting policy***

11 ***Disclosure regarding changes in cost accounting policy during reporting period***

12 ***Disclosure regarding adequacy of budgetary control system***

D. <u>Para 3 – Details of Product or Activity Group</u>

Details under this block are required to be provided in the form of a table. The number of columns would depend on the number of Product/Activity Groups in which the company is engaged in. The value of "Net revenue from Operations in respect of each of the Product/Activity Group is to be provided for both the current year and previous year as per the Annual Audited Accounts of the Company.

1 ***Whether previous year figures are reported:*** State Yes or No against each of the Product/Activity Group. The "Yes" or "No" regarding providing of previous year figures in this block actually relate to data in Para 4, 5 & 6, i.e., where product group-wise data is required to be provided. It may be

noted that for some product/activity group, the same may have come under both cost accounting records rules and cost audit for the first time during 2011-12. In such a case, the previous year figure for the product group will not be mandatory. However, for product/activity group which was covered under any of the erstwhile cost accounting records rules, providing previous year figure is mandatory irrespective of the fact whether the product/activity group was covered under cost audit.

In certain cases, a Product/Activity Group may consist of products covered under any of the erstwhile cost accounting records rules and some of the products/activities were not covered. Due to the classification of Product/Activity Group as notified by the MCA, both the categories have now got covered under the same Product/Activity Group. In such cases, the previous year figures would pertain to only such products that were covered under cost accounting records rules during the previous year. A suitable note in this respect should then be provided in the respective text blocks of Para 4, 5 & 6.

2 ***Details for not reporting previous year figures:*** If previous year figures are not provided in Para 4, 5 & 6, reasons therefor must be provided. This is a mandatory field if the response is "No" in the previous element.

<u>**General information of product or activity group**</u>**:**

3 ***Name of product or activity group:*** Enter name of product/activity group as per MCA Product Group classification. This is a mandatory field.

4 ***Product or activity group code:*** Enter product/activity group code as per MCA Product Group classification. This is a mandatory field.

3 ***Four digit CETA chapter headings included in product or activity group:*** Enter 4 digit CETA chapter headings pertaining to the products manufactured by the company comprised in the product/ activity group code. If there are more than one CETA codes, then all the relevant CETA codes are to be entered separated by comma. It may be noted that only relevant CETA codes that are applicable to the products of the company are to be entered and not all the codes as per the product group notification. This is a mandatory field.

4 ***Net operational revenue of product or activity group:*** Enter net operational revenue of the product/ activity group as per the audited financial accounts of the company. This is a mandatory field.

5 ***Whether product or activity group covered under cost audit:*** Enter YES/NO against each product group code. Every YES against a product group code should have at least one each corresponding para 4, para 5 and para 6. This is a mandatory field.

6 ***Other incomes of company:*** Enter other incomes of the company as a whole as per audited annual accounts.

7 ***Total revenue as per financial accounts:*** Sum of Net Operational Revenue and Other Incomes of the company. This figure should be equal to the Net Revenue of the company as per audited annual accounts.

Note: Under the Revised Schedule VI, the Profit and Loss Account represents the revenue of a company under (a) Revenue from Operations; (b) Other Operating Revenues; and (c) Other Incomes. The "Other Operating Revenue" can contain certain revenue incomes that cannot be directly linked to a particular product/activity group. For example, income from scrap sale is an item that is to be disclosed under "Other Operating Revenue" and such an income would arise from the operations involving all the product groups. In cost accounts, this income may be treated as a credit to individual material cost (if directly identifiable and conform to the CAS-6) or credited to overheads. For purposes of Para 3, this is required to be shown as a part of total Revenue of the company to reconcile with the total revenue of the company as per audited annual accounts. In such cases, "Other Operating Revenues" that cannot be directly linked to a product/activity group, such items are to be shown against Product Group Code **"4100 – Ancillary Products not elsewhere specified"**.

The rendering or presentation of Para-3 as per costing taxonomy can be made as below:

Name of the Company:

Product Group Details (For the company as a whole)

	Product	CETA	Covered	Previous	Net Operational Revenue	
Product Group Name	**Group**	**Chapter**	**In Cost**	**Year**	**Current Year**	**Previous Year**
	Code	**Heading**	**Audit**	**Figures**	₹	₹
1						
2						
3						
4						
5						
6						
7 (etc.)						
Total						
Other Incomes						
Total Income as per Audited Annual Report						

E. <u>Para 4 – Quantitative Information</u>

Details under this para are required to be provided for each Product Group under cost audit. The number of tables should be at least equal to the number of product groups covered under cost audit. In case a product group consists of products having different unit of measurement, then the information is required to be provided separately for the same product group for different units of measurement.

1 ***Name of product or activity group:*** Enter name of product group as per MCA Product Group classification. This is a mandatory field.

2 ***Product or activity group code:*** Enter product group code as per MCA Product Group classification. This is a mandatory field.

3 ***Unit of measurement for product or activity group:*** Enter unit of measurement of the product group. If the same product group contain different units of measurement, separate tables to be prepared for each unit of measurement. This is a mandatory field.

4 ***Installed capacity on start of reporting period:*** Provide details if applicable. This is a numeric field.

5 ***Capacity enhanced during reporting period:*** Provide details if applicable. The figure should be entered on annualised basis. This is a numeric field

6 ***Capacity available through leasing arrangements:*** Provide details if applicable. This is a numeric field

7 ***Capacity available through loan license or third parties:*** Provide details if applicable. This is a numeric field

8 ***Available capacity of product or activity group:*** This is a sum total of all the capacities above. This is a numeric field.

9 ***Self-manufactured quantity:*** Production quantity manufactured by the unit(s) for all products under this "Product Group". This is a numeric field.

10 ***Quantity produced under leasing arrangements:*** Quantity manufactured through machines taken on lease by the company. This is a numeric field.

11 ***Quantity produced on loan license or by third parties on job work:*** The quantity manufactured through some other entity under loan license basis or production obtained through third parties on job work basis. This is a numeric field.

12 ***Actual production quantity:*** Sum of serials 9 to 11 above. This is a numeric field.

13 ***Production as per excise records:*** Self-explanatory. It may be noted that the Actual production quantity need not always be equal to Production as per Excise records.

14 ***In house capacity utilization (%):*** To be computed as (self-manufactured quantity) expressed as a percentage of sum of (Installed Capacity + Capacity Enhanced).

15 ***Finished goods purchased of product or activity group – Domestic and Imported:*** The label has been changed from 'Stock Purchased for Trading'**.** Since this item is included in this para meant specifically for product groups covered under cost audit, it is to be understood that products that are manufactured by the company as well as purchased as finished goods would find a place here. In case of such finished goods, it should be combined with the finished goods manufactured and the total quantity should be considered for sales and not kept out as part of "Trading Activity".

16 **Stock and other adjustments of product or activity group**

(a) ***Change in stock of finished goods:*** Difference between opening and closing stocks of finished goods of the product group.

(b) ***Self or captive consumption including samples:*** Quantity of self or captive consumption of products comprised in the product group.

(c) ***Other quantitative adjustments:*** Any other quantitative adjustments like gain from waste.

(d) ***Total stock and other adjustments:*** Total of items (a), (b) and (c) above.

17 ***Available quantity for sale of product or activity group:*** Actual Production quantity plus Finished Goods Purchased plus Stock and other adjustments. This is a numeric field.

18 **Actual sales of product or activity group**

(a) ***Domestic sales of manufactured products:*** Quantity of sales from own manufactured product/activity group in the domestic market. This is a numeric field.

(b) ***Domestic sales of traded products***: Traded quantity of sales of the product/activity group in the domestic market. This sale would be from the Finished Goods Purchased. This is a numeric field.

(c) ***Export sale of manufactured products:*** Quantity of sales from own manufactured product/activity group exported. This is a numeric field.

(d) ***Export sale of traded products:*** Traded quantity of sales of the product/activity group exported. This sale would be from the Finished Goods Purchased. This is a numeric field.

(e) ***Total sales of product or activity group:*** This is sum of items 18(a) to 18(d) above. The quantity should be equal to quantity in item 17. This is a numeric field.

19 ***Notes to quantitative information for product or activity group:*** Enter any comments or observation relevant to this para.

The rendering or presentation of Para-4 as per costing taxonomy can be made as below:

Name of the Company:

Quantitative Information (for each product group separately)

Name of the Product Group		
Product Group Code		
Unit of Measurement		
Particulars	**Current Year**	**Previous Year**
1. Available Capacity		
(a) Installed Capacity at the beginning of the year		
(b) Capacity enhanced during the year		
(c) Capacity available through leasing arrangements		
(d) Capacity available through loan license / third parties		
(e) Total available Capacity		
2. Actual Production		
(a) Self-manufactured		
(b) Under leasing arrangements		
(c) 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 & Other Adjustments		
(a) Change in Stock of Finished Goods		
(b) Self / Captive Consumption		
(c) Other Quantitative Adjustments		
(d) Total Adjustments		
7. Total Available Quantity for Sale		
8. Actual Sales		
(a) Domestic Sales of Manufactured Products		
(b) Domestic Sales of Traded Products		
(c) Export Sale of Manufactured Products		
(d) Export Sale of Traded Products		
(e) Total Quantity Sold		

F. <u>Para 5 – Abridged Cost Statement of Product or Activity Group</u>

(a) Certain elements have been added in the Costing Taxonomy in respect of Para 5. This has been done to cater to fulfil the need that may arise in certain companies and because no extension is possible in the Taxonomy. To meet this requirement two new elements have been added – (1) Industry Specific Operating Expenses and (2) Finished Goods Purchased.

(b) Further, to meet the technical requirement of XBRL, the structure of Para 5 has been changed for data feeding to three separate blocks – quantitative information, cost information and cost per unit information.

(c) Additional information required to be provided is the element-wise cost information in respect of the first previous year.

(d) Since In the old format of table under para-5, information regarding "Material Consumed" was to be specified. The details of Material Consumed are to be provided in the Link Table of Material Consumed.

(e) As explained earlier, extensions are not possible in the taxonomy. In case of "Materials Consumed" or "Utilities Consumed" or the additional element of "Industry Specific Operating Expenses", the Cost Audit Report Rules required details of materials and utilities. The number of materials and utilities would vary from industry to industry and company to company. To meet this requirement, the Taxonomy has provided Link Tables for the details of Materials Consumed, Utilities Consumed and Industry Specific Operating Expenses and the totals are reflected in the main body of the statement. For each of these items, 10 rows have been provided in the detail link table. Only major items are required to be reflected in the link tables. In case the number of items in a particular group of Material or Utility etc. is more than 10, then item-wise details of 9 major items is to be provided and the balance can be shown clubbed together as "Others". The total of each of the link tables must be equal to the total in the main table.

(f) The element of ***Industry Specific Operating Expenses*** has been specifically added to meet the requirement of Regulated Industry like Telecommunication or Petroleum etc. where the cot elements or overheads would not match with the cost elements provided in the notified Para 5. In this case also 10 rows have been provided in the link table. If these cost elements are more than 10, then the top 9 major cost elements in descending order of value may be shown and the balance amount should be shown under 10th row.

(g) The respective quantitative details must match with the corresponding item of quantity shown in Para 4 of the Product/Activity group.

(h) All the elements of Para 5 under Quantitative Information and Cost Information in the Costing Taxonomy are self-explanatory.

(i) The computation of cost per unit details is explained below:

- The divisor of all individual cost elements from "Cost of Materials Consumed" till "Cost of Packing Materials" is the "Quantity Produced".
- "Cost per unit of total inputs and conversion cost" to be computed as the sum total of the "cost per unit of materials consumed" till "cost per unit of industry specific operating expenses".
- "Cost per unit of production or operations" to be computed as sum total of "Cost per unit of total inputs and conversion cost" till "Cost per unit of primary packing".
- "Cost per unit of finished goods purchased" to be computed as "Cost of finished goods purchased" divided by "Quantity of finished goods purchased".
- Cost per unit of production and purchases" to be computed as "Total cost of production and purchases" divided by sum of "Quantity produced" and "Quantity of finished goods purchased".

- "Cost per unit of stock and other adjustments" to be computed as difference between "Per unit cost of production or operation of goods or services sold" and "Cost per unit of production and purchases".
- The divisor of all individual cost elements from "Cost of production or operations of goods or services sold" till "Cost of interest and financing charges" is the "Quantity Sold".
- "Per unit cost of sales of product or activity group" to be computed as sum of cost per unit rates of "Cost of production or operations of goods or services sold" till "Cost of interest and financing charges".
- "Per unit net sales realization of product or activity group" to be computed as "Net sales realization of product or activity group" divided by "Quantity Sold".
- Per unit margin as per cost accounts of product or activity group" to be computed as difference between "Per unit net sales realization of product or activity group" and "Per unit cost of sales of product or activity group".

The rendering or presentation of Para-5 as per costing taxonomy can be made as below:

Name of the Company

Abridged Cost Statement (for each product group separately)

Name of Product or Activity Group	:	
Name of Product or Activity Group Code	:	
Unit of Measurement	:	

Year	**Production**	**Finished Goods Purchased**	**Finished Stock Adjustment**	**Captive Consumption**	**Other Adjustments**	**Quantity Sold**
Current Year						
Previous Year						

Previous Year			**Current Year**	
Amount	**Cost/Unit**	**Particulars**	**Amount**	**Cost/Unit**
₹	₹		₹	₹
		Materials Consumed		
		Process Materials/Chemicals		
		Utilities		
		Direct Employees Cost		
		Direct Expenses		
		Consumable Stores & Spares		
		Repairs & Maintenance		
		Quality Control Expenses		
		Research & Development Expenses		
		Technical know-how Fee / Royalty		
		Depreciation/Amortization		
		Other Production Overheads		
		Industry Specific Operating Expenses		
		Total		
		Increase/Decrease in Work-in-Progress		
		Less: Credits for Recoveries		
		Primary Packing Cost		

		Cost of Production/Operations		
		Cost of Finished Goods Purchased		
		Total Cost of production and purchases		
		Increase/Decrease in Stock of Finished Goods		
		Less: Self/Captive Consumption		
		Other Adjustments		
		Cost of Production of Goods Sold		
		Administrative Overheads		
		Secondary Packing Cost		
		Selling & Distribution Overheads		
		Interest & Financing Charges		
		Cost of Sales		
		Net Sales Realization		
		Margin [Profit/(Loss)]		

Details of Materials Consumed

Previous Year						Current Year		
Quantity	**Rate**	**Amount**	**Particulars**	**UOM**	**Category**	**Quantity**	**Rate**	**Amount**
			Material 1					
			Material 2					
			Material 3					
			Material 4					
			Material 5					
			Material 6					
			Material 7					
			Material 8					
			Material 9					
			Material 10					
			Total Materials					

Details of Utilities Consumed

Previous Year						Current Year		
Quantity	**Rate**	**Amount**	**Particulars**	**UOM**	**Category**	**Quantity**	**Rate**	**Amount**
			Utility 1					
			Utility 2					
			Utility 3					
			Utility 4					
			Utility 5					
			Utility 6					
			Utility 7					
			Utility 8					
			Utility 9					
			Utility 10					
			Total Utilities					

Details of Industry Specific Operating Expenses

Previous Year						Current Year		
Quantity	Rate	Amount	Particulars	UOM	Category	Quantity	Rate	Amount
			Industry specific 1					
			Industry specific 2					
			Industry specific 3					
			Industry specific 4					
			Industry specific 5					
			Industry specific 6					
			Industry specific 7					
			Industry specific 8					
			Industry specific 9					
			Industry specific 10					
			Total Industry Specific Operating Expenses					

G. <u>Para 6 – Operating Ratio Analysis (for each product group separately)</u>

(a) The operating ratios of Para 6 are required to be computed on the basis of data available in the corresponding Para 5 of the respective product groups under cost audit.

(b) In line with Para-5, two new elements have been added in Para 6 also, viz., Industry Specific Operating Expenses and Finished Goods Purchased.

(c) It is to be noted that the operating ratios are calculated as a percentage of cost of sales of the product group. In case there is any self/captive consumption, the value of the same gets reduced from the cost of sales and the resultant cost of sales is net of captive consumption whereas the cost elements starting from material consumption are gross and includes the cost of the element consumed/used for the value of captive consumption as well. Hence, computing operating ratios as a percentage of net cost of sales for gross usage of materials, labour, overheads etc. would not be a correct representation.

(d) In view of the above, the value of captive consumption should be added to the cost of sales to arrive at the gross value of cost of sales and the ratios computed as a percentage of this gross cost of sales (including value of captive consumption).

(e) The total of all the operating ratios must be equal to 100.

The computation of individual operating ratios is explained below. In the computation Gross Cost of Sales means Cost of Sales of Product group plus Cost of Self/Captive Consumption:

1 ***Ratio of materials including process materials cost:*** "Cost of materials consumed + Cost of process materials/chemicals consumed" divided by "Gross Cost of Sales".

2 ***Ratio of utilities cost:*** "Cost of utilities consumed" divided by "Gross Cost of Sales".

3 ***Ratio of direct employees cost:*** "Cost of direct employees" divided by "Gross Cost of Sales".

4 ***Ratio of direct expenses:*** "Cost of direct expenses" divided by "Gross Cost of Sales".

5 ***Ratio of stores and spares consumed:*** "Cost of stores & spares consumed" divided by "Gross Cost of Sales".

6 ***Ratio of repairs and maintenance cost:*** "Cost of repairs & maintenance" divided by "Gross Cost of Sales".

7 ***Ratio of depreciation and amortization cost:*** "Cost of depreciation or amortization" divided by "Gross Cost of Sales".

8 ***Ratio of industry specific operating cost:*** "Cost of industry specific operating expenses" divided by "Gross Cost of Sales".

9 ***Ratio of Packing cost:*** "Cost of Primary Packing" divided by "Gross Cost of Sales".

10 ***Ratio of other expenses:*** "Credit for recoveries + cost of other adjustments" divided by "Gross Cost of Sales".

11 ***Ratio of stock adjustments:*** "Cost of increase/decrease in work-in-progress + Cost of increase/ decrease in finished goods" divided by "Gross Cost of Sales".

12 ***Ratio of production overheads:*** "Cost of production overheads + Cost of quality control + Cost of research & development + Cost of Technical Know-how" divided by "Gross Cost of Sales".

13 ***Ratio of finished goods purchased:*** "Cost of finished goods purchased" divided by "Gross Cost of Sales".

14 ***Ratio of administrative overheads:*** "Cost of administrative overheads" divided by "Gross Cost of Sales".

15 ***Ratio of selling and distribution overheads:*** "Cost of selling & distribution overheads + Cost of secondary packing" divided by "Gross Cost of Sales".

16 ***Ratio of Interest and financing charges:*** "Cost of interest & financing charges" divided by "Gross Cost of Sales".

17 ***Ratio of total operating expenses:*** Sum of 1 to 16 above and the total must be equal to 100.

<u>The rendering or presentation of Para-6 as per costing taxonomy can be made as below:</u>

Name of Company:

Ratio of Operating Expenses to Cost of Sales (for each product group separately)

Name of Product or Activity Group	**:**	
Name of Product or Activity Group Code	**:**	
Unit of Measurement	**:**	

No.		**Current Year**	**Previous Year**
1	Materials (incl. Process Materials) Cost		
2	Utilities Cost		
3	Direct Employees Cost		
4	Direct Expenses		
5	Consumable Stores & Spares		
6	Repairs & Maintenance Cost		
7	Depreciation / Amortization Cost		
8	Industry Specific Operating Expenses		
9	Packing Cost		
10	Other Expenses		
11	Stock Adjustments		
12	Production Overheads		
13	Finished Goods Purchased		
14	Administrative Overheads		
15	Selling & Distribution Overheads		
16	Interest & Financing Charges		
17	Total		

H. **Para 7 – Profit Reconciliation (for the company as a whole)**

(a) The profit reconciliation statement is for the company as a whole. The previous year figures are also required to be provided.

(b) The figure against element "Profit (loss) for audited product or activity groups" must be equal to the sum total of Amount of margin as per cost accounts of all the Product Groups.

(c) Link tables have been provided for "Incomes not considered in cost accounts" and "Expenses not considered in cost accounts".

(d) **Income not considered in cost accounts** – Incomes which are 'Abnormal' in nature and 'purely financial' in nature is not considered in cost accounts to arrive at the costing Profit or Loss.

Abnormal Income means unexpected heavy income in the nature of windfalls, abnormal gains.

Income purely financial in nature: may be of the following nature:

(i) Interest received on investment, deposits outside the business

(ii) Dividends received on investment outside the business

(iii) Profits on sale of capital assets and investment

(iv) Fees received on transfer of shares

(v) Gains on foreign exchange fluctuation

(vi) Prior period income

(vii) Trading Profit

(e) **Expenses not considered in cost accounts** – Expenses which are 'Abnormal' in nature and 'purely financial' are not considered in cost accounts to arrive at the costing Profit or Loss.

Abnormal Expenses – Abnormal expenses may be:

(i) Abnormally high rejections;

(ii) Defective work, spoilages etc.;

(iii) Losses due to theft, pilferage, or acts of nature like earthquake, flood fire;

(iv) Abnormal idle time;

(v) Abnormal under-utilisation of plant facilities;

(vi) Losses due to abnormal situation like strikes, war, accidents etc.

Expenses Purely Financial in nature: may be of the following nature: for e.g. –

(i) Loss on sale of capital assets and investments

(ii) Stamp duty and expenses on issue and transfer of shares

(iii) Discount on bonds and debentures

(iv) Fines and Penalties

(v) Loss on investments

(vi) Loss on foreign exchange fluctuations

(vii) Premium on forward contract

(viii) Liquidated damages

(ix) Short recovery of Excise

(x) Bad Debts
(xi) Donations
(xii) Prior period expenses
(xiii) Expenses on Buy Back of shares
(xiv) Preliminary expenses written off
(xv) Trading Loss
(xvi) Reference also may be made to CAS & GACAP for specific items of this nature

The rendering or presentation of Para-7 as per costing taxonomy can be made as below:

Name of Company

Profit Reconciliation (for the company as a whole)

Particulars	**Current Year**	**Previous Year**
	₹	₹
Profit for the Audited Product Groups		
Profit for the Un-Audited Product Groups		
Add: Incomes not considered in Cost		
Less: Expenses not considered		
Total		
Add, Overvaluation of closing stock in financial accounts		
Add, Undervaluation of opening stock in financial accounts		
Less, Undervaluation of closing stock in financial accounts		
Less, Overvaluation of opening stock in financial accounts		
Profit as per Financial Accounts		

Details of Incomes not considered in Cost

Particulars	**Current Year**	**Previous Year**
	₹	₹
1.		
2.		
3.		
4. (etc.)		
Total		

Details of Expenses not considered in Cost

Particulars	**Current Year**	**Previous Year**
	₹	₹
1.		
2.		
3.		
4. (etc.)		
Total		

I. Para 8 – Value Addition and Distribution of Earnings (for the company as a whole)

(a) The element names in this para have been aligned with the nomenclature used in the Revised Schedule VI.

(b) All figures for the computation of Value Addition and Distribution of Earnings would flow from the audited Profit & Loss Account of the company.

(c) It is advisable to prepare a statement drawing the figures from the audited Profit & Loss Account showing details of individual elements. The resultant balance in the statement after consideration of all incomes, expenses, Income Tax, Dividend and transfer of undistributed profits to reserves should be equal to zero. This would ensure correctness of the computation.

(d) All the elements in this para are self-explanatory.

(e) The Net Revenue from Operations plus Export Incentives plus Other Incomes should be equal to the total revenue of the company as shown in Para 3.

(f) Other Distribution of Earnings would include all non-cost expenses available on the face of the Profit and Loss Account, e.g., Loss on sale of capital assets and investments, Loss/gain on forex, bad debts, stores/stocks written off, Demurrage, Fines and Penalties to statutory authorities, prior period expenses etc. Exceptional Items, if any, and Financial Costs considered in Profit & Loss Account would also be included here.

(g) Cost of other bought-out inputs of company would include expenses incurred for purchase of all types of bought out services like Telephone, Postage, Printing & Stationery, Rates & Taxes, Travelling Expenses, Rent, Insurance, Freight, outside conversion charges (if not included in cost of materials and used as input for further processing), audit fees, commission charges, brokerage, discount etc. In other words, Employee Cost and Benefits, Depreciation, Borrowing Costs and other Non-Cost Items of expenses shall not be included here.

(h) Funds retained by company would include Depreciation and Amortization Expense charged to the Profit & Loss Account during the year and undistributed surplus in Profit & Loss Account transferred to Reserves arising out of the current year profits after payment of tax and dividend.

The rendering or presentation of Para-8 as per costing taxonomy can be made as below:

Name of Company

Value Addition and Distribution of Earnings (for the company as a whole)

Sl.	Particulars	Current Year	Previous Year
No.		₹	₹
	Value Addition:		
1	Gross Revenue from Operations		
2	Less: Excise and Other Duties		
3	Net Revenue from Operations		
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 & Spares		
	(d) Utilities (e.g. power & fuel)		

	(e) Cost of Other Bought-Out Inputs		
	Total Cost of bought out inputs		
7	Value Added		
8	Other Incomes of Company		
9	**Earnings available for distribution**		
	Distribution of Earnings to:		
1	Employees as salaries & wages, retirement benefits, etc.		
2	Shareholders as dividend		
3	Funds retained by Company		
4	Government as taxes		
5	Other Distributions of Earnings		
	Total distribution of earnings		

J. <u>Para 9 – Financial Position and Ratio Analysis (for the company as a whole)</u>

(a) The element names in this para have been aligned with the nomenclature used in the Revised Schedule VI.

(b) All figures for the computation of the Financial Ratios would flow from the audited Profit & Loss Account and Balance Sheet of the company except for cost of production and cost of sales.

(c) The Profit to be considered for this para is the Profit before Tax of the company.

(d) The elements have been aligned with the nomenclatures of Revised Schedule VI.

(e) Capital Employed is defined as average of net fixed assets (excluding intangible assets, effect of revaluation of fixed assets and capital work-in-progress) plus net current assets existing at the beginning and close of the financial year

(f) Net Worth is defined as Share Capital plus Reserves and Surplus (excluding Revaluation Reserves) less accumulated losses and Intangible Assets.

The computation of individual elements of the para is explained below:

1. ***Share Capital:*** Subscribed and paid-up shares of any type including amount paid up on forfeited shares, if any.

2. ***Reserves and Surplus:*** Any reserves and surplus appearing in the Balance Sheet of the company. For computation of Net Worth and Deb-Equity Ratio, only free Reserves to be considered.

3. ***Long-term Borrowings:*** Long-Term Borrowings, both secured and unsecured. Other items shown under Non-Current Liabilities such as, Net Deferred Tax Liabilities, Other Long-Term Liabilities and Provisions and Short Term Borrowings reflected under Current Liabilities would not be part of this item.

4. ***Gross Tangible Assets:*** Gross Tangible Assets would consist of the average Gross Block of the Tangible Assets at the beginning and end of the period under audit. Intangible Assets, Capital work-in-progress, Intangible Assets under Development etc. would not form part of the Gross Fixed Assets represented here.

5. ***Net Tangible Assets:*** Net block of Tangible Assets only.

6. ***Current assets excluding current investments:*** Current Assets consisting of Inventories, Trade Receivables, Cash and Cash equivalents, Short-Term Loans and Advances and Other Current Assets. This item would exclude Current Investments.

7. ***Current liabilities excluding short term borrowings:*** This would be sum total of Current Liabilities excluding Short-Term Borrowings.

8. ***Net Current Assets:*** Difference between Current Assets (excluding Current Investments) and Current Liabilities (excluding Short Term Borrowings).

9. ***Capital Employed:*** Average of net fixed assets (excluding intangible assets, effect of revaluation of fixed assets and capital work-in-progress) plus net current assets existing at the beginning and close of the financial year

10. ***Net Worth:*** Share Capital plus Reserves and Surplus (excluding Revaluation Reserves) less accumulated losses and Intangible Assets.

11. ***Cost of production of company:*** Cost of production of all the products/activities of the company irrespective of whether these are covered under cost audit or not.

12. ***Cost of sales of company:*** Cost of sales of all the products/activities of the company irrespective of whether these are covered under cost audit or not.

13. ***Value added of company:*** Value added as per statement of Value Addition in Para 8.

14. ***Net Revenue from Operations of company:*** Net revenue from operations of company as per statement of Value Addition in Para 8.

15. ***Profit before Tax:*** Profit before Tax before adjustment for Exceptional Items as per Profit & Loss Account.

16. ***Profit before Tax to Capital Employed (%):*** Profit before Tax expressed as a percentage of Capital Employed.

17. ***Profit before Tax to Net Worth (%):*** Profit before Tax expressed as a percentage of Net Worth.

18. ***Profit before Tax to Net Revenue from Operations of company (%):*** Profit before Tax expressed as a percentage of Net Revenue from Operations.

19. ***Profit before Tax to Value Added of company (%):*** Profit before Tax expressed as a percentage of Value Added.

20. ***Debt Equity Ratio (%):*** Long Term Borrowings expressed as a percentage of Shareholders' Funds. Shareholders' Funds is Share Capital plus free Reserves & Surplus.

21. ***Current Assets to current Liabilities (%):*** Current Assets excluding current investments expressed as a percentage of Current Liabilities excluding short-term borrowings.

22. ***Value Added to Net Revenue from Operations of company (%):*** Valued Added expressed as a percentage of Net Revenue from Operations.

23. ***Net working capital to cost of sales excluding depreciation of company (in months):*** (Average Current Assets – Average Current Liabilities) divided by (Cost of Sales excluding depreciation divided by 12).

24. ***Raw materials stock to consumption of company (in months):*** Raw material stock divided by (Total Raw Material consumption divided by 12).

25. ***Stores and spares stock to consumption of company (in months):*** Stores & spares stock divided by (Total Stores & Spares consumption divided by 12).

26. ***Work-in-progress stock to cost of production of company (in months):*** Work-in-progress stock divided by (Cost of Production of company divided by 12).

27. ***Finished goods stock to cost of sales of company (in months):*** Finished goods stock divided by (Cost of sales of company divided by 12).

The rendering or presentation of Para-9 as per costing taxonomy can be made as below:

Name of the Company

Financial Position and Ratio Analysis (for the company as a whole)

Sno.	Particulars	Units	Current Year	Previous Year
A.	**Financial Position**			
1	Share Capital	₹ Lakhs		
2	Reserves & Surplus	₹ Lakhs		
3	Long Term Borrowings	₹ Lakhs		
4	(a) Gross Tangible Assets	₹ Lakhs		
	(b) Net Tangible Assets	₹ Lakhs		
5	(a) Current Assets excluding Current Investments	₹ Lakhs		
	(b) Less: Current Liabilities excluding Short Term Borrowings	₹ Lakhs		
	(c) Net Current Assets	₹ Lakhs		
6	Capital Employed	₹ Lakhs		
7	Net Worth	₹ Lakhs		
B.	**Financial Performance**			
1	Cost of Production	₹ Lakhs		
2	Cost of Sales	₹ Lakhs		
3	Net Revenue from Operations of Company	₹ Lakhs		
4	Value Added	₹ Lakhs		
5	Profit before Tax (PBT)	₹ Lakhs		
C.	**Profitability Ratios**			
1	PBT to Capital Employed (B5/A6)	%		
2	PBT to Net Worth (B5/A7)	%		
3	PBT to Net revenue from Operations (B5/B3)	%		
4	PBT to Value Added (B5/B4)	%		
D.	**Other Financial Ratios**			
1	Debt-Equity Ratio	%		
2	Current Assets to Current Liabilities	%		
3	Valued Added to Net Revenue from Operations	%		
E.	**Working Capital Ratios**			
1	Net Working Capital to Cost of Sales excl. depreciation	Months		
2	Raw Materials Stock to Consumption	Months		
3	Stores & Spares to Consumption	Months		
4	Work-in-Progress Stock to Cost of Production	Months		
5	Finished Goods Stock to Cost of Sales	Months		

K. Para 10 – Related Party Transactions (for the company as a whole)

(a) The information for this para is to be provided for the company as a whole.

(b) The information of related party transactions is to be given only for the period under cost audit. Previous year figures are not required to be provided.

(c) The Companies (Cost Audit Report) Rules 2011 stipulated that related party transactions of every transaction are to be provided. The Costing Taxonomy has now stipulated that only the aggregate quantity and value of product or services is required to be provided when such product or service involve transaction with a related party.

(d) There is no definition of Related Party provided in the Companies (Cost Audit Report) Rules 2011. In the Cost Audit Report Rules 2001, Related Party was defined in accordance with the definition provided in the Accounting Standard (AS)-18. Related Party for this para would have to be considered according to the definition as provided in Accounting Standard 18 as notified by the Ministry of Corporate Affairs.

(e) Related party disclosure for the Cost Audit Report Rules is restricted to Sale & Purchase of Goods and Receipt & Rendering of Services only.

(f) The disclosure requires basis for determination of Normal Price for transactions to be stated. Any of the basis as per section 92C of the Income Tax Act, 1961, viz., (i) Comparable Uncontrolled Price Method, (ii) Resale Price Method, (iii) Cost Plus Method,(iv) Profit Split Method, and (v) Transactional Net Margin Method may be adopted. In case any other method is adopted, the same has to be explained as a part of disclosure requirement.

(g) The Corporate Identity Number/Permanent Account Number/Country of origin are required to be disclosed depending on whether the related party is an Indian Company or an Individual or a Foreign Company respectively.

(h) Each product transacted will have to be identified with the 8-digit CETA Code.

The rendering or presentation of Para-10 as per costing taxonomy can be made as below:

Para 10: Related Party Transactions (For the Company as a whole)

Sr. No.	Product/ Service Code	Product/ Service Description	Name of Related Party	Type of Related Party	Identification of related party	Nature of Transaction	Aggregate Quantity	Average Transfer Price	Aggregate Amount of Transaction	Average Normal Price	Difference Between Average Transfer Price & Average Normal Price	Basis Adopted to determine the Normal Price
							(A)	(B)	(A*B)	C	(B-C)	
	Product 8-digit CETA Code or Service Code as per NIC Service Code			Separately for (i) Indian Company (ii) Indian Firm/ Individual (iii) Foreign Company	CIN if Indian Company // PAN if Indian Individual or Firm // Country Location, if Foreign Company or Individual	i. Sale of Product ii. Purchase of Product iii. Services Received iv. Services Rendered						Comparable Uncontrolled Price Method ii. Resale Price Method iii. Cost Plus Method iv. Profit Split Method v. Transactional Net Margin Method vi. Any Other method

L. Para 11 – Reconciliation of Indirect Taxes (for the company as a whole)

(a) This Para is to be prepared for the company as a whole covering excise duty, service tax and VAT (including CST and any other State Tax) for all types of products whether or not covered under cost audit.

(b) The information of indirect taxes is to be given for current year and no previous year's figures are required.

(c) The format under para 11 is slightly modified to suit the requirement of taxonomy and furnish the details correctly.

(d) CST and Other State Taxes have been added in the costing taxonomy to show the details relating to them also.

(e) Assessable Value relating to all types of taxes should be taken from the respective Returns submitted with the tax authorities. For example, assessable value for excise duty should be taken from RT 12 (now ER-1), the gross amount (assessable value) for service tax should be taken as gross value of services as mentioned in ST-3 (under section 70 of Finance Act 1994).

(f) The duties and taxes Payable is based on clearances of goods and services against the respective heads.

(g) Duties / Taxes Paid include CENVAT/ VAT Credit utilized on inputs, capital goods, input services and other utilization, if any.

(h) Taxes paid through PLA/ Cash refer to the payment of Excise Duty, Service Tax, Cess & Others and VAT through debit in PLA account or deposit in to the PLA account or payment in to the bank account by way of cheque or cash through the GAR-7 Challan or the Challan for making the payment of VAT.

(i) Duties /Taxes Recovered should be taken from Books of Account of the company. It is necessary that the gross turnover or the gross billings should be duly accounted under various heads such as net sales, excise duty, sales tax, service tax, etc.

(j) Difference between duties / taxes paid and recovered refer to the amount of total duties/ taxes paid and recovered. This may not match due to the following reasons –

- Excise duty element in stock of excise duty paid goods at depots, branches, and warehouse or with C & F agents.
- The goods lying at depots, etc. are duty paid goods which have not been sold to the customer. Hence, the duty has not been recovered from the customers.
- Excise duty/ sales tax paid on free issues, samples, where the taxes are not recovered from customers.
- Excise Duty paid on inter factory transfers.
- Excise Duty paid on the goods captively consumed.
- Excise duty / sales tax / service tax /cess and other payments arising out of Order-in-Original or Order-in-Appeal, etc.

(k) The fines, penalties, interest etc. are not a payment of Excise Duty, Service Tax, Cess & Others and VAT. However, sometimes it is paid through PLA or Cash (deposit in to the bank account by way of cheque or cash through Challan) under the separate code as specified in the Challan. In these circumstances, the amount should be identified and shown separately. This amount can be tallied from Monthly ER-1 Return (Excise), Annual Financial Information Statement in ER-4 (Excise), Half Yearly ST-3 Return (Service Tax) and Monthly / Annual VAT return.

The rendering or presentation of Para-11 as per costing taxonomy can be made as below:

Name of the Company

Reconciliation of Indirect Taxes

	Particulars	**Assessable Value**	**Excise Duty**	**Service Tax**	**Cess & Others**	**VAT / CST**
		₹ **Lakhs**	₹	₹	₹	₹
	Duties/Taxes Payable					
	Excise Duty					
1	Domestic					
2	Export					
3	Stock Transfers (Net)					
4	Others					
5	Total Excise Duty (1 to 4)					
6	Service Tax					
7	VAT / CST					
8	Other State Taxes if any					
9	**Total Duties / Taxes Payable (5 to 8)**					
	Duties/Taxes Paid					
10	Cenvat/VAT Credit Utilised - Inputs					
11	Cenvat/VAT Credit Utilised - Capital Goods					
12	Cenvat/VAT Credit Utilised - 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: Shaded cells will not have any figures.

9.7 COSTING TAXONOMY FOR COMPLIANCE REPORT

The Companies (Cost Accounting Records) Rules 2011 as well as the 6 Regulated Industries cost accounting records rules notified by the MCA contained the Compliance Report format and Annexure to the Compliance Report. A number of information was contained in the e-Form for filing of the Compliance Report. In the Costing Taxonomy for Compliance Report, the information contained under "General Information" in the e-form has been merged and the entire information has now been made a part of the information required to be filed in the Compliance Report. The explanation of each of the elements is provided below.

General information

1. ***Corporate identity number or foreign company registration number:*** Provide valid CIN/FCRN Number of the Company which should be same as per MCA Database. This is a mandatory field.
2. ***Name of company:*** Enter the name of the Company which should be based on CIN or FCRN as applicable and as per MCA Database. This is a mandatory field.
3. ***Address of registered office or of principal place of business in India of company:*** Enter registered office address. In case of a foreign company, enter address of principal place of business as per MCA Database. This is a mandatory field.
4. ***Address of corporate office of company:*** Enter corporate office address. In case it is the same as registered office, enter registered office address as per MCA Database. This is a mandatory field.
5. ***Email address of company:*** Enter email address of the company as per MCA Database. This is a mandatory field.
6. ***Date of start of reporting period:*** Enter date of start of reporting period. The format would depend on the tool being used. The date should be greater than or equal to date of incorporation in case of Indian company or date of establishment of place of business in case of foreign company and should be less than or equal to system date. This is a mandatory field.
7. ***Date of end of reporting period:*** Enter date of end of reporting period. The format would depend on the tool being used. The date should be less than or equal to system date and greater than or equal to Start Date of Reporting Period. Difference between start date and end date should not be greater than 18 months. This is a mandatory field.
8. ***Level of rounding used in cost statements:*** Enter level of rounding off used for the report, e.g., crores, lakhs, thousands, millions, etc. It is to be noted that the selected rounding off of figures must be adopted uniformly across the report for every para. This is a mandatory field.
9. ***Reporting currency of entity:*** The currency of reporting is INR. This is a mandatory field.
10. ***Date of board of directors meeting in which annexure to cost audit report was approved:*** Enter date of meeting of Board of Directors approving the annexure to compliance report. This is a mandatory field.
11. ***Nature of Employment of cost accountant:*** Enter whether the cost accountant is in employment or in practice. If the cost accountant is in practice, items 12 and 13 are mandatory fields.
12. ***Category of cost accountant:*** Enter whether the cost accountant is a firm or a sole proprietor. An individual practising in individual name is to be considered under the Sole Proprietorship category. This is a mandatory field.
13. ***Firm's registration number:*** Enter registration number of the firm allotted by the Institute. This is a mandatory field for all cost auditors.
14. ***Name of cost accountant or cost accountant's firm who has certified compliance report of company:*** Enter name of the firm or trade name of the sole proprietor (including individual). This name must be same as per the Institute of Cost Accountants of India database. This is a mandatory field.
15. ***Permanent account number of cost accountant or cost accountant's firm:*** Provide PAN of firm in case the cost auditor is a Firm. In case of a sole proprietor or an individual, enter the PAN of the individual member. The individual PAN of the Partner of the Firm is not to be provided here. This is a mandatory field.
16. ***Address of cost accountant or cost accountant's firm:*** Enter address of the firm as registered with the Institute. This is a mandatory field.
17. ***Email id of cost accountant or cost accountant's firm:*** Enter email id of the firm. This is a mandatory field.

18. ***Membership number of member signing report:*** Enter membership number of the signing Partner in case a Firm is appointed as the cost accountant. In case of an employee cost accountant or Sole Proprietor or individual in practice, enter membership number of the person signing he report. It should be a valid membership number as per the Institute of Cost Accountants of India database. This is a mandatory field.

19. ***Name of member signing report:*** Enter name of the member signing the report. The name should be entered as appearing in the database of the Institute. This is a mandatory field.

20. ***Date of signing compliance report by cost accountant:*** Enter date of signing

21. ***Place of signing compliance report by cost accountant:*** Enter place of signing

20. ***Whether compliance report has been qualified or has any reservations or contains adverse remarks:*** State whether the report has any adverse remarks.

Annexure to Compliance Report

Quantitative Information

1. ***Name of product or activity group:*** Enter name of product/activity group as per MCA Product Group classification. This is a mandatory field.

2. ***Product or activity group code:*** Enter product/activity group code as per MCA Product Group classification. This is a mandatory field.

3. ***Unit of Measurement:*** Enter Unit of Measurement of the Product Group. This is a mandatory field.

4. ***Quantity produced of product or activity group:*** Production quantity of the Product Group. This is a mandatory field.

5. ***Quantity sold of product or activity group:*** Sales quantity of the Product Group. This is a mandatory field.

6. ***Net operational revenue of product or activity group:*** Enter net operational revenue of the product/activity group as per the audited financial accounts of the company. This is a mandatory field.

7. ***Whether product or activity group covered under cost audit:*** Enter YES/NO against each product group code. This is a mandatory field.

8. ***Other incomes of company:*** Enter other incomes of the company as a whole as per audited annual accounts.This is a mandatory field.

9. ***Total revenue as per financial accounts:*** Sum of Net Operational Revenue and Other Incomes of the company. This figure should be equal to the Net Revenue of the company as per audited annual accounts. This is a mandatory field.

   Note: Under the Revised Schedule VI, the Profit and Loss Account represents the revenue of a company under (a) Revenue from Operations; (b) Other Operating Revenues; and (c) Other Incomes. The "Other Operating Revenue" can contain certain revenue incomes that cannot be directly linked to a particular product/activity group. For example, income from scrap sale is an item that is to be disclosed under "Other Operating Revenue" and such an income would arise from the operations involving all the product groups. In cost accounts, this income may be treated as a credit to individual material cost (if directly identifiable and conform to the CAS-6) or credited to overheads. For purposes of Para 3, this is required to be shown as a part of total Revenue of the company to reconcile with the total revenue of the company as per audited annual accounts. In such cases, "Other Operating Revenues" that cannot be directly linked to a product/activity group, such items are to be shown against Product Group Code **"4100 – Ancillary Products not elsewhere specified".**

The Para can be presented in the following format:

QUANTITATIVE INFORMATION

Year ended ___________

Product Group Name	Product Group Code	UOM	Covered In Cost Audit	Actual Production	Net Operational Revenue Quantity Units	Net Operational Revenue Value ₹ Lakhs
Total						
Other Incomes						
Total Income as per Audited Annual Report						

Reconciliation Statement (for the company as a whole)

(a) The profit reconciliation statement is for the company as a whole. The previous year figures are not required to be provided.

(b) Link tables have been provided for "Amount of incomes not considered in cost accounts" and "Amount of expenses not considered in cost accounts".

(c) **Amount of incomes not considered in cost accounts** – Incomes which are 'Abnormal' in nature and 'purely financial' in nature is not considered in cost accounts to arrive at the costing Profit or Loss.

Abnormal Income means unexpected heavy income in the nature of windfalls, abnormal gains.

Income purely financial in nature: may be of the following nature:

(i) Interest received on investment, deposits outside the business

(ii) Dividends received on investment outside the business

(iii) Profits on sale of capital assets and investment

(iv) Fees received on transfer of shares

(v) Gains on foreign exchange fluctuation

(vi) Prior period income

(vii) Trading Profit

(d) **Amount of expenses not considered in cost accounts** – Expenses which are 'Abnormal' in nature and 'purely financial' are not considered in cost accounts to arrive at the costing Profit or Loss.

Abnormal Expenses – Abnormal expenses may be:

(i) Abnormally high rejections;

(ii) Defective work, spoilages etc.;

(iii) Losses due to theft, pilferage, or acts of nature like earthquake, flood fire;

(iv) Abnormal idle time;

(v) Abnormal under-utilisation of plant facilities;

(vi) Losses due to abnormal situation like strikes, war, accidents etc.

Expenses Purely Financial in nature: may be of the following nature: for e.g. –

(i) Loss on sale of capital assets and investments

(ii) Stamp duty and expenses on issue and transfer of shares

(iii) Discount on bonds and debentures

(iv) Fines and Penalties

(v) Loss on investments

(vi) Loss on foreign exchange fluctuations

(vii) Premium on forward contract

(viii) Liquidated damages

(ix) Short recovery of Excise

(x) Bad Debts

(xi) Donations

(xii) Prior period expenses

(xiii) Expenses on Buy Back of shares

(xiv) Preliminary expenses written off

(xv) Trading Loss

(xvi) Reference also may be made to CAS & GACAP for specific items of this nature

The rendering or presentation of the reconciliation Statement as per costing taxonomy can be made as below:

Name of Company

Reconciliation Statement (for the company as a whole)

Particulars	**Current Year**
	₹ Lakhs
Profit (loss) from product or activity groups covered under cost audit	
Profit (loss) from product or activity groups covered under cost accounting records rules but not covered under cost audit	
Profit (loss) from activities not covered under cost accounting records rules	
Total profit (loss) as per cost accounts	
Add: Amount of incomes not considered in cost accounts	
Less: Amount of expenses not considered in cost accounts	
Total	
Difference in stock valuation as per cost and financial records	
Profit (loss) as per financial accounts	

Details of Amount of incomes not considered in cost accounts

Particulars	Current Year
	₹ Lakhs
1.	
2.	
3.	
4. (etc.)	
Total	

Details of Amount of expenses not considered in cost accounts

Particulars	Current Year
	₹ Lakhs
1.	
2.	
3.	
4. (etc.)	
Total	

Appendix - A

9.8 FAQS

8.1 General FAQs

1. What is XBRL?

XBRL (eXtensible Business Reporting Language) is a language based on XML (Extensible Markup Language) family of languages. It is an open standards-based reporting system that is built to accommodate the electronic preparation and exchange of business reports around the world using internet as a medium. It has been defined specifically to meet the requirements of business and financial information.

It enables unique identifying tags to be applied to items of accounting data. The tags provide a range of information about the item, such as whether it is a monetary item, percentage or fraction. XBRL not only allows labels in any language to be applied to items, it also allows the accounting references or other subsidiary information to be added to the tags.

2. What are the potential uses of XBRL?

XBRL can be applied to a very wide range of business applications including financial and cost data. XBRL has applications in the following areas:-

- Reporting for internal and external purposes by an entity involving financial and costing data/ information.
- Business reporting to all types of regulators, including tax and financial authorities, central banks and governments.
- Filing of loan reports and applications; credit risk assessments.
- Exchange of information between government departments, institutions and banks.

3. Who can benefit from using XBRL?

All types of organisations can make use of XBRL to automate their process of data collection and distribution to various stakeholders. It helps in saving costs and improving the efficiency in managing business information – financial or cost. XBRL, being extensible and flexible, can be adapted to a wide variety of requirements. All stakeholders whether they are preparers, transmitters or users of business data in the financial information supply chain can benefit from the use of XBRL.

4. What is the future of XBRL?

XBRL has a bright future ahead of it that goes way beyond the current focus on regulatory reporting and compliance. Businesses that are now creating XBRL filings for regulatory bodies should be thinking about how they can leverage their investment in understanding and using XBRL to drive more consistent and comparable internal reporting. By tagging data at the account/transaction level, by investigating how XBRL can help to deliver new holistic reports that integrate and connect financial and non-financial data, and by leveraging emerging online XBRL data streams for better industry performance and peer group analytics, every business can power its own journey towards financial transformation.

5. Who developed XBRL?

The Extensible Business Reporting Language (XBRL) is managed and promoted by XBRL International, a not-for-profit consortium, with companies, government bodies and other organizations as its members. Currently over 600 organizations are associated with XBRL International. It is comprised of jurisdictions, which represent countries, regions or international bodies and which focus on the progress of XBRL in their area.

6. What is the benefit of having cost related data in XBRL format?

Government and Regulators require cost data of different sectors for policy making. The availability of cost data [without compromising on the confidentiality] in XBRL format enables informed decision making and for sectoral studies.

With full adoption of XBRL, companies would be able to integrate its financial and cost data across its operational areas and exercise better control on its activities.

7. What is Costing Taxonomy?

Costing Taxonomy is a dictionary of all cost elements required in the cost audit report and compliance report. The costing taxonomy contains the properties and interrelationships of all these cost elements for the purposes of capturing the required reporting data in XBRL format.

8. Where can I find the Costing Taxonomy and related Business Rules?

The Costing Taxonomy and related Business Rules including sample instance documents can be downloaded from the website of MCA (http://mca.gov.in). The specific links are as follows:

Costing Taxonomy –

http://mca.gov.in/Ministry/pdf/costing_taxonomy_20112-9-12.zip

Business Rules –

http://www.mca.gov.in/Ministry/pdf/Business_Rules_XBRL_Cost_Audit_taxonomy_2012_21_Sep_2012.zip

9. What is the use of other files given in xml / xsd format along with the taxonomy?

Taxonomy file has extensions of XML and XSD. An XBRL processor (computer software that understands and/or manipulates XBRL documents) will need those XML and XSD documents.

10. How and where can a person interested in filing cost audit report and compliance report in XBRL format take training for the same?

The Institute of Cost Accountants of India has been organizing XBRL training programmes across the country to familiarize interested professionals with the Costing Taxonomy. The details of the programmes are available on the website of the Institute (www.icwai.org) as well the website of MCA (www.mca.gov.in).

11. How can the cost audit report and compliance report is converted into the XBRL format?

XBRL is an open source technology. Any of the following methods can be adopted to create the instance document required for filing of the respective reports.

- XBRL-enabled software packages developed by different software vendors which support the creation of cost reports in XBRL format can be used to create the necessary document.
- Various elements of Cost Audit Report and Compliance Report can be mapped into XBRL tags of the costing taxonomy using specialised XBRL software tools specifically designed for this purpose.
- Different third party packages can be integrated into the existing accounting systems to generate XBRL Cost statements.
- There are various web based applications available that take input reports in various formats viz. Microsoft Excel etc. and transform them into XBRL format.

The methodology adopted by an individual company will depend on its requirements and the cost accounting software and systems being used and other factors.

12. Does preparing XBRL Documents mean that the entire report has to be typed (Data Entry) in XBRL?

XBRL software is required for creating instance documents. The way of working and sequence of entering data in the software may be different, but the output, i.e. the XBRL instance document has to be same irrespective of the software used. The softwares developed by individual vendors being different, some may require data entry to be done, while some others may facilitate tagging on the document itself.

13. Is the XBRL software required to be purchased from a software vendor or MCA will provide the software. Which agency should I approach to get the XBRL software?

XBRL instance document creation software is required to be purchased from the software vendors in the market. This software is used to create XBRL instance documents for uploading on the MCA portal. MCA21 system provides facility for validation of the instance document and filing of the same. MCA is not recommending any specific XBRL software.

There are several software vendors in the market, who are in the business of developing XBRL software tools. The users are free to choose the one that suits their requirements in order to create XBRL documents for filing.

14. Which companies are required to file the Cost Audit Report and Compliance Report in XBRL format and what is the authority for the same?

MCA vide Circular No. 8/2012 dated May 10, 2012 has mandated filing of Cost Audit Reports and Compliance Reports in XBRL format from the financial year 2011-12 (including the overdue reports relating to any previous year).

MCA vide Circular No. 18/2012 dated July 26, 2012, has extended the last date of filing of cost audit reports and compliance reports with the Central Government in XBRL format up to December 31, 2012.

15. What is the purpose of the Final Costing Taxonomy and the Business Rules?

The final costing taxonomy published by MCA is to be used for mapping of individual cost elements of the company to the Taxonomy. The Business Rules of the Costing Taxonomy published by the MCA provides details of the character of individual elements of the taxonomy and the validation checks built into the system to ensure correctness of the information.

16. What process is to be followed to file the reports in XBRL Format?

The following steps have to be followed in sequence:

- Mapping the individual cost elements of the company to the elements of the costing taxonomy.
- Populating the relevant data in the software/filing tool.
- Creating instance document.
- Validating the Instance Document with the Validation Tool of MCA.
- Use available tool to convert the Instance document to a human readable format and check correctness of data.
- Attaching the Instance Document to the e-Form and filing on MCA Portal.

17. Is the necessary to convert the instance document (xml) into a human readable / pdf format?

Though technically, it is not required to convert the xml instance document into human readable / pdf format, it is advisable to generate a human readable format of the instance document to ensure its correctness by matching with relevant Cost Audit Report or Compliance Report prepared by the Cost Auditor/Accountant before it is uploaded.

18. Whether it is required to validate the instance document created before uploading the same on MCA portal?

Yes, validating the instance document is a pre requisite before filing the Cost Audit Report and Compliance Report on MCA portal. A tool has been provided on the MCA portal for validating the generated XBRL instance document. You are required to download the tool from the portal and validate the instance document before uploading the same. The MCA XBRL validation tool can be downloaded from the XBRL website of the Ministry of Corporate Affairs. (www.mca.gov.in/XBRL)

19. Will extension to the taxonomy be allowed based on company specific requirements?

No extensions are allowed in the Costing Taxonomy. This means the tagging is required to be done with the elements already defined in the Costing Taxonomy and additional elements cannot be added.

20. When we are filing Cost Audit Report/ Compliance in XBRL format, then whether the previous Form-I and Form-A are still in existence or not?

Previous forms are no longer in existence. Only the new forms 23CAR-XBRL and 23CR-XBRL are to be used for filing of Cost Audit Report and Compliance Report respectively in the XBRL format.

8.2 Stakeholder's FAQs

Filing Related

1. Which are the companies that need to file the Cost Audit Report and Compliance Report in XBRL format?

Ministry of Corporate Affairs has mandated filing of the Cost Audit Report and Compliance Report from the financial year 2011-12 onwards (including overdue reports relating to any previous year) by using the XBRL taxonomy. The relevant General Circular No. 8/2012 dated 10.5.2012 [as amended on 29.6.2012] and No. 18/2012 dated 26.7.2012 issued by MCA can be accessed from the following link:

http://www.mca.gov.in/Ministry/companies_act.html.

2. Which companies are not required to file the Cost Audit Report?

All such companies that are **NOT** covered under the company specific Cost Audit Orders issued prior to 31.3.2011 and/or under the industry specific Cost Audit Order No. 52/26/CAB-2010 dated 2nd May 2011, 30th June 2011 and 24th January 2012 are not required to file Cost Audit Report. However, companies meeting with the threshold limits as prescribed in the relevant Cost Accounting Records Rules 2011 are required to file Compliance Report in the XBRL format.

3. Which companies are exempted from filing the Compliance Report?

All such companies that are not covered under any of the Cost Accounting Records Rules notified in 2011 are not required to file the Compliance Report.

Further, as per MCA's General Circular No. 68/2011 dated 30.11.2011 read with the General Circular No. 12/2012 dated 4.6.2012, such companies that are covered under any of the Cost Accounting Records Rules notified in 2011 but wherein all their products/activities, excluding the exempted categories, are covered under cost audit, are not required to separately file the Compliance Report.

4. If my Cost Audit Report pertains to the financial year prior to 2011-12, then do I need to file the report in XBRL format?

As per MCA's General Circular No. 8/2012 dated 10.5.2012, all Cost Audit Reports required to be filed with the Central Government starting from financial year 2011-12 and also in respect of any financial years prior to 2011-12 [that has not been filed so far] need to be filed in XBRL format.

5. Central Government vide General Circular no. 18/2012 dated July 26, 2012 has extended filing of the Cost Audit Report in XBRL format till December 31, 2012. A company follows different financial year viz. from October 01, 2011 to September 30, 2012. As per Companies (Cost Audit Report) Rules, 2011, filing of Cost Audit Report becomes due by March 27, 2013, i.e. within 180 days from the end of the reporting year. Is this company still required to file the Cost Audit Report in XBRL format by December 31, 2012 or it would be allowed to file the report until March 27, 2013?

The companies are required to file their Cost Audit Report [or the Compliance report] for the year 2011-12 within 180 days of the close of the financial year or by December 31, 2012, whichever is later.

6. Who will certify XBRL filing for Cost Audit Report?

The Cost Auditor [or the lead Cost Auditor in case the company has more than one Cost Auditors] is required to digitally sign and file the Cost Audit Report for the company as a whole.

7. Who will certify XBRL filing for Compliance Report?

Any valid Member of the Institute of Cost Accountants of India who is either in full-time employment with the concerned company or is holding full-time Certificate of Practice can only certify the Compliance Report.

8. I am holding valid membership of the Institute of Cost Accountants of India as well as of the Institute of Company Secretaries of India. As a full-time employee of the company, can I certify its Compliance Report?

Yes, being a valid Member of the Institute of Cost Accountants of India and in full-time employment with the concerned company, you can certify its Compliance Report provided you are not signing the Compliance Report as Company Secretary or as Director of the company also.

9. The responsibility of filing Cost Audit Report with the Central Government lies with the Cost Auditor. Whose responsibility is it to create XBRL document?

Creation of the Cost Audit Report in XBRL format, as approved by the Board and certified by the Cost Auditor, is the responsibility of the company. However, filing the Cost Audit Report in XBRL format with the Central Government is the responsibility of the Cost Auditor, who has to ensure the correctness of data and other information contained in the XBRL Instance Document.

10. I have completed the Cost Audit and the Board of Directors has also approved the Cost Audit Report / Compliance Report. Is the Board of Directors of the company required to approve the Instance document of the Cost Audit Report / Compliance Report?

No separate approval from the Board is required for the Instance document of the Cost Audit Report or of the Compliance Report since the data/information contained in the Instance document would already have been approved by the Board of Directors. However, if the data & other information as given in the Instance document differ from that approved by the Board, then it is advisable to get fresh approval of the revised Cost Audit Report or the Compliance Report unless the Board while according approval had authorized any officer of the company to make modifications as required in the XBRL document.

11. A company has not appointed anyone as the lead cost auditor. Is it required to appoint a lead cost auditor for consolidation?

The company is not required to separately appoint a lead Cost Auditor. It may designate/nominate any one of the existing Cost Auditors as the lead Cost Auditor and assign the additional task of consolidation, who would be responsible for verifying the consolidated report and filing the same with the Central Government.

12. Is Performance Appraisal Report required to be filed with the Central Government as a part of the Cost Audit Report?

As per provisions of the Companies (Cost Audit Report) Rules, 2011, every cost auditor, who submits a cost audit report, is also required to furnish Performance Appraisal Report to the Board/Audit Committee of the company in the prescribed format (Form III). However, this report will not be required to be filed with the Central Government.

13. My company is in the business of power generation. As per the MCA Circular, power companies are not required to file the Balance Sheet and Profit & Loss Account in XBRL format. Do I still need to file Cost Audit Report / Compliance Report (as applicable) in XBRL format?

Power generation companies have been exempted from filing their Balance Sheet and Profit & Loss Account in XBRL format as the relevant taxonomy as per disclosure requirements under the Electricity Act, 2003 is still under development. However, under the said Act, there are no such separate disclosure requirements for cost details. Hence, the costing Taxonomy for filing the Cost Audit Report or the Compliance Report is common to all companies. Therefore, companies engaged in the business of power generation, transmission or distribution are also required to file Cost Audit Report / Compliance Report (as applicable) in the XBRL format.

Taxonomy Related

14. Can I use C&I taxonomy to create Cost Audit Report or Compliance Report?

No, there is a separate in-Cost taxonomy for creating Cost Audit Report or Compliance Report. The Costing Taxonomy can be accessed from the website of Ministry of Corporate Affairs. The relevant link for the costing taxonomy is: http://www.mca.gov.in/Ministry/pdf/Costing_taxonomy_2012-09-12.zip

15. Do I need separate validation tool for validating the instance document of Cost Audit Report/ Compliance report or the same validation tool as applicable for validating the instance document of Balance Sheet and Profit & Loss account can be used?

Ministry of Corporate Affairs is in the process of developing a single validation tool that will validate all types of instance documents whether it is for Cost Audit Report or Compliance report or Balance Sheet and Profit & Loss account. However, while validating, the user would be required to select appropriate taxonomy used for creation of the Instance document.

16. My company has to file both Cost Audit Report and Compliance report. Can I use the same taxonomy for both the reports?

Yes. The in-Cost taxonomy contains elements for both Cost Audit Report and Compliance Report. The entry points are different. However, common elements are defined at one place only.

17. Costing taxonomy shows variation when compared to the formats of Cost Audit Report and Compliance Report given in the notified Cost Accounting Records Rules and Cost Audit Report

Rules. Can the instance documents created as per Costing taxonomy be filed with the Central Government or I need to create instance document conforming to the notified formats?

In XBRL mode, only the requisite data & other information as per the Costing Taxonomy is required to be filed by attaching the valid instance document with the relevant e-Form. No other formats as earlier notified are required to be filed. The final Costing Taxonomy as available on the MCA website supersedes the formats of Cost Audit Report and Compliance Report as given in the earlier notified Cost Accounting Records Rules and Cost Audit Report Rules.

18. The revised structure of the Compliance Report as well as the Cost Audit Report has stipulated reporting at the "Product or Activity Group" level. What would be the basis of determining a "Product or Activity Group" for a multi-product company?

"Product or Activity Group classification" shall be strictly in accordance with the notification issued by the Ministry of Corporate Affairs vide S.O. No. 1747(E) dated 7th August 2012. The link for accessing the product group notification is: http://mca.gov.in/Ministry/pdf/S.O.(E)1747_07_08_2012.pdf

19. If my company deals in multiple product groups and there are multiple cost auditors appointed in the company. Do I need to file multiple Cost Audit Reports or only consolidated Cost Audit Report in XBRL format?

In the XBRL format, you are required to file only one consolidated Cost Audit Report for the company as a whole. If a company has multiple Cost Auditors, then in such case, one of them may be designated/nominated as the lead Cost Auditor who will file the consolidated cost audit report for the company as a whole. However, the lead Cost Auditor would be required to provide details of all the Cost Auditors of the company including the report of the individual Cost Auditors with their comments and observations separately for each Cost Auditor in the consolidated report. Only the data contained in para 3 to 11 would be consolidated, wherever applicable.

20. In the Abridged Cost Statement (Para 5) of the Cost Audit Report pertaining to my company, I want to report cost elements for which I am not able to find the corresponding elements in the taxonomy? How do I report such costs?

In the Costing taxonomy, there is provision for separate link Table for Industry Specific Operating Expenses in the Abridged Cost Statement of the Cost Audit Report. Such cost details, for which no matching corresponding cost element is found in the Abridged Cost Statement, such cost elements are to be defined and reported in the industry specific operating expenses link table.

21. In the Abridged Cost Statement (Para 5) of the Cost Audit Report pertaining to my company, I want to report more than 10 numbers of materials / utilities / industry specific operating expenses? However, the taxonomy supports only reporting 10 numbers of materials / utilities / industry specific operating expenses in the corresponding link tables? How do I report additional cost elements under these heads?

The materials/utilities/industry specific operating expenses link tables in the Abridged Cost Statement have a provision for reporting only 10 different cost elements respectively. In case, a company has more than 10 numbers of materials/utilities/industry specific operating expenses, 9 nos. of such materials/utilities/industry specific operating expenses, whose value is in descending order need to be reported separately and the balance may be clubbed together as "others" so as to ensure that the total value of such materials/utilities or industry specific operating expenses is equal to the materials cost or the utilities cost or the industry specific operating cost [as the case may be] reported in the main part of the Abridged Cost Statement. Since the "others" category would be an amalgamation of different elements, the unit, quantity and rate in the "others" category may be kept blank.

22. Where do I get 8-digit ITC Codes / NPCS Codes to be used for preparing the Cost Audit Report?

The 8-digit ITC Codes can be accessed from the link:

http://www.mca.gov.in/XBRL/pdf/ITC_HS_codes.pdf

The 8-digit NPCS Code can be accessed from the link:

http://mca.gov.in/XBRL/pdf/NPCS_codes.pdf

23. In my company, two different units of measurement are used for the same product group. How do I report details about such product groups under the relevant Para of the Cost Audit Report?

If a company has two different units of measurement for the same product group, then details for the same product group are to be reported twice with different units of measurement for all the relevant paras and such details need not be aggregated on the Product or Activity Group Code. In this connection, the notes provided in the notification issued by the Ministry of Corporate Affairs vide S.O. No. 1747(E) dated 7th August 2012 may be referred to.

24. My company has related party transactions only in respect of the financial transactions? Do I need to fill in the details of these transactions in the related party transactions para?

In the cost audit report, as per the notified taxonomy, details in respect of only the following types of transactions are to be reported. Therefore, details of all the remaining financial transactions with the related parties are not to be reported in the Cost Audit Report.

1. Sale or Purchase of Goods
2. Services Received or Rendered

25. I am an individual practising cost accountant? What do I need to fill in the "Category of Cost Accountants" or the "Category of Cost Auditor"? It only gives the option of "Firm / Sole Proprietor"?

An individual practising cost accountant needs to fill in as "Sole Proprietor" Option under the category of Cost Accountants or of the Cost Auditors. The category of Sole Proprietor includes individuals also.

26. Form 23C has been filed by my company but the same is not yet approved. Can I still file the Cost Audit Report pertaining to my company?

Cost Audit Reports can be filed for the company only after filing Form 23C and ensuring that the same is approved.

27. Form 23C has been filed by my company but related Form 23D has not been filed. Can I still file the Cost Audit Report pertaining to my company?

Filing of Form 23D has been made mandatory for appointments of cost auditors from the financial year commencing on or after April 1, 2011. Since earlier years' reports (prior to 2011-12) are also required to be filed in the XBRL format for which no Form 23D was applicable, hence filing of Form 23D is not applicable for filing such cost audit reports.

28. The taxonomy provides the option of providing multiple SRN number of Form 23C and Form 23D for the same Cost Auditor. Under what circumstances do I provide multiple SRN Numbers for the same Cost Auditor?

If the company has filed multiple Form 23C against the same cost auditor either for the same or for different products/units, then the SRN numbers of all such Form 23C and the SRN numbers of all the corresponding Form 23D filed by the cost auditor(s) are required to be provided in the fields provided for the same in the taxonomy. Such cases would arise in respect of Form 23C filed before the new Form 23C was introduced enabling appointment of a cost auditor for multiple products under multiple cost audit orders.

29. Does a company mandatorily require indicating previous year(s) figures in the relevant columns of the Para(s) to Annexure to the Cost Audit Report even if the Cost Accounting Records Rules were not applicable to the company in the previous years?

If a company was already covered under erstwhile Cost Accounting Records Rules, previous year figures are required to be given in the cost audit report even in the first year of cost audit. Suitable disclosure may be made by the cost auditor that the previous year figures are as provided by the management.

In case some of the products of the company was under cost accounting records/cost audit prior to 2011-12 and additional products have come under cost accounting records and cost audit from 2011-12, then previous year figures in respect of such products that were under cost accounting records prior to 2011-12 is required to be provided. The taxonomy provides reporting of previous year figures according to product group and the same should be suitably disclosed in Para 3.

However, if both cost accounting records rules and cost audit becomes simultaneously applicable for the first time on a company, then disclosure of previous year figures is optional.

Any non-disclosure of previous year figures must be supported with reasoned justification.

E-Filing Related

30. Whether the existing e-forms are to be used for filing Cost Audit Report / Compliance Report in XBRL mode?

No, the existing forms are not to be used for filing Cost Audit Report/ Compliance Report. For this, new Form 23CAR-XBRL and 23CR-XBRL will be shortly made available on the MCA portal.

31. By when can we file the Form 23CAR-XBRL and 23CR-XBRL for Cost Audit Report & Compliance Report?

All cost auditors and companies can file their Cost Audit Reports / Compliance Reports by 31st December 2012, in XBRL mode by using e-Form 23CAR-XBRL and 23CR-XBRL, without any penalty, up to 31stDecember 2012 or 180 days from the end of the financial year, whichever is later.

32. Do we have the option to file detailed Cost Audit Report/ Compliance Report with the form as PDF attachment instead of XBRL format?

No, the PDF formats of Cost Audit Report / Compliance Report are not allowed to be attached. Only the XBRL instance documents of Cost Audit Report / Compliance Report needs to be attached with the Form 23CAR-XBRL and 23CR-XBRL respectively.

33. Whether the instance documents attached with Form 23CAR-XBRL and 23CR-XBRL needs to be digitally signed. If yes, by whom?

No, the instance documents attached with the e-Forms are not required to be digitally signed. Only the e-Form 23CAR-XBRL for filing the Cost Audit Report need to be digitally signed by the Cost Auditor [or by the lead Cost Auditor as the case may be as well as by one director and another director/ manager/company secretary of the company.

The e-Form 23CR-XBRL for filing the Compliance Report need to be digitally signed by the Cost Accountant who has certified such Compliance Report of the company as well as by one director and another director/manager/ company secretary of the company.

34. While filing the Form 23C in MCA-21 portal, there was some mistake pertaining to the name of the firm. Can I still file the Cost Audit Report for the company?

Yes, you can still file the Cost Audit Report in the XBRL format provided the Form 23C belongs to the same company and same cost auditor.

35. Does Government allow re-filing of the revised Cost Audit Report / Compliance Report in case of any errors in the original filings?

For the current year, the MCA-21 system would allow re-filing of the revised Cost Audit Report/ Compliance Report of the company only in case of an error in the original fillings.

36. Does Government allow multiple filings of the Cost Audit Report / Compliance Report for the same company?

For each company, only one consolidated Cost Audit Report/ Compliance Report for the company as a whole is required to be filed in the XBRL format.

37. What shall be the process for uploading the filled Form 23CAR-XBRL and 23CR-XBRL on MCA portal?

The process for uploading the filled Form 23CAR-XBRL and 23CR-XBRL is same as the process of filing of any other e-form, for example, Form 23C or Form 23D or earlier e-form for filing cost audit report with pdf attachment.

38. How to view the Cost Audit Report / Compliance Report submitted in XBRL format on MCA Portal?

The Cost Audit Report / Compliance Report filed by the company are not public documents and cannot be viewed in public domain by anyone.

Appendix - B

9.9 GLOSSARY

attribute — a property of an element (e.g., its name, balance, and data type).

block tagging — the process of applying a selected element to a block of text in a report (e.g., an entire footnote disclosure, a significant accounting policy, or a table).

calculation linkbase — a file containing calculation relationships between elements.

context — the company- and report-specific information that indicates the relationships of tagged data to other information.

definition linkbase (or dimensional linkbase) — a file used to define dimensional relationships between elements.

extension taxonomy — a taxonomy that allows users to add to a base taxonomy by creating new elements or changing element relationships and labels without altering the original taxonomy. It will usually consist of a "schema file" (an XBRL term for an element declaration file) and several "linkbases" (an XBRL term for a relationships file).

identifier — an identifier for the business entity. For example, an SEC registrant might use the Central Index Key (CIK) code as its identifier.

instance document — an XML file that contains an entity's report-specific information. It represents a compilation of the reporting entity's financial and report-specific information using elements from one or more taxonomies.

label linkbase — a file used to associate labels with designated tags.

linkbase — an XBRL technical term for a relationships file.

mapping — the process of determining the appropriate tag or element for an item in the financial statements, including the notes to the financial statements and financial statement schedules, or determining if a new extension element should be created.

namespace — an XML namespace is a collection of names, identified by a Uniform Resource Identifier (URI) reference, which are used in XBRL documents as element types and attribute names.

presentation linkbase — a file that defines the organizational relationships (order) of elements using parent-child hierarchies.

reference linkbase — a file used to associate elements within the taxonomy to references to authoritative accounting literature.

relationships file — a taxonomy file that defines specific relationships between elements and other data about elements. There are five standard relationships file types: Presentation, Calculation, Definition (Dimensional), Label, and Reference.

schema — an XBRL Schema defines the structure and the content of the XBRL documents that refer to it, by defining, in particular, the elements and attributes and providing information about their type and possible content.

tag (noun) — an XBRL tag, or element, is a computer-readable financial reporting term or concept (e.g., a line item on the face of the financial statements, an important narrative disclosure, or an item disclosed in a financial statement schedule).

tagging (verb) — the process of associating or applying selected tags or elements to financial data, as well as adding context to the data. The tagging process is performed during the creation of an instance document.

taxonomy — a dictionary of computer-readable business reporting terms (known as tags or elements) in which each term is defined and assigned a relationship to other terms.

Uniform Resource Locator (URL) — a type of Uniform Resource Identifier (URI) that specifies where an identified resource is available and the mechanism for retrieving it.

validate — the process of verifying that certain aspects of instance documents and taxonomies comply with XBRL specifications.

Appendix-C

9.10 MCA CIRCULARS ON XBRL FOR COST AUDIT REPORT AND COMPLIANCE REPORT

Circular No.	Date	Description	Annexure
General Circular No. 8/2012	May 10, 2012	Filing of Cost Audit Report (Form-I) and Compliance Report (Form-A) in the eXtensible Business Reporting Language (XBRL) mode.	Annexure-1
52/17/CAB-2011	June 29, 2012	Filing of Cost Audit Report (Form-I) and Compliance Report (Form-A) in the eXtensible Business Reporting Language (XBRL) mode.	Annexure- 2
General Circular No. 18/2012	July 26, 2012	Filing of Cost Audit Report and Compliance Report in the eXtensible Business Reporting Language (XBRL) mode.	Annexure-3
S.O. 1747(E)	August 07, 2012	Product or Activity Group Classification	Annexure- 4

Study Note - 10

BASICS OF INTERNAL CONTROL AND INTERNAL AUDIT

This Study Note includes

10.1 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.

10.2 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.

10.3 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.

10.4 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.

10.5 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, 2003 (CARO) requires that the auditor's report on the account of a company to which this Order applies shall inter-alia include a statement as to whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory, fixed assets and for the sale of goods. It will also include whether there is a continuing failure to correct major weaknesses in internal control.

Section 292A of the Companies Act, 1956 provides for establishment of a committee of the Board known as "Audit Committee" by every public company having paid-up capital of Rs. 5 crore or more. The sub-section (5) of said section provides that the statutory auditor, the internal auditor, if any and director in-charge of finance shall attend every meeting of the audit committee but shall not have the right to vote. Sub-section (6) of this section clearly provides that the Audit Committee should have discussions with the auditors periodically about internal control systems, scope of audit including the observations of auditors and review of the half yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems. Moreover, Clause 49 of the uniform listing agreement prescribed by Securities and Exchange Board of India, which is applicable to all the listed companies provides that the Audit Committee is empowered to investigate any activity within terms of reference, seek information from any employee, obtain outside advice and secure attendance of outsiders, if necessary. Its role shall inter-alia include recommending appointment and removal of external auditor, reviewing the adequacy of internal audit function, reviewing the company's financial and risk management policies etc.

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.

10.6 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 depts. allowed. If so, under what circumstance?			
(9) (a) (b) (c)	Whether specific approvals required for the following : 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? High value purchases. 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?			

10.7 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

10.8 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, 1956.

10.9 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.

10.10 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.

10.11 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 226 of the Companies Act. However, there are no minimum qualifications prescribed under the companies act for the persons appointed to act as internal auditors. Similarly, section 227 of the Companies Act allows to the statutory auditor, the right of access at all times to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere. Statutory auditor is also entitled to require such information and explanation as he may think necessary for the performance of his duties as statutory auditor. However, there are no such rights available to the internal auditor.

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.

10.12 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?

10.13 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.

10.14 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. Section 292A of the Companies Act, 1956 - In addition, Section 292A of the Companies Act, 1956, requires public companies having paid up capital not less than Rs. 5 crores to constitute a committee of the Board, i.e., the Audit Committee. In terms of sub section 5 of the said Section, the internal auditor is required to attend and participate at the meetings of such Audit Committees.

iii. Companies (Auditor's Report) Order, 2003 - The Central Government, in terms of the power vested under Section 227(4A) of the Companies Act, 1956 had notified the Companies (Auditor's Report) Order, 2003. Clause (vii) of the said 2003 order requires the auditor to report as follows: "whether in case of listed companies and/or other companies having paid-up capital and reserves exceeding Rs. 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business."

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.

10.15 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:

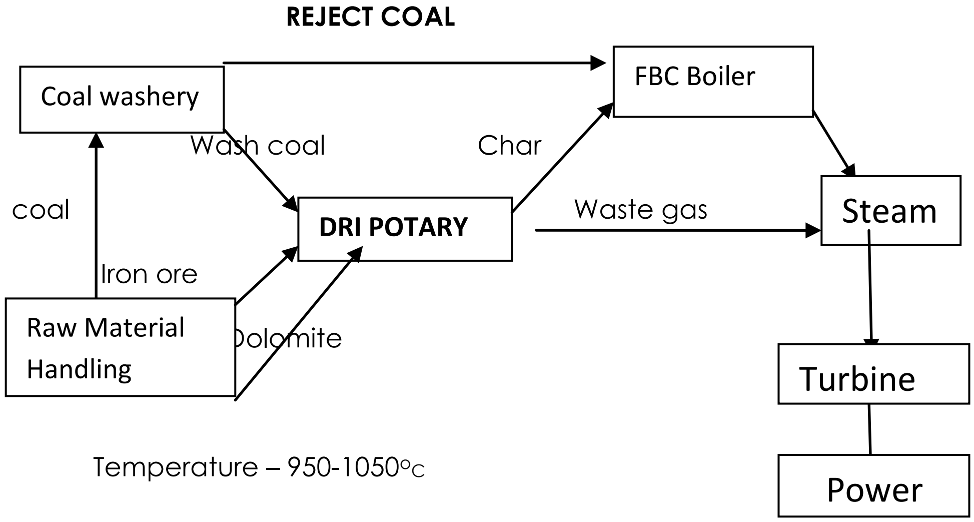
(a) Gas based

(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

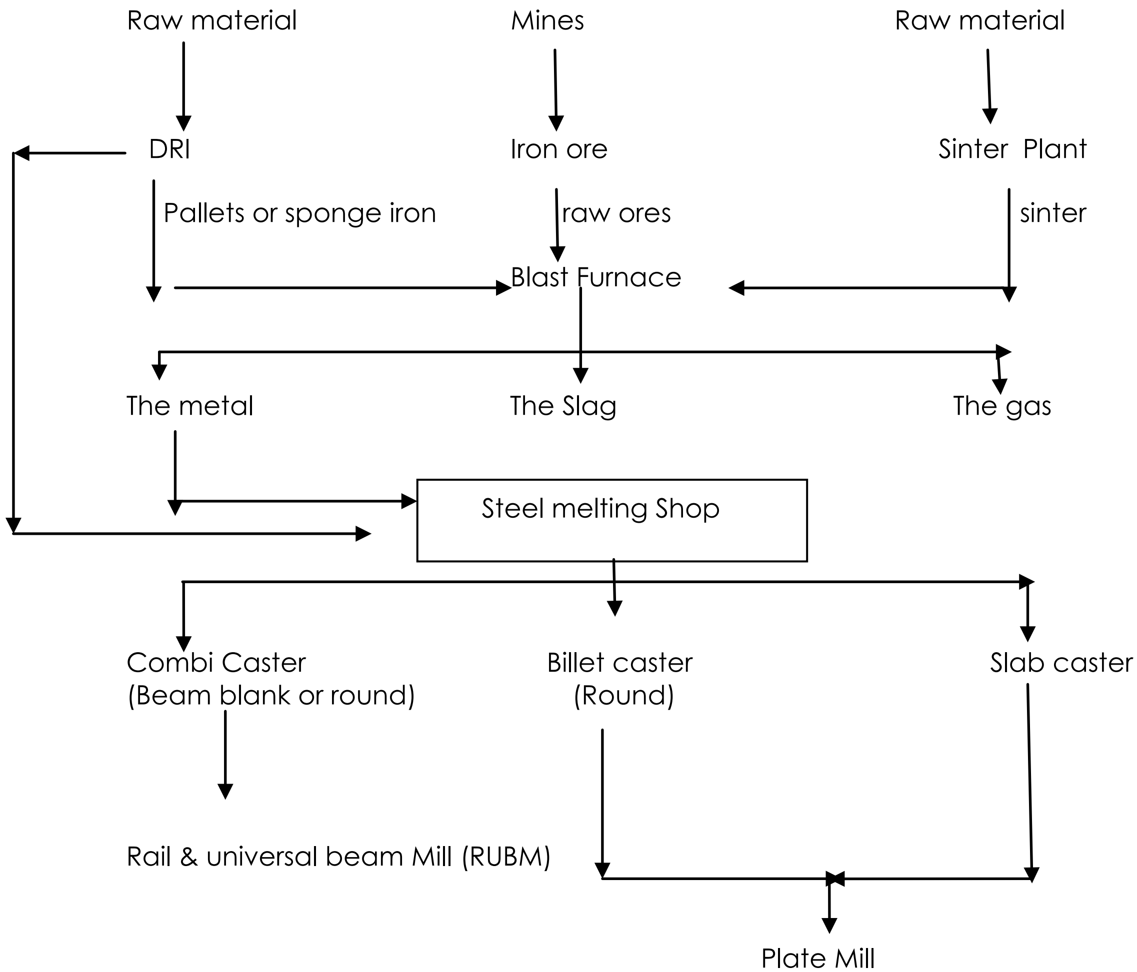
Cooling Bed

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.

<u>SMS</u>: - By purification and reducing the percentage of carbon, sulpher and phosphorous, the hot metal is converted into steel.


Raw material
Mines
Raw material
DRI
Iron ore
Sinter Plant
Pallets or sponge iron
raw ores
sinter
Blast Furnace
The metal
The Slag
The gas
Steel melting Shop
Combi Caster
(Beam blank or round)
Billet caster
(Round)
Slab caster
Rail & universal beam Mill (RUBM)
Plate Mill

Study Note - 11

BASICS OF OPERATIONAL AUDIT

This Study Note includes

11.1 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.

11.2 BUDGETARY CONTROL SYSTEM

11.2.1 **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.

11.2.2 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.

11.3 CAPACITY UTILISATION

11.3.1 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 211 of the Companies Act, 1956, that prescribes the form and contents of the balance sheet as well as profit and loss account (Part II of the Schedule VI of the Companies Act).

(ii) For purpose of Cost Audit Report under section 233 – B of the Companies Act, 1956 where a cost audit has been ordered by Government.

(iii) For internal management purpose, to be used:

(a) in planning, scheduling and controlling production, and

(b) in planning expansion of capacity and correction of imbalances.

(iv) For assessment of capacities for national level planning.

(v) For fixing the price of product(s) after ascertaining the capacity costs and per unit incidence thereof, and

(vi) For determination of allotment of scarce raw-materials in the form of quotas, import licenses, etc.

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

$$\text{Capacity utilization} = \frac{\text{Real output}}{\text{Minimum Capital Output Ratio}} \times 100$$

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 Cost Audit or Cost Accounting Records Rules, 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.

11.4 INVENTORY CONTROL

11.4.1 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.

11.4.2 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?

11.5 MANAGEMENT INFORMATION SYSTEM

11.5.1 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?

11.6 NATURE AND SCOPE OF MANAGEMENT AUDIT

11.6.1 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.

11.6.2 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.

11.6.3 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.

11.6.4 **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.

11.6.5 **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.

11.6.6 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.

11.7 AUDIT OF MANAGEMENT PROCESS AND FUNCTIONS

11.7.1 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 organiza-tion	Marketing	Manufact-ring	Materials manage-ment	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.

11.7.2 **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 Manufacturing and other Companies (Auditors' Report) Order, 1988 (MAOCARO) under the Companies Act, 1956 in India. Gradually, the scope of internal audit in Indian Companies has been enlarged from merely clerical activity to a management tool of great use. It is carried out by own employees at middle level in large and medium companies who cannot report fearlessly. It is mainly confined to verification or compliance of set procedures. It does not cover top management appraisal or responsibility accounting.

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.

11.7.3 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.

11.7.4 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.

11.7.5 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.

11.8 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. :

	1998-99	*1997-98*	*1996-97*
		(₹ 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	1998-99	1997-98	1996-97
Sales – quantity kgs.	43,50,890	34,36,921	37,25,405
Sales Value in Rs. Lakhs	5,091	3,938	4,215
Average sales realization per Kg.-Rs.	117	115	113
Raw Materials, stores & spares consumed (₹- Lakhs)	3,728	2,775	2,964
Material cost as % of sales value (%)	73.2	70.5	70.3
Direct wage cost % of sales value (%)	3.2	5.4	4.9
Observations:			

From the above figures, it is apparent that the Company's declining profitability is NOT due to market conditions as revealed by the following factors :

(a) The sales price has been marginally increasing year to year.

(b) The very small increase in material cost is also in step with the increase in sales realization.

(c) The company has been able to control direct labour cost effective.

(d) The level of production has been maintained and has in fact improved in the latest year.

(e) Inventory and book debt levels have been brought down considerably.

On the other hand, the following factors present a disturbing picture and lead to the inference that the financial management is either incompetent, or the management was diverted the borrowed working funds to some other activity or invested in unproductive assets like vehicles:

	1998-99	1997-98	1996-97
Long term borrowings	287	180	160
Working capital loans	1639	451	672
Net block	1009	541	612
Loans & advances	2641	1286	1231
Depreciation, repairs & maintenance of vehicles	109	59	54
Interest	277	130	152

The increase in working capital borrowings and the consequent interest thereon were not warranted, especially when the funds blocked in inventory and book debts have come down. The additional interest burden and additional expenses on vehicles amount to Rs. 197 lakhs whereas the increase in loss as compared to the previous year is only Rs. 115 lakhs.

Preliminary conclusion:

(i) Prima facie, it appears that the unit has become sick due to diversion of funds by the management to other activities or for personal expenditure.

(ii) The fixed assets have doubled. But there is no profit accruing by the increased assets.

Question 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 fro 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 - 12

MANAGEMENT AUDIT IN DIFFERENT FUNCTIONS

This Study Note includes

12.1 CORPORATE CULTURE AND OBJECTIVES

12.1.1 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.

12.1.2 **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.

12.1.3 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.

12.1.4 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?

12.2 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.

12.3 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?

12.4 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.

12.5 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?

12.6 AUDIT OF SOCIAL RESPONSIBILITY OF MANAGEMENT — ENVIRONMENTAL POLLUTION CONTROL

12.6.1 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.

12.6.2 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.

12.7 AUDIT CHECKS OF DIFFERENT FUNCTIONS

12.7.1 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.

12.7.2 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?

12.7.3 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?

12.7.4 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?

12.7.5 **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?

12.7.6 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?

12.7.7 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?

12.7.8 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?

12.7.9 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?

12.7.10 **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?

12.7.11 **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?

12.7.12 **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?

12.7.13 **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?

12.7.14 **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?

12.7.15 **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?

12.7.16 **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?

12.7.17 **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?

12.7.18 **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?

12.7.19 **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?

12.8 CORPORATE DIVISIONS/DEPARTMENTS/FUNCTIONS

12.8.1 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?

12.8.2 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?

12.8.3 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?

12.8.4 **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?

12.8.5 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.

12.8.6 **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?

12.8.7 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?

12.9 CORPORATE GOVERNANCE AND AUDIT COMMITTEE

12.9.1 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 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 regarding constitution of

Audit Committees. The new provision covers every public company having a paid-up capital of Rs 5 crore and above. The board of directors is required to constitute an audit committee consisting of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors. The annual report should disclose the composition of the audit committee, which should have the authority to investigate in to any matter, in relation to the items specified in Section 292A.

SEBI also constituted N.R. Narayanamurthy Committee in the year 2002 to further review the clause 49 of the standard listing agreement and suggest measures to improve corporate governance standards. The committee gave its report in February, 2003. The clause 49 has since been amended with the recommendations of the committee's report. Report of the SEBI Committee recommended that the mandatory recommendations on matters of disclosure of contingent liabilities, CEO/CFO Certification, definition of Independent Director, independence of Audit Committee and independent director exemptions in the report of the Naresh Chandra Committee, relating to corporate governance, be implemented by SEBI. Narayana Murthy Committee recommendations included role of Audit Committee, Related party transactions, Risk management, compensation to Non- Executive Directors, Whistle Blower Policy, Affairs of Subsidiary Companies, Analyst Reports and other non-mandatory recommendations. Significant amendments to Clause 49:

- Sea Change in the definition of Independent Director.
- Non-executive / Independent directors fees require approval of shareholders.
- Board shall be responsible for compliance with laws and regulations.
- Code of conduct to be laid for Board and senior management – declaration signed by CEO affirming compliance to be incorporated in the Annual report.
- 2/3rd of the members of Audit Committee to be independent Directors.
- Audit Committee meetings – every quarter within a gap of 4 months between two meetings.
- Members of audit committee to be financially literate and at least one member shall have accounting or financial management expertise.
- Review of quarterly financial statements before submission to the Board for approval by Audit Committee.
- Reviewing performance of statutory and internal auditors.
- Mandatory review of certain information by the Audit Committee.
- Independent Director to be on Board of material non-listed Indian subsidiary and additional role of Audit Committee and Board.
- Increased disclosures for related party transactions.
- Disclosures of proceeds from public, rights, preferential etc. issues – annual statement of funds utilized other than stated in offer document / prospectus / notice to be certified by the statutory auditor.
- Disclosures on Risk Management Framework.
- The CEO / CFO of every applicable company would be required to certify the financial statements on true and fair view of the company's affairs, compliance with applicable laws and regulations, fraudulent, illegal or violation of company's code of conduct transactions, responsibility for establishing and maintaining internal controls and evaluation of the effectiveness of the internal control systems of the company.

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.

12.10 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 Statute in India**

The Companies Amendment Act, 2000 had introduced a new section 292A regarding constitution of Audit Committees. The new provision covers every public company having a paid-up capital of Rs. 5 crore and above. The Board of Directors is required to constitute an audit committee consisting of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole time directors. Similarly, Clause 49 of the uniform listing agreement prescribed by Securities and Exchange Board of India (SEBI), which is applicable to all companies listed in India, requires the setting up of a qualified and independent Audit Committee.

Sub-section (6) of Section 292A requires that the Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.

Sub-section (7) of Section 292A provides that the Audit Committee shall have authority to investigate into any matter inter-alia in relation to these matters and shall have full access to the information contained in the records of the company and external professional advice, if necessary.

The clause 49 of the listing agreement provides that the audit committee shall have powers which should include the following :

(b) to investigate any activity within its terms of reference;

(c) to seek information from any employee;

(d) to obtain outside legal or other professional advice; and

(e) to secure attendance of outsiders with relevant expertise, if it considers necessary.

This clause further provides that the role of the audit committee shall inter-alia include the following:

(b) Oversight of the company's financial reporting process and the disclosure of its financial information;

(c) Recommending the appointment and removal of external auditor, fixation of audit fee and also approval for payment for any other services;

(d) Reviewing the annual financial statements with management before submission to the board;

(e) Reviewing external and internal auditors with the management and the adequacy of internal control systems;

(f) Reviewing the adequacy of internal audit system;

(g) Discussion with Internal Auditors of any significant findings and follow-up action thereon;

(h) Discussion with External Auditors; and

(i) Reviewing the company's financial and risk-management policies.

Sub-section (8) and sub-section (9) of Section 292A provides that the recommendations of the Audit Committee will be binding on the Board. In case the Board does not accept the recommendations of the Audit Committee, it will have to record the reasons and communicate the same to the shareholders. In short, the provisions related to Audit Committees can be summarized as under :

- All public limited companies having paid up capital of Rs. 5 crores or more are required to establish a committee of the Board known as Audit Committee.
- The Committee shall have at least three directors as members.

  Two-third of the total number of members shall be non-executive directors.
- The Audit Committee shall act in accordance with terms of reference to be specified in writing by the Board.
- The Statutory Auditors, the Internal Auditor, if any and director in-charge of finance shall attend and participate the meetings of Audit Committee but shall not have the right to vote.
- The Audit Committee should have discussions with the auditors periodically about internal control system, the scope of audit and review of the half yearly and annual financial statements before presenting the same to the Board.
- The Audit Committee shall have right to investigate any matter covered under the broad terms of reference.
- In case of any default, the company and every officer who is in default shall be punishable with imprisonment for a term which may extend to one year, or with fine, which may extend to fifty thousand rupees or with both.

12.10.3 **Types of Committees Under Clause 49**

The clause 49 of the listing agreement prescribes two committees as mandatory committees namely :

(c) Audit Committee; and

(d) Shareholder's Grievance Committee.

In addition to above, the Board of Directors may set up a remuneration committee also, which is a non-mandatory requirement.

12.10.4 **Functions of Audit Committee under Section 292A**:

Sub-section (2) of Section 292A provides that every Audit Committee constituted shall act in accordance with terms of reference to be specified in writing by the Board. Sub section (6) provides that the Audit Committee should have periodic discussions with the auditors on the following matters :

(c) Internal control systems;

(d) The scope of audit including the observations of the auditors;

(e) Review of the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems; and

(f) Compliance of Internal Control Systems.

Sub-section (7) of Section 292A further provides that the Audit Committee shall have the authority to investigate into any matter :

(a) In relation to the items specified in section 292A; and

(b) In relation to the items referred to it by the Board of Directors.

Sub-section (7) further provides that the Audit Committee shall have full access to information contained in the records of the company and external professional advice if necessary.

Sub-section (8) provides that the recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board. Sub-section (9) provides that in case, the Board does not accept the recommendations of the Audit Committee, it shall record the reasons for non-acceptance and communicate such reasons to the shareholders.

12.10.5 **Penalty for Contravention of Section 292A:**

Sub-section (11) of Section 292A provides that the company and every officer who is in default in complying with the provisions of this section shall be punishable with imprisonment for a term which may extend to one year or with fine which may extend to fifty thousand rupees or with both.

12.10.6 **Meetings of the Audit Committee:**

Clause 49 to the listing agreement provides that the Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one-third of the members of Audit Committee whichever is greater. However, there should be a minimum of two independent members present. In view of quarterly results, it becomes otherwise also essential to meet at least once in a quarter. However, there is no bar on the maximum number of sittings by an Audit Committee. The Companies Act, 1956 has assigned a role to these committees and does not provide anything about the minimum numbers of meetings.

12.11 CONFEDERATION OF INDIAN INDUSTRIES (CII) CODE FOR DESIRABLE CORPORATE GOVERNANCE

12.11.1 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.

12.11.2 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.

<u>Annexure - X to the Listing Agreement</u>

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.

<u>Annexure - XI to the Listing Agreement</u>

<u>Format of Quarterly Compliance Report on Corporate Governance</u>

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.

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