FINAL
Paper 17

Cost and Management Audit

Study Notes
SYLLABUS 2022

The Institute of Cost Accountants of India
CMA Bhawan, 12, Sudder Street, Kolkata - 700 016
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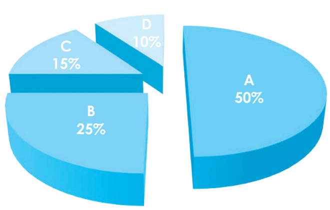
PAPER 17: COST AND MANAGEMENT AUDIT

Syllabus Structure:

The syllabus in this paper comprises the following topics and study weightage:

Module No.	Module Description	Weight
	Section A: Cost Audit	**50%**
1	Basics of Cost Audit	5%
2	Companies (Cost Records and Audit) Rules, 2014 (as amended)	10%
3	Cost Auditor	10%
4	Overview of Cost Accounting Standards and GACAP	10%
5	Cost Auditing and Assurance Standards	
6	Cost Audit Programme	5%
7	Cost Audit Documentation, Audit Process and Execution	5%
8	Preparation and Filing of Cost Audit Report	5%
	Section B: Management Audit	**25%**
9	Basics of Management Audit	5%
10	Management Reporting Issues and Analysis	5%
11	Management Audit in Different Functions	5%
12	Evaluation of Corporate Image	5%
13	Information Systems Security Audit	5%
	Section C: Internal Control, Internal Audit, Operational Audit and Other Related Issues	**15%**
14	Internal Control and Internal Audit	5%
15	Operational Audit and Internal Audit under Companies Act, 2013	5%
16	Audit of Different Service Organisations	5%
	Section D: Forensic Audit and Anti-Money Laundering	**10%**
17	Forensic Audit	5%
18	Anti-Money Laundering	5%



Learning Engironment

Subject Title	**COST AND MANAGEMENT AUDIT**
Subject Code	**CMAD**
Paper No.	**17**
Course Description	The subject Cost and Management Audit deals with the following four key areas: i) Cost Audit, ii) Management Audit, iii) Internal Control, Internal Audit, Operational Audit and Other Related Issues and iv) Forensic Audit and Anti-Money Laundering. It provides a thorough understanding of various contemporary issues related to Cost and Management Audit with detailed coverage on Cost Accounting Standards and Cost Auditing Standards issued by Cost Accounting Standards Board(CASB) and Cost Auditing and Assurance Standards Board (CAASB) respectively. It also provides a detailed coverage on various Management Reporting issues and analysis, evaluation of Internal Control, role of CMA's in Management Audit, Internal Audit and Operational Audit. In addition to the above, the subject provides an overview of the techniques of Forensic Audit and international standards on combating Money Laundering.
CMA Course Learning Objectives (CMLOs)	1. Interpret and appreciate emerging national and global concerns affecting organizations and be in a state of readiness for business management. a. Identify emerging national and global forces responsible for enhanced/varied business challenges. b. Assess how far these forces pose threats to the status-quo and creating new opportunities. c. Find out ways and means to convert challenges into opportunities 2. Acquire skill sets for critical thinking, analyses and evaluations, comprehension, syntheses, and applications for optimization of sustainable goals. a. Be equipped with the appropriate tools for analyses of business risks and hurdles. b. Learn to apply tools and systems for evaluation of decision alternatives with a 360-degree approach. c. Develop solutions through critical thinking to optimize sustainable goals. 3. Develop an understanding of strategic, financial, cost and risk-enabled performance management in a dynamic business environment. a. Study the impacts of dynamic business environment on existing business strategies. b. Learn to adopt, adapt and innovate financial, cost and operating strategies to cope up with the dynamic business environment. c. Come up with strategies and tactics that create sustainable competitive advantages. 4. Learn to design the optimal approach for management of legal, institutional, regulatory and ESG frameworks, stakeholders' dynamics; monitoring, control, and reporting with application-oriented knowledge. a. Develop an understanding of the legal, institutional and regulatory and ESG frameworks within which a firm operates. b. Learn to articulate optimal responses to the changes in the above frameworks. c. Appreciate stakeholders' dynamics and expectations, and develop appropriate reporting mechanisms to address their concerns. 5. Prepare to adopt an integrated cross functional approach for decision management and execution with cost leadership, optimized value creations and deliveries. a. Acquire knowledge of cross functional tools for decision management. b. Take an industry specific approach towards cost optimization, and control to achieve sustainable cost leadership. c. Attain exclusive knowledge of data science and engineering to analyze and create value.

<table>
<tr><td>Subject Learning Objectives [SLOB(s)]</td><td>
A. Cost Audit
1. To gain in-depth knowledge about the statutory provisions of Companies (Cost Records and Audit Rules) to ensure adherence to the regulations in conducting cost audit. (CMLO 4a, b)
2. To develop detail understanding on preparation of Cost Audit Programme. (CMLO 4b)
3. To develop detail understanding of Cost Accounting and Auditing Standards to ensure appropriate evaluation of cost records maintained. (CMLO 4a, b)
4. To focus on basic cost information, appropriately computed cost centre wise, system-based cost data support for decision-making processes. (CMLO 5a)
B. Management Audit
5. To obtain in-depth knowledge about management audit processes to identify the scope of improvement at various functional areas of the organisation. (CMLO 2a, b)
6. To develop detail understanding about management reporting system to facilitate preparation of reliable reports which will ensure accurate data driven cost effective decisions and will build brand image. (CMLO 5b)
7. To develop adequate knowledge on information system, its security framework to evaluate whether information systems are safeguarding corporate assets, and maintaining the integrity of stored and communicated data. (CMLO 3c)
C. Internal Control, Internal Audit, Operational Audit and Other Related Issues
8. To obtain a detail understanding of the scope and structure of internal control to conduct an evaluation of the same to identify the root causes of inadequacies and thereby recommend appropriate corrective actions. (CMLO 3a, c)
9. To obtain in-depth knowledge about the existing regulatory framework for internal and operational audit to conduct effective audit procedure in organisations. (CMLO 4a, b)
10. To develop detail understanding of the audit procedure in various service organisations with an objective to facilitate risk-based performance management and maximisation of value creation or minimisation of value destruction. (CMLO 1a, b)
D. Forensic Audit and Anti-Money Laundering
11. To develop detail understanding of the financial forensics and forensic audit techniques to identify the scope left for committing frauds and recommend appropriate corrective actions. (CMLO 2a, b)
12. To understand international standards on combating money laundering and provide guidance to prevent and control money laundering transactions in the business operations. (CMLO 2c)
</td></tr>
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<tr>
<td>Subject Learning Outcome [SLOC(s)] and Application Skill [APS]</td>
<td>
A. Cost Audit
SLOCs:
1. Students will be able to guide the management in maintaining appropriate cost accounting records to ensure adherence to existing regulations.
2. Students will be able to prepare effective cost audit programme with due consideration to the regulatory requirements relating cost audit after elaborately identifying the scope of audit in a given assignment.
APSs:
1. They will develop appropriate skills to maintain Cost Records as per Statutory Regulations and Generally Accepted Cost Accounting Principles.
2. They will be skilled to draft Cost Audit Programme and Cost Audit report with accuracy and fairness.

B. Management Audit
SLOCs:
1. Students will be able to effectively guide a management audit process to identify inadequacies in various functional areas and recommend possible means to rectify them.
2. Students will be able to guide an information system audit and identify possible threats due to system inadequacies.
APSs:
1. Students will develop necessary skills to conduct management audit procedures at various functional areas of the organisation.

C. Internal Control, Internal Audit, Operational Audit and Other Related Issues
SLOCs:
1. Students will be able to guide the management in ensuring regulatory compliance relating to internal control and audit.
2. Students will be able to guide an internal control evaluation process to identify the root causes of inadequacies and thereby recommend appropriate corrective actions.
APSs:
1. Students will be able to develop appropriate skills to conduct an all-round evaluation of the internal control system of the organisation.
2. They will be able to prepare detail audit programme with due consideration to the industry concerned.
D. Forensic Audit and Anti-Money Laundering
SLOCs:
1. Students will learn to identify organised financial frauds through application of various techniques.
2. Students will be able to identify non-adherence to financial regulations resulting into money laundering cases and thereby guide the management in avoiding such instances.
APSs:
1. Students will be able to equip themselves with necessary skills for detection of financial frauds and money laundering instances and guide the management in devising appropriate measures to avoid the same.
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Module wise Mapping of SLOB(s)

<table>
<tr><th>Module No.</th><th>Topics</th><th>Additional Resources (Research articles, books, case studies, blogs etc.)</th><th>SLOB Mapped</th></tr>
<tr><td colspan="4">Section A: Cost Audit</td></tr>
<tr><td>1</td><td>Basics of Cost Audit</td><td rowspan="8">1. Cost and Management Audit - CMA Abhishek Jain, Himalaya Publishing House
2. Cost Audit and Management Audit - Saxena & Vashist, Sultan Chand Publishers
3. The Institute of Cost Accountants of India’s Publication relating to Cost Accounting Record Rules, The Institute of Cost Accountants of India’s Publication
4. Practical Guide to Cost Accounting Records and Cost Audit – CMA Kunal Banerjee, Taxmann
5. Cost Audit and Management Audit - A.R. Ramanathan, Tata McGraw – Hill
6. Guide to Cost Accounting Records and Cost Audit - Srinivasan Anand G, Taxmann</td><td rowspan="5">1. To gain in-depth knowledge about the statutory provisions of Companies (Cost Records and Audit) Rules to ensure adherence to the regulations in conducting cost audit.
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10	Management Reporting Issues and Analysis		To develop detail understanding about management reporting system to facilitate preparation of reliable reports which will ensure accurate data driven cost effective decisions and will build brand image.
11	Management Audit of Different Functions		To obtain in-depth knowledge about management audit processes to identify the scope of improvement at various functional areas of the organisation.
12	Evaluation of Corporate Image		To develop detail understanding about management reporting system to facilitate preparation of reliable reports which will ensure accurate data driven cost effective decisions and will build brand image.
13	Information Systems Security Audit		To develop adequate knowledge on information system, its security framework to evaluate whether information systems are safeguarding corporate assets, and maintaining the integrity of stored and communicated data.

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<tr><th colspan="4">Section C: Internal Control, Internal Audit, Operational Audit and Other Related Issues</th></tr>
<tr><td>14</td><td>Internal Control and Internal Audit</td><td rowspan="3">1. Handbook on Internal Audit - CA Kamal Garg, Bharat's
2. Internal Audit Assurance: Governance, Risk and Control - Deepjee Singhal, CCH India
3. Auditor's Practice Manual - Kamal Garg, Bharat Law House Pvt Ltd
4. Auditing Principles and Practice - Ravinder Kumar and Virender Sharma, PHI</td><td>To obtain a detail understanding of the scope and structure of internal control to conduct an evaluation of the same to identify the root causes of inadequacies and thereby recommend appropriate corrective actions.</td></tr>
<tr><td>15</td><td>Operational Audit and Internal Audit under Companies Act, 2013</td><td>To obtain in-depth knowledge about the existing regulatory framework for internal and operational audit to conduct effective audit procedure in organisations.</td></tr>
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<tr><td>17</td><td>Forensic Audit</td><td rowspan="2">1. Forensic Audit Decoded - G.C. Pipara, Taxmann
2. Forensic Audit - CA Kamal Garg, Bharat Law House Pvt Ltd
3. Essentials of Forensic Accounting - Michael A. Crain, William S. Hopwood, Carl Pacini, George R. Young
4. Forensic Audit – The Institute of Cost Accountants of India's Publication, Kolkata
5. Case Studies in Forensic Accounting and Fraud Auditing - D. Larry Crumbley, Wilson A. LaGraize, Christopher E. Peters, CCH Inc.
6. IT Auditing Using Controls to Protect Information Assets - Davis Chris, McGraw – Education
7. Commentary on Law on Oral and Documentary Evidence - Field C D, Delhi Law House
8. Cyber Security - Godbole Nina, Wiley</td><td>To develop detail understanding of the financial forensics and forensic audit techniques to identify the scope left for committing frauds and recommend appropriate corrective actions.</td></tr>
<tr><td>18</td><td>Anti-Money Laundering</td><td>To understand international standards on combating money laundering and provide guidance to prevent and control money laundering transactions in the business operations.</td></tr>
</table>

		9. The Modern Law of Evidence - Keane Adrian, OUP, UK 10. Forensic Analytics: Methods and Techniques for Forensic Accounting Investigations - Mark J. Nigrini, John Wiley & Sons. 11. Accounting: What the World's Best Forensic Accountants and Auditors Know About Forensic Accounting and Auditing – That You Don't - Greg Shields, Bravex Publications 12. Forensic Accounting for Dummies - Shraibman and Sampath	

Contents as per Syllabus

Contents as per Syllabus

Contents as per Syllabus

Contents as per Syllabus

Contents as per Syllabus

SECTION - A

COST AUDIT

Basics of Cost Audit 1

This Module includes:

Basics of Cost Audit

SLOB Mapped against the Module

To develop detail understanding of Cost Accounting and Auditing Standards to ensure appropriate evaluation of cost records maintained. (CMLO 4a, b)

Module Learning Objectives:

This module helps to know about basis of Cost Audit. Cost Audit represents the verification of cost accounts and check on the adherence to cost accounting plan and also ascertain the accuracy of cost accounting records to ensure that they are in conformity with Cost Accounting principles, plans, procedures and objective. After studying this module, the students will be able to –

- Understand the Nature and Scope of Cost Audit
- Learn about the inception of Cost Audit
- Identify the Objectives of Cost Audit
- Ascertain the Utility and Advantages of Cost Audit
- Know and interpret the Cost Accounting Standards

Nature and Scope of Cost Audit

1.1

Cost Accounting is a process of identification, classification, measurement, and assignment of costs to various cost objects. Preparation & Presentation of cost records and cost statements is the responsibility of the Management. Therefore, Cost Accounting Standards are guidelines for the companies [for the management] that specify the cost accounting treatment for various cost elements, minimum disclosure requirements and ensure the comparability, consistency, and completeness of cost records.

According to Chartered Institute of Management Accountants, London (CIMA), cost audit is "the verification of the correctness of cost accounts and of the adherence to the cost accounting plan". In other words, cost audit is the verification of the cost of production of any product, service or activity on the basis of accounts maintained by an enterprise in accordance with the accepted principles of cost accounting.

The Institute of Cost Accountants of India, defines cost audit as "a system of audit for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries, as mandated by the applicable Companies Act and Rules framed thereunder."

Cost Audit is an independent examination of cost statements, cost records and other related information of an entity, with a view to express an opinion thereon. Standards on Cost Auditing provide guidance to the cost auditor through each step of the audit process with regard to the audit procedures to be followed; responsibilities of the cost auditor; and cost reporting.

Practices, procedures and principles relating to cost accounting are covered in the Cost Accounting Standards; and practices, procedures and requirements relating to cost auditing are covered in the Standards on Cost Auditing. Standards on Cost Auditing are the best guide for the cost auditors. If followed scrupulously, the standards would help the cost auditor to streamline audit, to do better planning, better documentation, and effective implementation. Thus, these will help in improving the overall quality of audit. The cost auditor should carefully go through the standards and make best use of them. The Standards authorize the cost auditor to use the work of another auditor or expert – hence if satisfied, there is no need for checking every detail again which is already audited by another auditor or is certified by an expert. Therefore, if required & satisfied, the cost auditor can rely on the work done by another auditor/expert. The Standards are not to be remembered, but to be practiced by making these a part of the work culture and teaching these to the entire audit team.

Scope of Cost Audit

The primary objective of 'Cost Audit' is ensuring accuracy of cost data, accumulation and exact computation of the cost of a product. However, the vast scope of Cost Audit works as a mirror of entity's performance. The tune is perfectly captured in the definition of 'Cost Audit' propagated by the professional bodies entrusted with the responsibility of regulating and monitoring Cost Audit.

The Institute of Cost & Works Accountants of Indlia defines a cost audit as: "An audit of efficiency of minute details of expenditure ... Cost audit is mainly a preventive measure, a guide for management policy and decision ... and a barometer of performance."

The Institute of Cost & Management UK defined cost audits as “the verification of the correctness of cost accounts and a check on the adherence to the cost accounting plan.”

In today’s dynamic business world, to become competitive in every product or services of the entity is of paramount importance. Hence, the prime mover of pricing and attached quality can only be ensured through appropriate cost structure. In view of this, ‘cost audit’ refers to the detailed verification of the correctness of costing techniques, costing systems, and cost accounts. It is necessary to ensure that records maintained for the purpose are accurate and correct to drive entity’s decision making process.

Beyond propriety, Cost Audit scope encompasses overall ‘efficiency’ and its’ improvement. The wider scope of Cost Audit can help-

a. Control over element-wise cost

b. Help in determining Sales Price and margin

c. Assist Management in decision-making

d. Necessity and results from each of the activity performed

e Setting of Standards and budgetary controls

f. Minimizing wastages, if any

g. Accuracy of inventory valuation

h. Overall efficiency improvement of the entity

Hence, Cost Audit not only to be considered as a Compliance tool (where the same is mandatory), the outcome is far reaching to go ‘beyond compliance’.

Genesis of Cost Audit

1.2

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 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.

History of The Institute of Cost Accountants of India

1944 : Institute of Cost & Works Accountants of India was established under the Companies Act 1913, as a Limited company.

1959 : The Institute of Cost and Works Accountants of India (ICWAI) was established under Cost & Works Accountants Act, 1959.

2012 : The Institute of Cost and Works Accountants of India (ICWAI) was renamed as "The Institute of Cost Accountants of India"

History of Cost Audit

1965 : Cost Audit was first introduced in India with the introduction of Sec 233B of Companies Act 1956 for Cost Audit and Sec 209 (1) (d) for maintenance of Cost Records.

1965-2008 : 44 industries covered under cost record maintenance & cost audit on a company specific basics.

2008 : Expert Group set up to study the existing system of maintenance of cost accounting records and audit thereof.

2009 : Expert Group submitted its report to the Central Government.

2011 : Introduction of mandatory Cost Audit of Cost Records maintained by the Companies under Companies Act 1956 for Manufacturing, Mining and processing operations depending on limits of Turnover and Limits of Net Worth and issue of Compliance Certificate by the Cost Accountants

2014 : New Companies (Cost Records and Audit Rules), 2014 issued under Companies Act, 2013

Section 148 of Companies Act, 2013, empowers the "Central Government to specify audit of items of cost in respect of certain companies", as under:

1. Notwithstanding anything contained in this Chapter, 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 (5) of section 147.

Objectives of Cost Audit

1.3

Cost Audit has both general and social objectives.

General Objectives:

- 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 prescribed procedures of the 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
- Advising management, on the basis of inter-unit/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.
- Helping the entity in matters of Anti Dumping Duty, valuation of cost of production of goods and services, anti-profiteering (e.g. GST), price controls (e.g. Pharma industry in the past), etc.

Socials Objectives:

- Verifying whether the pricing of the products are justified as per the product and quality are concerned,
- Removing the disparities, if any, in the pricing of products and/or services.
- Looking into that no cost based economic imbalance may occur in product and /or services.
- Facilitating in the global market cost competitiveness of the products.
- Ensuring the efficient utilization of resources.

Utility and Advantage of Cost Audit 1.4

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

The liberalization of the economy and consequential globalization has further enhanced the need for authentic data. The Expert committee formed by the Government of India to study the Cost Audit scenario in the country, highlighted the following benefits of cost information:

(a) Cost information enables the organisation to structure the cost, understand it and use it for communicating with the stakeholders.

(b) Costing is an important tool in assessing organisational 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.

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

(d) 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.

(e) 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.

(f) 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) cost audits help to ascertain whether an organisation'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 weakness 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.

Cost Accounting Standards 1.5

Cost Accounting Standards are set of standards that are designed to achieve uniformity and consistency in cost accounting principles and practices.

The Institute of Cost Accountants of India, recognising the need for structured approach to the measurement of cost in manufacture or service sector and to provide guidance to the user organisations, government bodies, regulators, research agencies and academic institutions to achieve uniformity and consistency in classification, measurement and assignment of cost to products and services, has constituted Cost Accounting Standards Board (CASB) with the objective of formulating the Cost Accounting Standards.

The Cost Accounting Standards:

- Provide a structured approach to measurement of costs in manufacturing process or service industry;
- Integrate, harmonize, and standardize cost accounting principles and practices;
- Provide guidance to users to achieve uniformity and consistency in classification, measurement, assignment, and allocation of costs to products or services;
- Arrive at the basis of computing the cost of product, activity, or service where required by legal or regulatory bodies;
- Enable practicing members to make use of Cost Accounting Standards in the attestation of General Purpose Cost Statements; and
- Assist in clear and uniform understanding of all the related issues of various user organisations, government bodies, regulators, research agencies and academic institutions.

Exercise

A. Theoretical Questions

- **Multiple Choice Questions**

1. Cost Audit was first introduced in the year _______.

   A. 1959

   B. 1965

   C. 1949

   D. 1975

2. Cost Audit was first introduced for _________ industry.

   A. Cement

   B. Iron & Steel

   C. Jute

   D. Sugar

3. Govt. of India has issued order with respect to introduction of mandatory Cost Audit of Cost Records maintained by the Companies in the year __________.

   A. 2008

   B. 2009

   C. 2011

   D. 2014

4. The report on the audit of cost records is submitted by the cost auditor to ________.

   A. Managing Director

   B. Finance Director

   C. Audit Committee

   D. Board of Directors

5. The cost auditor of the company who is in default in compliance with section 148 shall be punishable in the manner as provided in ________.

   A. Section 139 of Companies Act, 2013

   B. sub-sections (1) to (3) of section 148 of Companies Act, 2013

   C. Section 143 of Companies Act, 2013

   D. sub-sections (2) to (5) of section 147 of Companies Act, 2013

State True or False

1. The Defense contract during the World war-II were mostly given based on Cost Plus 15% margin basis.
2. The Institute of Cost and Works Accountants of India was set up in 1944 with the objectives of determining cost of production.
3. A company shall submit cost audit report to the Central Government within thirty days from the date of signing of the same.
4. Cost Accounting Standards has formulated by Cost Auditing and Assurance Standards Board.
5. The auditor conducting the cost audit shall comply with the Cost Accounting Standards.

Fill in the Blanks

1. The Institute of Cost Accountants of India was set up in the year ________.
2. The Cost Accounting system was initially developed based on recommendation of __________ Commission.
3. The company and every officer of the company who is in default in compliance with Section 148 shall be punishable under Sub-section _______ of Section _______ .
4. The Institute of Cost and Works Accountants of India (ICWAI) was renamed as "The Institute of Cost Accountants of India" in the year _______.

Short Essay type Questions

1. What are the objectives of Cost Audit?
2. What is the Genesis of Cost Audit?

Answer:

Multiple Choice Questions

1.	B. 1965
2.	A. Cement
3.	C. 2011
4.	D. Board of Directors
5.	D. Sub-sections (2) to (5) of section 147 of Companies Act, 2013

State True or False

1.	(False) - The Defence contract during the World War-II were mostly given based on Cost Plus margin basis.
2.	(False) - 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.
3.	(False) - A company shall submit cost audit report to the Central Government within thirty days from the date of received of the same.
4.	(False) - Cost Accounting Standards has formulated by Cost Accounting Standards Board.
5.	(False) - The auditor conducting the cost audit shall comply with the Cost Auditing Standards.

Fill in the Blanks

1.	1944
2.	Vivian Bose.
3.	Sub-section (1) of section 147
4.	2012

Companies (Cost Records and Audit) Rules, 2014 (as Amended) 2

This Module includes:

Companies (Cost Records and Audit) Rules, 2014 (as Amended)

SLOB Mapped against the Module

To gain in-depth knowledge about the statutory provisions of Companies (Cost Records and Audit) Rules to ensure adherence to the regulations in conducting cost audit. (CMLO 4a, b)

Module Learning Objectives:

The Central Government issued Companies (Cost Records and Audit)Rules, 2014 on June 30, 2014. Subsequently, it issued Companies (Cost Records and Audit) Amendment Rules, where certain changes to the original Rules issued on June 30, 2014. The Companies (Cost Records and Audit) Rules, 2014 read with the Amendment Rules 2014 are now applicable and governs the maintenance of cost accounting records and cost audit as per Section 148 of the Companies Act, 2013. After studying this module, the students will be able to –

- Learn about the Companies (Cost Records and Audit) Rules, 2014

Companies (Cost Records and Audit) Rules, 2014 (as Amended)

2.1

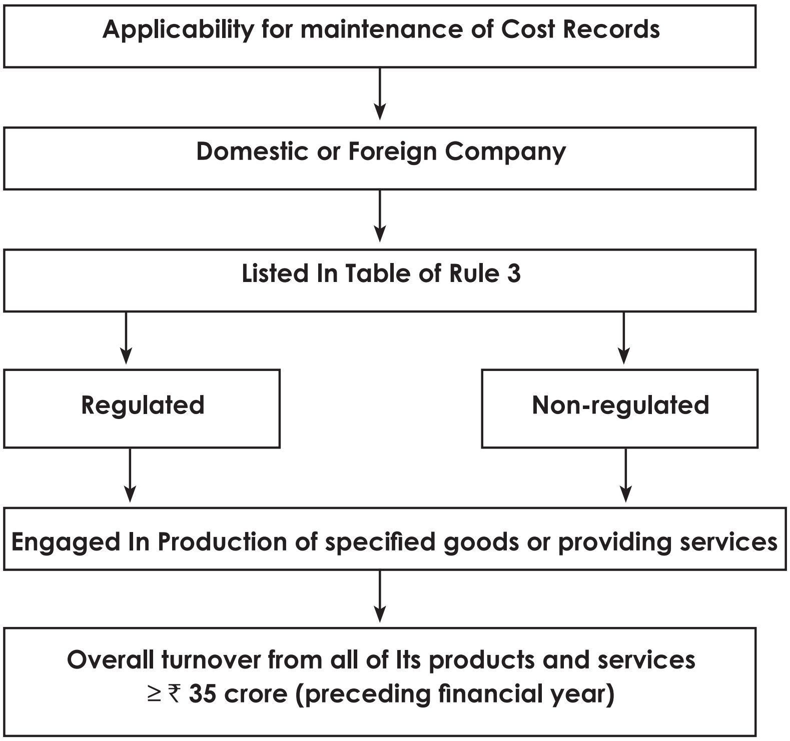
The Companies Act, 2013 empowers the Central Government to make the rules in the area of maintenance of cost records by the companies engaged in the specified industries, manufacturing / providing such goods / services; and for getting such cost records audited, vide Section 148.

Thus, it is the "subordinate legislative power" of the Central Government, to make rules for maintenance of cost records and audit thereof in respect of specific industries. Accordingly, the Central Government made, from time to time, several notifications / orders, ever since the provisions were made in the erstwhile Companies Act, 1956, as well as under the current Act of 2013. The original rules under Companies Act, 1956 were superseded and Companies (Cost Records & Audit) Rules 2014 issued. The current effective Rule is Companies (Cost Records & Audit) Amendment Rules, 2019 though Companies (Cost Records & Audit) Rules 2014 still remains the principal rules.

An Analysis through diagrammatic representation is given below:

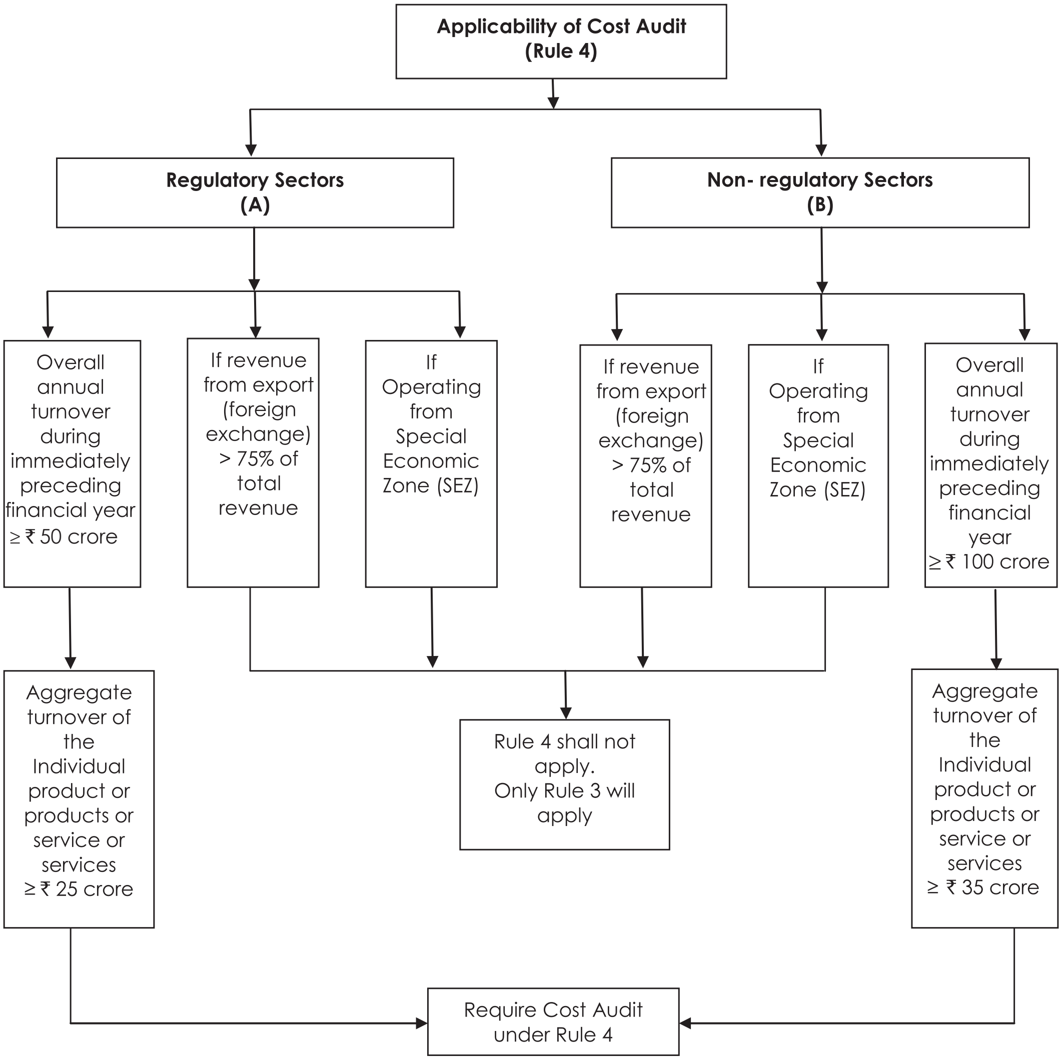
Rules/Forms	Summary
Rule 1: Short title and commencement	**(1)** These rules may be called the Companies (Cost Records and Audit) Rules, 2014. **(2)** They shall come into force on the date of publication in the Official Gazette i.e. 30.06.2014.
Rule 2: Definitions	In these rules, defined various points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

Rule 3: Diagrammatic Representation

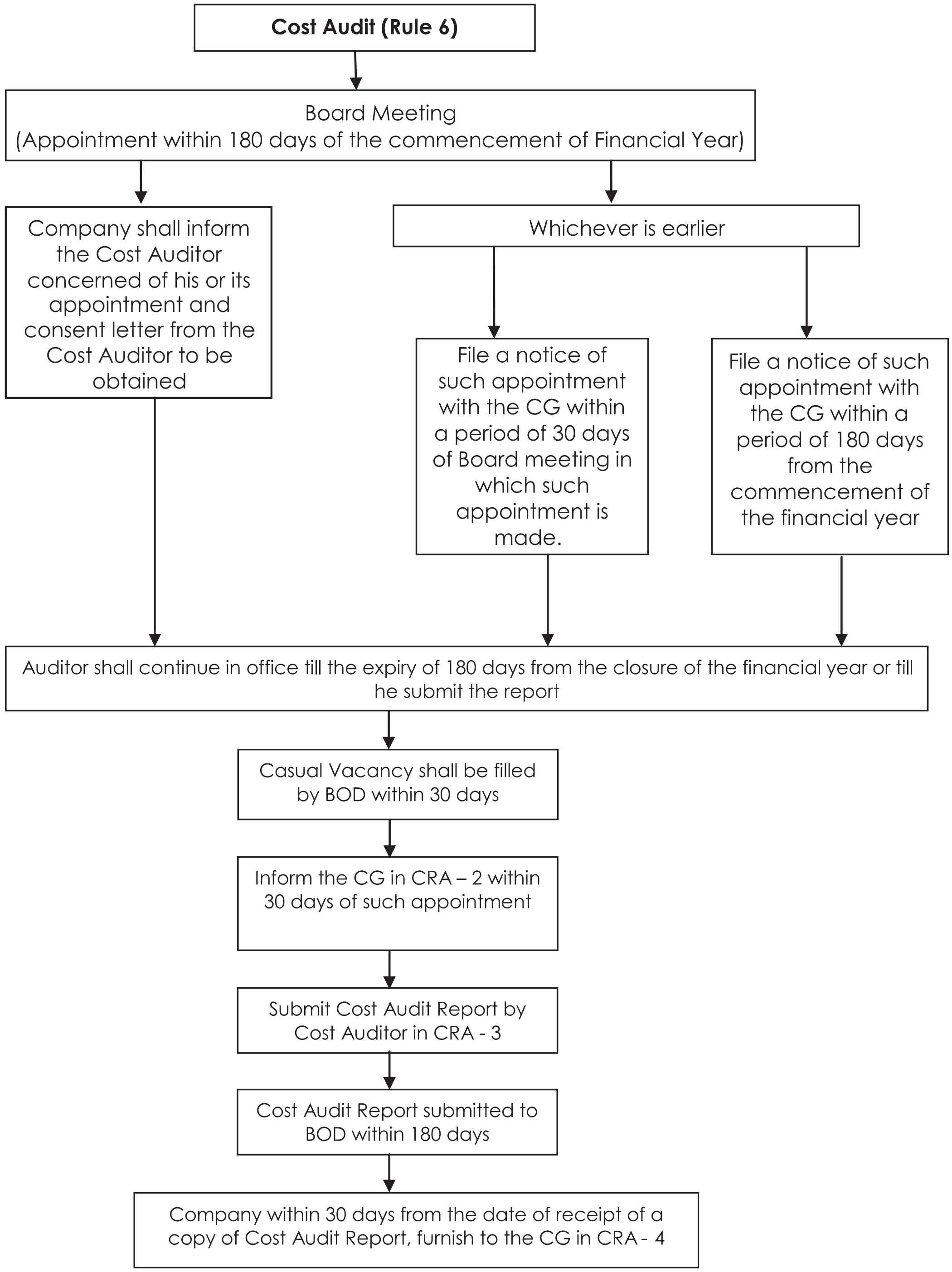


Rule-4: Applicability for Cost Audit	Even for regulated sectors like Telecommunication, Electricity, Petroleum and Gas, Drugs and Pharma, Fertilizers and Sugar, Cost audit requirement has been made subject to a turnover based threshold of ₹ 50 crores for all product and services and ₹ 25 crores for individual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

Rule 4: Diagrammatic Representation



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


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

CRA-1: Forms in which cost records shall be maintained **[Pursuant to rule 5(1)]**	The form CRA-1 prescribes the form in which cost records shall be maintained. The form categorises the requirement of maintaining proper details as per 30 headings. The headings are as follows: **(1)** Material Cost, **(2)** Employee Cost, **(3)** Utilities, **(4)** Direct Expenses, **(5)** Repair and Maintenance, **(6)** Fixed Assets and Depreciation, **(7)** Overheads, **(8)** Administrative Overheads, **(9)** Transportation Cost, **(10)** Royalty and Technical Know-how, **(11)** Research and Development expenses, **(12)** Quality Control Expenses, **(13)** Pollution Control Expenses, **(14)** Service Department Expenses, **(15)** Packing Expenses, **(16)** Finance Costs, **(17)** Any other item of Cost, **(18)** Capacity Determination, **(19)** Work-in-progress and finished stock, **(20)** Captive Consumption, **(21)** By-Products and Joint Products, **(22)** Adjustment of Cost Variances, **(23)** Reconciliation of Cost and Financial Accounts, **(24)** Related Party Transactions, **(25)** Expenses or Incentives on Exports, **(26)** Production records, **(27)** Sales records, **(28)** Cost Statements, **(29)** Statistical Records, **(30)** Records of Physical Verification, **(31)** Unit of Measurement (UoM).
CRA-2: Form of intimation of appointment of cost auditor by the company to **Central Government** **[Pursuant to rule 6(2) & (3A)]**	**(1)** Corporate Identity Number (CIN) or Foreign Company Registration Number (FCRN) of the company **(2)** General Information **(3)** Product**(s)**/Service**(s)** to which Cost Audit relates **(4)** Details of all the Cost Auditor**(s)** appointed **(5)** Financial year to be covered under the Cost Audit **(6)** Details of previous Cost Auditor which has not been reappointed **(7)** Attachments - Copy of the Board resolution of the company - Optional attachment - if any
CRA-3: Form of Cost Audit Report **[Pursuant to rule 6(4)]**	Clause (vii) have been added to auditor's report as under: Detailed unit-wise and product/service-wise cost statements and schedules thereto In respect of the product/services under reference of the company duly audited and certified by me/us are/are not kept in the company.

Annexure to Cost Audit Report	Annexure has been reclassified into four parts as under:
	Part-A General Information, General Details of Cost Auditors, Cost Accounting Policy, Product/Service Details –for the company as a whole. **Part-B For Manufacturing Sector** Quantitative Information, Abridged Cost Statement, Details of Materials Consumed, Details of Utilities Consumed, Details of Industry Specific Operating Expenses. **Part-C For Service Sector** Quantitative Information, Abridged Cost Statement, Details of Materials Consumed, Details of Utilities Consumed, Details of Industry Specific Operating Expenses. **Part-D** Product and Service Profitability Statement, Profit Reconciliation, Value Addition and Distribution of Earnings, Financial Position and Ratio Analysis, Related Party Transactions, Reconciliation of Indirect taxes.
CRA – 4: Form for filing Cost Audit Report with the **Central Government** **[Pursuant to rule 6(6)]**	**(1)** Corporate Identity Number (CIN) or Foreign Company Registration Number (FCRN) of the company **(2)** General Information **(3)** Details of Industries/Sectors/Product**(s)**/Service**(s)** (CTA heading level, wherever applicable as per Rules for Regulated and Non-regulated sector) for which the Cost Audit Report is being submitted **(4)** Details of Industries/Sectors/Product**(s)**/Service**(s)** (CTA heading level, wherever applicable as per Rules for Regulated and Non-regulated sector) not covered in the Cost Audit Report **(5)** Details of the cost auditor**(s)** appointed **(6)** Details of observation of the Cost Audit report **(7)** Attachment - XBRL document in respect of the cost audit report and Company's information and explanation on every Qualification and reservation contained therein - Optional attachment, if any.

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

The Companies (Cost Records and Audit) Rules, 2014 came into force on 30th June, 2014. These rules were amended on 31st December, 2014 giving effect to Rule 2, 3, 4, 5, 6, 7 and Form CRA 1 & CRA 3. It was further amended on 12th June'2015 to giving effect on Form CRA 2 & CRA 4. Further amendment was made on 14th July, 2016. Latest amendment has been made on 15th October, 2019.

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

1. Short title and commencement

(1) These rules may be called the Companies (cost records and audit) Rules, 2014.

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

(3) The companies who have already filed their Cost Audit Report in form CRA-4 for the financial year 2018-19 with the Central Government before the publication of this notification are not required to file their Cost Audit Report for the said financial year.

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

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

(aa) "Customs Tariff Act Heading" means the heading as referred to in the Additional Notes in the First Schedule to the Customs Tariff Act, 1975 (51 of 1975).

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

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

(d) "cost audit report" means the duly signed cost auditor's report on the cost records examined and cost statements which are prepared as per these rules, including attachment, annexure, qualifications or observations attached with or included in such report

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

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

(fa) "Indian Accounting Standards" means Indian Accounting Standards as referred to in Companies (Indian Accounting Standards) Rules, 2015.

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

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

3. Application of Cost Records

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

TABLE

(A) Regulated Sectors

Sl. No	Industry/ Sector/ Product/ Service	Customs Tariff Act Heading (wherever applicable)
1	Telecommunication services made available to users by means of any transmission or reception of signs, signals, writing, images and sounds or intelligence of any nature and regulated by the Telecom Regulatory Authority of India under the Telecom Regulatory Authority of India Act, 1997 (24 of 1997); including activities that requires authorization or license issued by the Department of Telecommunications, Government of India under Indian Telegraph Act, 1885 (13 of 1885);	Not applicable.
2	Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003 (36 of 2003);	Generation- 2016; Other Activity- Not Applicable
3	Petroleum products; including activities regulated by the Petroleum and Natural Gas Regulatory Board under the Petroleum and Natural Gas Regulatory Board Act, 2006 (19 of 2006);	2709 to 2715; Other Activity- Not Applicable
4	Drugs and pharmaceuticals;	2901 to 2942; 3001 to 3006.
5	Fertilisers;	3102 to 3105
6	Sugar and industrial alcohol	1701; 1703; 2207.

(B) Non-regulated Sectors

Sl No	Industry/ Sector/ Product/ Service	Customs Tariff Act Heading (wherever applicable)
1	Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items; Explanation. - For the purposes of this sub-clause, any company which is engaged in any item or items supplied exclusively for use under this clause shall be deemed to be covered under these rules.	8401; 8801 to 8805; 8901 to8908.
2	Turbo jets and turbo propellers;	8411
3	Arms and ammunitions and Explosives	3601 to 3603; 9301 to 9306
4	Propellant powders; prepared explosives (other than propellant powders); safety fuses; detonating fuses; percussion or detonating caps; igniters; electric detonators;	3601 to 3603
5	Radar apparatus, radio navigational aid apparatus and radio remote control apparatus;	8526

6	Tanks and other armoured fighting vehicles, motorised,whether or not fitted with weapons and parts of such vehicles, that are funded (investment made in the company) to the extent of ninety per cent or more by the Government or Government agencies	8710
7	Port services of stevedoring, pilotage, hauling, mooring, re-mooring, hooking, measuring, loading and unloading services rendered for a port in relation to a vessel or goods regulated by the Tariff Authority for Major Ports under the Major Port Trusts Act, 1963 (38 of 1963);	Not applicable.
8	Aeronautical services of air traffic management, aircraft operations, ground safety services, ground handling, cargo facilities and supplying fuel rendered at the airports and regulated by the Airports Economic Regulatory Authority under the Airports Economic Regulatory Authority of India Act, 2008 (27 of 2008);	Not applicable.
9	Iron and Steel	7201 to 7229; 7301 to 7326
10	Roads and other infrastructure projects corresponding to para No. (1) (a) as specified in Schedule VI of the Companies Act, 2013;	Not applicable
11	Rubber and allied products being regulated by the Rubber Board constituted under the Rubber Act, 1947 (XXIV of 1947).	4001 to 4017
12	Coffee and tea;	0901 to 0902
13	Railway or tramway locomotives, rolling stock, railway or tramway fixtures and fittings, mechanical (including electro mechanical) traffic signalling equipment's of all kind;	8601 to 8608, 8609
14	Cement;	2523; 6811 to 6812
15	Ores and Mineral products;	2502 to 2522; 2524 to 2526; 2528 to 2530; 2601 to 2617
16	Mineral fuels (other than Petroleum), mineral oils etc.;	2701 to 2708
17	Base metals;	7401 to 7403; 7405 to 7413; 7419; 7501 to 7508; 7601 to 7614; 7801 to 7802; 7804; 7806; 7901 to 7905; 7907; 8001; 8003; 8007; 8101 to 8113
18	Inorganic chemicals, organic or inorganic compounds of precious metals, rare-earth metals of radioactive elements or isotopes, and Organic Chemicals;	2801 to 2853; 2901 to 2942; 3801 to 3807; 3402 to 3403; 3809 to 3824.
19	Jute and Jute Products	5303, 5307, 5310
20	Edible Oil;	1507 to 1518
21	Construction Industry as per para No. (5) (a) as specified in Schedule VI of the Companies Act, 2013 (18 of 2013)	Not applicable.
22	Health services, namely functioning as or running hospitals, diagnostic centres, clinical centres or test laboratories;	Not applicable.

23	Education services, other than such similar services falling under philanthropy or as part of social spend which do not form part of any business.	Not applicable
24	Milk powder;	0402
25	Insecticides;	3808
26	Plastics and polymers;	3901 to 3914; 3916 to 3921; 3925
27	Tyres and tubes;	4011 to 4013
28	Pulp and Paper;	4701 to 4704; 4801 to 4802
29	Textiles;	5004 to 5007; 5106 to 5113; 5205 to 5212; 5303; 5307; 5310; 5401 to 5408; 5501 to 5516
30	Glass;	7003 to 7008; 7011; 7016
31	Other machinery and Mechanical Appliances;	8402 to 8487
32	Electricals or electronic machinery;	8501 to 8507; 8511 to 8512; 8514 to 8515; 8517; 8525 to 8536; 8538 to 8547.
33	Production, import and supply or trading of following medical devices, namely:- (i) Cardiac stents; (ii) Drug eluting stents; (iii) Catheters; (iv) Intra ocular lenses; (v) Bone cements; (vi) Heart valves; (vii) Orthopaedic implants; (viii) Internal prosthetic replacements; (ix) Scalp vein set; (x) Deep brain stimulator; (xi) Ventricular peripheral shud; (xii) Spinal implants; (xiii) Automatic impalpable cardiac defibrillators; (xiv) Pacemaker (temporary and permanent); (xv) Patent-ductus arteriosus, atrial septal defect and ventricular septal defect closure device; (xvi) Cardiac re-synchronize therapy ; (xvii) Urethra spinicture devices; (xviii) Sling male or female; (xix) Prostate occlusion device; and (xx) Urethral stents:	9018 to 9022

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

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

4. Applicability for Cost Audit

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

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

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

(i) whose revenue from exports, in foreign exchange, exceeds seventy five per cent of its total revenue; or

(ii) which is operating from a special economic zone;

(iii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant. For this purpose, the term "Captive Generating Plant" shall have the same meaning as assigned in rule 3 of the Electricity Rules, 2005.

5. Maintenance of records

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

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

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

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

The following records (not exhaustive) would form part of Cost Accounting Records.

(i) Production

- Raw Material Consumption Record – material-wise and product-wise
- Production Report
- Rejection/Wastage/Scrap Report

- Machine Utilization Report/Machine Running Hours
- Idle/Stoppage Time Report of Machines with reasons
- Idle time of labour report with reasons
- Details such as production hours, labour hours and machine hours

(ii) Work-in-Progress and Finished Goods

- Record of Work-in-Progress Stocks, cost centre-wise and product-wise
- Record of Finished Goods Stock, Product-wise, pack-wise, type-wise etc.

(iii) Repairs & Maintenance

- Job order record/card showing material and spares consumed and labour utilized for repair jobs
- In case of workshop, additional records as described under (i) above

(iv) Utilities (Steam, Power, Water, Air Conditioning, Humidification, Effluent Treatment etc)

- Quantitative Records of Inputs and Outputs
- Records of cost centre-wise consumption of respective utilities
- Separate records showing source-wise, cost of own generation of power and purchased power

(v) Other Service Cost Centres – Quality Control, Research & Development, Pollution Control etc.

- Function of each of the Departments and how it keeps track of its time and resource deployment to the products concerned
- Basis of cost apportionment and justification for the same

(vi) Raw Materials, Process Materials, Colour and Chemicals, Consumable Stores and Spare Parts

- Goods received Record
- Bin cards
- Materials/Stores Ledgers in quantity and value
- Product wise material consumption reports in quantity and value
- Physical stock verification and shortage/excess statement, reasons for differences and its treatment in accounts

(vii) Wages & Salaries

- Attendance record and leave records
- Wages/salary Records – cost centre-wise
- Leave Wages, Bonus, Gratuity payments and other fringe benefits
- Overtime, Idle Time etc. records
- Details of VRS, Retrenchment compensation, Lay-off payment

(viii) Overheads

- Expenses analysis, cost centre-wise

(ix) Sales

- Sales analysis by products (Quality, size, variety-wise) in terms of quantity and value
- Export Sales, product –wise, country wise
- Product-wise analysis of export incentives and benefits
- Analysis of sales to related parties

(x) Records of inter-company and related party transactions, information about normal price

(xi) Cost Accounts/Records/Statements

- Cost centre-wise assets record
- Finished product-wise movement record (Quantity reconciliation)
- Factory-wise, Product-wise, Pack-wise, Size-wise etc. Cost Statements

(xii) Reconciliation of profit/ (loss) as per cost records and financial accounts

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

6. Cost Audit

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

Provided that before such appointment is made, the written consent of the cost auditor to such appointment, and a certificate from him or it,as provided in sub-rule (1A), shall be obtained

(1A) The cost auditor appointed under sub-rule (1) shall submit a certificate that─

(a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act, the Cost and Works Accountants Act, 1959(23 of 1959) and the rules or regulations made thereunder;

(b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Act, so far as may be applicable;

(c) the proposed appointment is within the limits laid down by or under the authority of the Act; and

(d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct."

(2) Every company referred to in sub-rule (1) shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the

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

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

Provided that the cost auditor appointed under these rules may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the Cost Auditor and recording the reasons for such removal in writing;

Provided further that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect;

Provided also that nothing contained in this sub-rule shall prejudice the right of the cost auditor to resign from such office of the company;

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

(3B) The cost statements, including other statements to be annexed to the cost audit report, shall be approved by the Board of Directors before they are signed on behalf of the Board by any of the director authorised by the Board, for submission to the cost auditor to report thereon

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

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

(6) Every company covered under these rules shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in Form CRA-4 in Extensible Business Reporting Language format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 alongwith fees specified in the Companies (Registration Offices and Fees) Rules, 2014.".

"Provided that the Companies which have got extension of time of holding Annual General Meeting under section 96(1) of the Companies Act, 2013, may file form CRA-4 within resultant extended period of filing financial statements under section 137 of the Companies Act, 2013".

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

Companies (Cost Records and Audit) Rules, 2014

[as amended]

FORM CRA-1

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

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

1. Material Costs

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

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

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

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

(e) Spare parts shall be recognised as property, plant and equipment when they meet the definition of property, plant and equipment and depreciated accordingly. Otherwise, such items shall be classified as inventory.

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

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

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

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

(j) Subsidy or grant or incentive and any such payment received or receivable with respect to any material cost shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

(k) Issues shall be valued using appropriate method as per the provisions contained in the accounting standard applicable for the time being in force.

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

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

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

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

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

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

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

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

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

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

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

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

2. Employee Cost

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

(b) Employee cost shall be ascertained taking into account the gross pay including all allowances payable along with the cost to the employer of all the benefits, including the cost of retirement benefits charged in the financial statements in an accounting period. In case of companies to which Indian Accounting Standards apply, any re-measurement of such costs recognised in other comprehensive income shall not form part of the employee cost.

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

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

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

(f) Employee cost shall not include imputed costs.

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

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

(i) Subsidy or grant or incentive and any such payment received or receivable with respect to any employee cost shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

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

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

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

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

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

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

(r) The amortised separation costs related to voluntary retirement, retrenchment, and termination 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.

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

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

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

3. Utilities

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

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

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

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

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

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

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

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

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

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

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

(l) Subsidy or grant or incentive and any such payment received or receivable with respect to any cost of utilities shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

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

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

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

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

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

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

4. Direct Expenses

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

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

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

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

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

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

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

(h) Subsidy or grant or incentive and any such payment received or receivable with respect to any direct expenses shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

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

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

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

5. Repairs and Maintenance

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

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

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

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

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

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

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

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

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

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

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

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

(m) 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.

(n) Subsidy or grant or incentive and any such payment received or receivable with respect to repairs and maintenance activity shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

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

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

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

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

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

6. Fixed Assets and depreciation

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

(b) The depreciation and amortisation shall be the amount recognised as an expense for the year in the financial statements, which shall be measured as per the provisions contained in schedule II of the Companies Act, 2013 and the accounting standards applicable for the time being in force. The amount of Depreciation and Amortisation not recognised as expense in the financial statements shall be treated as a non-cost item.

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

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

(e) Spare parts, stand-by equipment and servicing equipment shall be recognised as property, plant and equipment when they meet the definition of property, plant and equipment and depreciated accordingly. Otherwise, such items shall be classified as inventory.

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

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

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

7. Overheads

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

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

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

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

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

(f) Overheads shall not include imputed cost.

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

(h) Subsidy or grant or incentive and any such payment received or receivable with respect to overheads shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

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

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

(m) Overheads shall be classified according to functions, viz., works, administration, selling and distribution. Works overheads, also known as Production Overheads, Operation Overheads, Factory Overheads or Manufacturing Overheads, shall be the indirect costs involved in the production of a product or in providing service. Administrative overheads shall be the aggregate of cost of resources consumed in activities relating to general management and administration of an organisation. Selling and distribution overheads shall be the aggregate of cost of resources consumed in the selling and distribution activities of the organization.

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

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

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

(q) 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.

(r) Selling and Distribution Overheads, the benefits of which are expected to be derived over a long period, shall be amortized on a rational basis.

(s) Any demurrage or detention charges or penalty levied by the transportation or other authorities in respect of distribution activity shall not form part of Selling and Distribution Overheads.

8. Administrative Overheads

9. Transportation Cost

(a) Proper records shall be maintained for recording the actual cost of transportation showing each element of cost such as freight, cartage, transit insurance and others after adjustment for recovery of transportation cost. Abnormal costs relating to transportation, if any, are to be identified and recorded for exclusion of computation of average transportation cost.

(b) In case of a manufacturer having his own transport fleet, proper records shall be maintained to determine the actual operating cost of vehicles showing details of various elements of cost, such as salaries and wages of driver, cleaners and others, cost of fuel, lubricant grease, amortized cost of tyres and battery, repairs and maintenance, depreciation of the vehicles, distance covered and trips made, goods hauled and transported to the depot.

(c) In case of hired transport charges incurred for despatch of goods, complete details shall be recorded as to date of despatch, type of transport used, description of the goods, destination of buyer, name of consignee, challan number,quantity of goods in terms of weight or volume, distance involved, amount paid and other related details.

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

(e) Separate records shall be maintained for identification of transportation cost towards inward movement of material (procurement) and transportation cost of outward movement of goods removed or sold for both home consumption and export.

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

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

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

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

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

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

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

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

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

(o) The following basis shall be used, in order of priority, for apportionment of outward transportation cost depending upon the nature of products, unit of measurement followed and type of transport used, namely:-

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

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

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

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

10. Royalty and Technical Know-how

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

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

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

(d) Subsidy or grant or incentive and any such payment received or receivable with respect to amount of royalty and technical know-how fee shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

(g) Any change in the cost accounting principles applied for the measurement of the amount of royalty and technical know-how fee 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.

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

- **(i)** Units produced
- **(ii)** Units sold
- **(iii)** Sales value

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

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

11. Research and Development Expenses

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

- **(i)** the cost of materials and services consumed in research and development activities.

- **(ii)** cost of bought out materials and hired services as per invoice or agreed price including duties and taxes directly attributable thereto net of trade discounts, rebates, taxes and duties refundable or to be credited.
- **(iii)** the salaries, wages and other related costs of personnel engaged in research and development activities;
- **(iv)** the depreciation of equipment and facilities, and other tangible assets, and amortisation of intangible assets to the extent that they are used for research and development activities;
- **(v)** overhead costs, other than general administrative costs, related to research and development activities.
- **(vi)** costs incurred for carrying out research and development activities by other entities and charged to the entity; and
- **(vii)** expenditure incurred in securing copyrights or licences;
- **(viii)** expenditure incurred for developing computer software;
- **(ix)** costs incurred for the design of tools, jigs, moulds and dies;
- **(x)** other costs that can be directly attributed to research and development activities and can be identified with specific projects.

(b) Subsidy or grant or incentive and any such payment received or receivable with respect to research and development activity shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

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

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

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

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

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

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

12. Quality control expenses

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

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

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

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

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

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

(g) Subsidy or grant or incentive and any such payment received or receivable with respect to any quality control cost shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

(j) Any change in the cost accounting principles applied for the measurement of the quality control cost shall be made only if, it is required by law or 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.

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

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

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

13. Pollution control expenses

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(p) Subsidy or grant or incentive and any such payment received or receivable with respect to pollution control activity shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

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

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

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

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

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

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

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

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

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

14. Service department expenses

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

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

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

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

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

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

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

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

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

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

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

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

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

(n) Subsidy or grant or incentive and any such payment received or receivable with respect to any service cost centre shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

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

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

(s) Any change in the cost accounting principles applied for the measurement of the cost of Service cost centre shall be made, only if it is required by law or 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.

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

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

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

15. Packing expenses

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

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

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

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

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

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

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

(h) Subsidy or grant or incentive and any such payment received or receivable with respect to packing material shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

(i) Issue of packing materials shall be valued using appropriate method as per the provisions contained in the accounting standard applicable for the time being in force.

(j) Wherever, packing material costs include transportation costs, determination of costs of transportation shall be governed by Cost Accounting Standard on determination of average (equalized) cost of transportation.

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

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

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

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

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

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

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

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

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

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

16. Finance Costs

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

(b) Finance costs incurred shall be identified for-

  (i) acquisition or construction or production of qualifying assets including fixed assets; and

  (ii) other finance costs for production of goods or operations or services rendered which cannot be classified as qualifying assets.

(c) Finance costs directly attributable to the acquisition or construction or production of a qualifying asset shall be included in the cost of the asset.

(d) Finance costs shall not include imputed costs.

(e) Subsidy or grant or incentive and any such payment received or receivable with respect to finance costs shall be reduced from cost of the cost object in the financial year when such subsidy or grant or incentive and any such payment is recognised as income.

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

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

(h) Assignment of finance costs to the cost objects shall be based on either of the following two principles; namely:-

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

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

17. Any other item of cost

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

18. Capacity determination

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

(b) Installed capacity is determined based on:

(i) Manufacturers' Technical specifications

(ii) Capacities of individual or interrelated production centres

(iii) Operational constraints or capacity of critical machines or

(iv) Number of shifts

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

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

(i) Holidays, normal shut down days and normal idle time,

(ii) Normal time lost in batch change over,

(iii) Time lost due to preventive maintenance and normal break downs of equipment's,

(iv) Loss in efficiency due to ageing of the equipment, or

(v) Number of shifts;

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

19. Work-in-progress and finished stock

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

20. Captive consumption

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

21. By-Products and Joint Products

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

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

22. Adjustment of cost variances.

Where the company maintains cost records on any basis other than actual such as standard costing, the records shall indicate the procedure followed by the company in working out the cost of the goods or services under such system. The cost variances shall be shown against separate heads and analyzed into material, labour, overheads and further segregated into quantity, price and efficiency variances. The method followed for adjusting the cost variances in determining the actual cost of the goods or services shall be indicated clearly in the cost records.The reasons for the variances shall be duly explained in the cost records and statements.

23. Reconciliation of cost and financial accounts

The cost statements shall be reconciled with the financial statements for the financial year specifically indicating the expenses or incomes not considered in the cost records or statements so as to ensure accuracy and to adjust the profit of the goods or services under reference with the overall profit of the company. The variations, if any, shall be clearly indicated and explained.

24. Related party transactions

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

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

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

(i) Comparable uncontrolled price method;

(ii) Resale price method;

(iii) Cost plus method;

(iv) Profit split method;

(v) Transactional net margin method; or

(vi) Any other method, to be specified.

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

(i) purchase and sale of raw materials, finished good(s), rendering of service(s), process materials and rejected goods including scraps, etc. ;

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

(iii) supply of utilities and any other services;

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

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

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

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

25. Expenses or incentives on exports

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

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

26. Production Records

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

27. Sales records

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

28. Cost statements

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

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

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

(d) If the company is operating more than one plant, factory or service centre, separate cost statements as specified above shall be prepared in respect of each plant, factory or service centre.

(e) Any other statement or information considered necessary for suitable presentation of costs and profitability of goods or services produced by the company shall also be prepared.

29. Statistical Records

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

(b) Proper records shall be maintained to enable the company to identify the capital employed, net fixed assets and working capital separately for the production of goods or rendering of services under reference and other goods or services to the extent such elements are separately identifiable. Non-identifiable items shall be allocated on a suitable and reasonable basis to different goods or services. Fresh investments on fixed assets for production of goods or rendering of services under reference that have not contributed to the production of goods or rendering of services during the relevant period or year shall be indicated in the cost records. The records shall, in addition, show assets added as replacement and those added for increasing existing capacity.

30. Records of Physical Verification

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

31. Unit of Measurement (UoM)

The Unit of Measurement (UoM) for each Customs Tariff Act Heading, wherever applicable, shall be the same as provided for in the Customs Tariff Act, 1975 (51 of 1975) corresponding to that particular Customs Tariff Act Heading.

FORM NO. CRA-2

[Pursuant to section 148(3) of Companies Act, 2013 and rule 6(2) & 6(3A) of the Companies (cost records and audit) Rules, 2014]

सत्यमेव जयते

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

Form language ◉ English ◯ Hindi

Note: Refer the instruction kit for filing the form.
IN CASE OF REVISED CRA-2, ALL THE DETAILS MUST BE FILLED AFRESH.

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

(b) Global location number (GLN) [ ]

2.(a) Name of the company [ ]

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

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

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

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

I

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

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

[ ]

(iii) *Date of casual vacancy [ ]

(iv) *Reason of casual vacancy [ ]

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

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

Details of such industries/sectors/products/services

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

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

Details of such industries/sectors/products/services

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

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

Number of cost auditor(s)

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

(b) (i) *Membership number of the cost auditor or member representing the firm/LLP

(ii)*Name of the cost auditor or member representing the firm/LLP

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

(iv)*Name of the Cost auditor's firm/LLP

(c) (i) Address *Line I

Line II

(ii) *City

(iii)*State

(iv)*Country

(v)* Pin code

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

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

(e) *Type of appointment

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

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

5.* Financial year to be covered by the cost auditor(s)

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

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

Attachments

List of attachments

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

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

[Remove attachment]

Declaration

I am authorized by the Board of Directors of the Company vide resolution number* ____

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

***To be digitally signed by** ____

*Designation ____

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

Note: Attention is drawn to provisions of Section 448 and 449 which provide for punishment for false statement / certificate and punishment for false evidence respectively.

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

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

Form CRA-3

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

FORM OF THE COST AUDIT REPORT

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

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

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

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

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

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

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

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

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

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

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

SIGNATURE AND SEAL OF THE COST AUDITOR(S)

MEMBERSHIP NUMBER(S)

Notes:

(1) Delete words not applicable.

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

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

Annexure to the Cost Audit Report

Part - A

1. General Information

1	Corporate identity number or foreign company registration number	
2	Name of company	
3	Address of registered office or of principal place of business in India of company	
4	Address of corporate office of company	
5	Email address of company	
6	Date of beginning of reporting financial year	dd/mm/yyyy
7	Date of end of reporting financial year	dd/mm/yyyy
8	Date of beginning of previous financial year	dd/mm/yyyy
9	Date of end of previous financial year	dd/mm/yyyy
10	Level of rounding used in cost statements (in INR)	Absolute/thousands/ lakhs/crores
11	Whether Indian Accounting Standards are applicable to the company	Yes/No
12	Number of cost auditors for reporting period	
13	Date of board of directors meeting in which annexure to cost audit report was approved	
14	Whether cost auditors report has been qualified or has any reservations or contains adverse remarks	
15	Consolidated qualifications, reservations or adverse remarks of all cost auditors	
16	Consolidated observations or suggestions of all cost auditors	
17	Whether company has related party transactions for sale or purchase of goods or services	

2. General Details of Cost Auditor

1	Whether cost auditor is lead auditor	
2	Category of cost auditor	
3	Firm’s registration number	
4	Name of cost auditor/cost auditor’s firm	
5	PAN of cost auditor/cost auditor’s firm	
6	Address of cost auditor or cost auditor’s firm	

7	Email id of cost auditor or cost auditor's firm	
8	Membership number of member signing report	
9	Name of member signing report	
10	Name(s) of product(s) or service(s) with CTA headings	
11	SRN number of Form CRA-2	
12(a)	Number of audit committee meeting(s) during year for which cost auditor was invited	
12(b)	Number of audit committee meeting(s) attended by cost auditor during the year	
13	Date of signing cost audit report and annexure by cost auditor	
14	Place of signing cost audit report and annexure by cost auditor	

3. Cost Accounting Policy

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

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

(b) Accounting for material cost including packing materials, stores and spares 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 or services, scarps, wastage etc.

(f) Basis for Inventory Valuation.

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

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

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

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

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

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

Name of Product(s)/Service(s)	UOM	CTA Heading (Wherever applicable)	Whether Covered under Cost Audit Yes/No	Net Operational Revenue (net of taxes, duties etc.)	
				Current Year (₹)	Previous Year (₹)
1.					
2.					
3.					
4.					
....					
Total Net Operational Revenue of Manufactured Product or Service					
Other Operative Incomes of the Company					
Total Operative Incomes of the Company					
Other Incomes of Company					
Total Revenue as per Financial Accounts					
Exceptional and Extra Ordinary Income					
Other Comprehensive Income, If any					
Total Revenue including Exceptional, Extra Ordinary and Other Comprehensive Income, if any					
Turnover as per Excise/Service Tax/ GST Records					

Note: Explain the difference, if any, between Turnover as per Financial Statements and Turnover as per Excise/ Service Tax/GST Records.

Part-B

FOR MANUFACTURING SECTOR

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

2. ABRIDGED COST STATEMENT (for each product with CTA heading separately)

Name of Product	
CTA heading	
Unit of Measure	

	Production	Finished Goods Purchased	Finished Stock Adjustment	Captive Consumption	Other Adjustments	Quantity Sold
Current Year						
Previous Year						

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

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

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

2A. Details of Materials Consumed

Name of Product									
CTA heading									
Sl. No	Description of Material	Category	UOM	Current Year			Previous Year		
				Quantity	Rate per Unit (₹)	Amount (₹)	Quantity	Rate per Unit (₹)	Amount (₹)
1.									
2.									
3.									
4.									
5.									
6.									
7.									
8.									
9.									
10.									

Category: Indigenous/ Imported/ Self Manufactured

2B. Details of Utilities Consumed

Name of Product								
CTA heading								
Sl. No.	Description of Utilities Consumed	UOM	Current Year			Previous Year		
			Quantity	Rate per Unit (₹)	Amount (₹)	Quantity	Rate per Unit (₹)	Amount (₹)
1.								
2.								
3.								
4.								
5.								
6.								
7.								
8.								
9.								
10.								

2C. Details of Industry Specific Operating Expenses

Name of Product			
CTA heading			
Sl. No.	Description of Industry Specific Operating Expenses	Current Year	Previous Year
		Amount (₹)	Amount (₹)
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			

Part - C
FOR SERVICE SECTOR

1. QUANTITATIVE INFORMATION (for each service separately)			
Name of Service			
Service Code (if applicable)			
Particulars	**Unit of Measurement**	**Current Year**	**Previous Year**
1. Available Capacity			
(a) Installed capacity			
(b) Capacity enhanced during the year, if any			
(c) Total available capacity			
2. Actual Services Provided			
(a) Own services			
(b) Services under contractual arrangements			
(c) Outsourced services			
(d) Total services			
3. Total Services Provided as per Service Tax/ GST Records			
4. Capacity Utilization (in-house)			
5. Other Adjustments			
(a) Self or captive consumption			
(b) Other quantitative adjustments, if any			
(c) Total other adjustments			
6. Total Available Services for Sale [2(d)+5(c)]			
7. Actual Services Sold			
(a) Services rendered – Domestic			
(b) Services rendered – Export			
(c) Total services rendered			

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

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

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

2A. Details of Materials Consumed

Name of Service									
Service Code (if applicable)									
Sl. No.	Description of Material	Category	UOM	Current Year			Previous Year		
				Quantity	Rate per Unit (₹)	Amount (₹)	Quantity	Rate per Unit (₹)	Amount (₹)
1.									
2.									
3.									
4.									
5.									
6.									
7.									
8.									
9.									
10.									
Category: Indigenous/ Imported/ Self Manufactured									

2B. Details of Utilities Consumed

Name of Service								
Service Code (if applicable)								
Sl. No.	Description of Utilities Consumed	UOM	Current Year			Previous Year		
			Quantity	Rate per Unit (₹)	Amount (₹)	Quantity	Rate per Unit (₹)	Amount (₹)
1.								
2.								
3.								
4.								
5.								
6.								
7.								
8.								
9.								
10.								

2C. Details of Industry Specific Operating Expenses

Name of Service			
Service Code (if applicable)			
Sl. No.	Description of Industry Specific Operating Expenses	Current Year	Previous Year
		Amount (₹)	Amount (₹)
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			

Part - D

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

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

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

Sl. No.	Particulars	Current Year (₹)	Previous Year (₹)
1	Profit or Loss as per Cost Accounts		
	(a) For the audited product(s)/service(s)		
	(b) For the un-audited product(s)/servlce(s)		
2	Add: Incomes not considered in cost accounts (specify details)		
	(a)		
	(b)		
	(c)		
	(d)		
	(e)		
	(f)		
	(g)		
	(h)		
	(i)		
	(j)		
3	Less: Expenses not considered in cost accounts (specify details)		
	(a)		
	(b)		
	(c)		
	(d)		
	(e)		
	(f)		
	(g)		
	(h)		
	(i)		
	(j)		
4	Difference In Valuation of stock between financial accounts and cost accounts		
5	Other adjustments, if any		
6	Profit or Loss as per Financial Accounts (excluding other comprehensive income for companies following Ind AS)		

Note: Show abnormal wastages, expenses on strikes/lock-outs and any other items of expenses or incomes of abnormal nature etc. not considered in cost separately

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

Sl. No.	Particulars	Current Year (₹)	Previous Year (₹)
	Value Addition:		
1	Revenue from Operations		
2	Less: Taxes and Other Duties		
3	Net Revenue from Operations		
4	Add: Export Incentives		
5	Add/less: Adjustment in 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) Others, if any		
	Total Cost of bought out inputs		
7	Value Added		
8	Add: Income from any other sources		
9(i)	Exceptional & Extra Ordinary Income		
9(ii)	Other Comprehensive Income, if any		
10	Earnings available for distribution		
	Distribution of Earnings to:		
1	Employees as salaries & wages, retirement benefits, etc.		
2	Shareholders as dividend		
3	Company as retained funds		
4	Government as taxes (specify)		
5	Exceptional and Extra Ordinary Expenses, if any		
6	Others, if any (specify)		
7	Total distribution of earnings		

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

Sl. No.	Particulars	Units	Current Year	Previous Year
A.	**Financial Position**			
1	Share Capital			
2	Reserves & Surplus			
3	Long Term Borrowings			
4	(a) Gross Fixed Assets (b) Net Fixed Assets			
5	(a) Current Assets (b) Less: Current Liabilities (c) Net Current Assets			
6	Capital Employed			
7	Net Worth			
B.	**Financial Performance**			
1	Value Added			
2	Net Revenue from Operations of Company			
3	Profit before Tax (PBT)			
C.	**Profitability Ratios**			
1	PBT to Capital Employed (B3/A6)	%		
2	PBT to Net worth (B3/ A7)	%		
3	PBT to Value Added (B3/B1)	%		
4	PBT to Net Revenue from Operations (B3/B2)	%		
D.	**Other Financial Ratios**			
1	Debt- Equity Ratio			
2	Current Assets to Current Liabilities			
3	Value Added to Net Revenue from operations	%		
E.	**Working Capital Ratios**			
1	Raw Materials Stock to Consumption	Months		
2	Stores & Spares to Consumption	Months		

Notes: **1.** In this table, in case of companies to which Indian Accounting Standards apply:

(a) Share capital shall mean 'Equity Share Capital'

(b) Reserves & Surplus shall mean 'Other Equity'

(c) Long Term Borrowings shall mean 'Borrowing under Non Current Liabilities'

(d) Net Fixed Assets shall mean the sum total of 'Property, Plant and Equipment', 'Capital Work in Progress', 'Goodwill', 'Other intangible assets', 'Intangible assets under development' and 'Biological assets other than bearer plants'.

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

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

4. In case of companies to which Indian Accounting Standards apply:

(a) Revenue shall be net of taxes & duties

(b) PBT shall not include "Other Comprehensive Income"

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

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

Notes: **1.** Details should be furnished for each Related Party and Product /Service separately.

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

6. RECONCILIATION OF INDIRECT TAXES (for the Company as a whole)

Particulars		Taxable Value/ Assessable Value	Excise Duty/ VAT, CST, Cess etc./ Other State Taxes, if any	Goods & Services Tax			
				CGST	SGST/ UTGST	IGST	Cess and Others
		(₹)	(₹)	(₹)	(₹)	(₹)	(₹)
	Excise Duty						
1	Domestic						
2	Export						
3	Stock Transfers (Net)						
4	Others, if any						
5	**Total Excise Duty (1 to 4)**	-	-				
6	**VAT, CST, Cess etc.**						
7	**Other State Taxes, if any**						
	Goods & Services Tax						
8	Outward Taxable Supplies (other than zero rated, nil rated and exempted)						
9	Outward Taxable Supplies (zero rated)						
10	Inward Supplies (liable to reverse charge)						
11	Other Outward Supplies (nil rated, exempted)						
12	Non-GST Outward Supplies						
13	**Total (8 to 12)**	-		-	-	-	-
14	**Total Duties / Taxes Payable (5+6+7+13)**		-	-	-	-	-
	Duties/Taxes paid [by Utilisation of Input Tax Credit and Payment through Cash Ledger, as the case may be]						

	Input Tax Credit Utilised						
15	CGST/CENVAT						
16	SGST/UTGST/VAT						
17	IGST						
18	CESS						
19	Transitional Credit						
20	Others, if any, specify						
21	**Total Input Tax Credit Utilised (15 to 20)**			-	-	-	-
22	Payment through Cash Ledger						
23	**Total Duties/Taxes Paid (21+22)**		-	-	-	-	-
	Difference between Taxes Paid and Payable (14-23)		-	-	-	-	-
24	Interest/Penalty/Fines Paid						

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

Note:

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

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

(3) The Unit of Measurement (UoM) for each Customs Tariff Act Heading, wherever applicable, shall be the same as provided for in the Customs Tariff Act, 1975 (51 of 1975) corresponding to that particular Customs Tariff Act Heading.

FORM NO. CRA-4

[Pursuant to Sub-rule (6) of rule 6]

सत्यमेव जयते

Form for filing Cost Audit Report with the Central Government

Form Language ◉ English ○ Hindi

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

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

(b) Global location number (GLN) of company [ ]

2.(a) Name of the company [ ]

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

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

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

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

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

(b) *Whether any change in Financial Year ○ Yes ○ No

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

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

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

(i) Regulated [ ]

(ii) Non-Regulated [ ]

(b) Details of such Industries/ Sectors/ product(s)/ service(s) of the company

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

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

(ii) Details of such industries/sectors/products/services under non-regulated sectors

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

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

(i) Regulated

(ii) Non-Regulated

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

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

(b) (ii) Details of such Industries/ Sectors/ product(s)/service(s) of the company under non-regulated sector

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

(6) Details of the cost auditor(s) appointed

* (i)Number of cost auditor(s) appointed

(a). *Category of the auditor ◯ Individual ◯ Partnership firm ◯ Limited liability partnership (LLP)

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

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

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

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

(c) (i) Address * Line I

Line II

(ii) *City

(iii) *State

(iv) Country

(v)* Pin code

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

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

(e) *Type of appointment ◯ Original ◯ Appointment due to casual vacancy

◯ Appointment for new products/services/locations

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

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

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

If yes, please state

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

If yes, please state

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

If yes, please state

(d) *Whether the cost auditor's report contain any observations or suggestions

If yes, cost auditor's observations/ suggestions ◯ Yes ◯ No

Attachments

List of attachments

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

(2). Optional attachment, if any. — Attach

Remove attachment

Declaration

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

I have been authorized by the Board of Directors *resolution number *dated to sign and submit the application. (DD/MM/YYYY)

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

***To be digitally signed by**

DSC BOX

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

*Designation

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

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

Modify | Check Form | Prescrutiny | Submit

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

Illustration 1.

The following figures are extracted from the statement prepared by the Cost Accountant and the Trial Balance of ABC Ltd., which is a single product company:

(₹ In lakhs)

	31.03.2022	31.03.2021	31.03.2020
Net Sales	1,745	1,705	1,610
Raw Materials consumed	1,140	1,060	975
Direct Wages	35	32	27
Power and Fuel	30	27	24
Stores and Spares	6	5	4
Depreciation charged to production cost centres	16	15	13
Factory overheads:			
Salaries and wages	5	4	3
Depreciation	2	2	2
Rates and Taxes	1	1	1
Other overheads	6	5	4
Administrative overheads:			
Salaries and Wages	10	9	8
Rates and Taxes	2	2	2
Other overheads	162	154	148
Selling and distribution overheads:			
Salaries and Wages	7	6	5
Packing and Forwarding	6	6	5
Depreciation	1	1	1
Other overheads	124	118	108
Interest	85	74	68
Bonus and Gratuity	12	10	9
Gross Current Assets	840	724	640
Current Liabilities and Provisions	324	305	246

You are required to compute the following ratios as per requirement of Part D, Para 3 & 4 of the Annexure to Cost Audit Report under the Companies (Cost Records and Audit) Rules, 2014 for 3 years:

(i) Operating Profit as percentage of Value Addition.

(ii) Value Addition as percentage of Net Sales.

(iii) Note: The computation should be based on EBDIT as Operating Profit.

Solution:

	Year Ending (₹ In lakhs)		
	31.03.22	**31.03.21**	**31.03.20**
Net sales (A)	1,745	1,705	1,610

Cost of Sales excluding depreciation & Interest			
Raw Material consumed	1,140	1,060	975
Direct Wages	35	32	27
Power and Fuel	30	27	24
Stores and Spares	6	5	4
Factory overheads (excluding depreciation)	12	10	8
Administrative overheads (excluding depreciation)	174	165	158
Selling and distribution overheads (excluding depreciation)	137	130	118
Bonus and Gratuity	12	10	9
Total (B)	1,546	1,439	1,323
Operating Profit (A) - (B) =	199	266	287

Value addition is defined in Part D, Para 3 & 4 of the Annexure to Cost Audit Report under the Companies (Cost Records and Audit) Rules, 2014 as "the difference between the net output value (Net Sales) and cost of bought out materials and services for the product under reference".

The working will be :

	Year Ending		
	31.03.22	**31.03.21**	**31.03.20**
(X) Net sales	1,745	1,705	1,610
Less : (i) Cost of Bought Out Materials & Service (Raw Materials and Stores & Spares)	1,146	1,065	979
(ii) Power & Fuel, other bought out services	30	27	24
(iii) Over heads (excluding Salaries & Wages, Rates & Taxes and depreciation)	298	283	265
(Y) = (i) + (ii) + (iii)	1,474	1,375	1,268
Value Addition : (X) - (Y) =	271	330	342

	Year Ending		
	31.03.22	**31.03.21**	**31.03.20**
Hence,			
(a) Operating profit as % of Value Added	199/271	266/330	287/342
i.e.	73.43%	80.6%	83.92%
			= 84%
(b) Value Addition as % of Net Sales	271/1745	330/1705	342/1610
i.e.	15.53%	19.35%	21.24%

Illustration 2.

The following figures are obtained from the Cost Accounting Records of Sinjini Ltd. a single product manufacturing company:

Year ended 31st March	2022	2021
	(Amount in ₹ lakh)	
Net Sales	4,800	3,840
Other Income	300	200
Increase in Value of Stock of Finished Goods	20	10
Raw materials Consumed	1,760	1,440
Direct wages, Salaries, Bonus, Gratuity etc.	440	352
Power & Fuel	240	192
Stores and Spares	160	140
Cess and local Taxes	120	100
Other manufacturing Overheads	430	370
Administrative Overheads:		
Audit fees	36	30
Salaries & Commission to Directors	48	40
Other Overheads	260	220
Selling and Distribution Overheads:		
Salaries & Wages	36	30
Packing and Forwarding	20	16
Other Overheads	250	200
Total Depreciation	120	120
Interest Charges:		
On Working Capital Loans from Bank	60	25
On Fixed Loans from IDBI	90	70
On Debentures	30	30
Provision for Taxes	316	200
Proposed Dividends	420	230

You are required to calculate the following parameters as stipulated PART-D, PARA-3 of the Annexure to Cost Audit Report under the Companies (Cost Records and Audit) Rules, 2014 for the year ended March 31, 2022 and March 31, 2021:

(i) Value Addition

(ii) Earnings available for Distribution

(iii) Distribution of Earnings to the different claimants.

Solution:

Sinjini Ltd.

Calculation of Value Addition

(Amount in ₹ lakh)

	2022		2021	
Year ended March 31,				
VALUE ADDITION:				
Net Sales		4,800		3,840
Add: Export Incentives		-		-
Add/Less: Adjustment in Finished stocks		20		10
		4,820		3,850
Less: Cost of bought out input:				
(i) Cost of Raw materials consumed		1,760		1,440
(ii) Consumption of stores and spares		160		140
(iii) Power & Fuel		240		192
(iv) Other overheads		1,056		861
(430+36+260+20+250+60) = 1,056				
(370+30+220+16+200+25) = 861				
Total cost bought out input		3,216		2,633
(i) VALUE ADDED		1,604		1,217
Add: Other Income		300		200
(ii) Earnings Available for distribution		1,904		1,417
(iii) Distribution of earnings to:				
(a) Employees as salaries and wages, bonus, gratuity etc.		476		382
Directors- Salaries and Commission		48		40
(b) Shareholders as dividend		420		230
(c) Company as retained funds (including depreciation)		404		365
(d) Government as taxes				
Local Taxes:	120		100	
Income Taxes	316	436	200	300
(e) Providers of Capital/Fund as Interest on Debentures				
Interest on debentures	30		30	
Interest on Fixed loans from IDBI	90	120	70	100
Total distribution of earnings		1,904		1,417

Illustration 3.

The following figures are obtained from the Cost Accounting Records of Vennela Ltd. :

Year ended 31st March	2022	2021
Particulars	(Amount in ₹ lakhs)	
Net Sales	7,120	5,700
Other Income	450	300
Export Incentives	80	60
Increase in Value of Stock of Finished Goods	30	15
Raw materials consumed	2,640	2,160
Direct wages, salaries, bonus, gratuity etc.	660	528
Power & Fuel	360	288
Stores and spares	240	210
Other manufacturing overheads	645	555
Administrative Overheads :		
Audit fees	54	45
Salaries & commission to directors	72	60
Other overheads	390	330
Selling and distribution overheads :		
Salaries & Wages	54	45
Packing and forwarding Other overheads	30 375	24 300
Total depreciation	180	180
Interest Charges :		
On working capital loans from Bank	90	75
On fixed loans from IDBI	135	105
On Debentures	45	45
Tax paid including provisions	474	300
Dividend paid	630	345
Dividend Distribution Tax	110	60

You are required to calculate the following parameters as stipulated PART-D, PARA-3 of the Annexure to Cost Audit Report under the Companies (Cost Records and Audit) Rules, 2014 for the year ended March 31, 2022 and March 31, 2021:

(i) Value addition

(ii) Earning available for Distribution

(iii) Distribution of Earning to the different claimants

Solution:

Annexure to Cost Audit Report:

Part D-3: Value Addition And Distribution Of Earnings (For **Vennela Ltd.** as a whole)

(Amount In ₹ lakhs)

SI.	**Particulars**	**Current**	**Previous**
No.		**Year 2021-22**	**Year 2020-21**
	Value Addition:		
1.	Net Sales	7120	5700
2.	Add: Export incentives	80	60
3.	Add:/ (Less) Adjustment In Finished Stocks	30	15
		7,230	5,775
	Less: Cost of bought out input:		
	(a) Cost of Raw materials consumed	2,640	2,160
	(b) Consumption of stores and spares	240	210
	(c) Power & Fuel	360	288
	(d) Other overheads	1,584	1,329
	(645+54+390+30+375+90) = 1584		
	(555+45+330+24+300+75) = 1329		
	Total cost bought out inputs	**4,824**	**3,987**
4.	Value Added:	2,406	1,788
5.	Add: Other income	450	300
6.	Add: Extra ordinary income	---	-----
7.	Earnings available for distribution	**2,856**	**2,088**
	Distribution of earnings to:		
(a)	Employees as salaries and wages, bonus, gratuity etc.	714	573
	Directors- Salaries and commission	72	60
(b)	Shareholders as dividend	630	345
(c)	Company as retained funds (including depreciation)	676	600
(d)	Government as taxes		
	Dividend Distribution Taxes	110	60
	Income taxes paid (including provisions)	<u>474</u>	<u>300</u>
		584	360
(e)	Providers of Capital/Fund as Interest on Debentures:		
	Interest on Debentures:	45	45
	Interest on Fixed Loans from IDBI	<u>135</u>	<u>105</u>
		180	150
	Total distribution of earnings	**2,856**	**2,088**

Illustration 4.

In the Financial Accounts of Chemicals & Fertilizers Ltd. for the year ended March 31, 2022 the profit was ₹8,98,07,500. The profit as per Cost Accounting records for the same period was less. The following details are extracted from the accounting schedules and Cost Accounting records of the company.

	Financial Accounts ₹ '000	Cost Accounts ₹ '000
Opening : Semi Finished Goods	31700	35210
: Finished Goods	83220	78590
Closing : Semi Finished Goods	35260	39420
: Finished Goods	89320	80450
Urea & Transport subsidy	348	
Expenses on CSR	56	
Profit on sale of Fixed Assets	150	
Chemical used internally	382	365
Favourable Exch. Rate variation	294	
Post-retirement Medical grant	584	
Purchase Tax Refund	453	
Litigation Recovery-Prior year	125	

You are required to prepare a Reconciliation Statement and arrive at the Profit as per Cost Records for the year ended March 31, 2022.

Solution:

Chemicals & Fertilizers Ltd.

Reconciliation of financial profit and costing profit for the year ended March 31, 2022

Amount in ₹ thousand

Profit or loss as per Financial Accounts		89807.50
A. Less: Incomes not considered in Cost Accounts:		
i. Profit on sale of Fixed Assets	150	
ii. Urea & Transport Subsidy	348	
iii. Litigation Recovery-Prior year	125	
iv. Favorable Exch. Rate Variation	294	
v. Purchase tax Refund	453	
vi. Own consumption (chemicals) valuation difference (382-365)	17	(1387.00)
B. Add: Expenses not considered in Cost Accounts		
i. Expenses on CSR	56	
ii. Post-retirement medical grant	584	640.00
C. Less:		
Difference in Valuation of stock between Financial Accounts and Cost Accounts (9660-6070) (workings)		(3590.00)
Profit as per Cost Accounts		85470.50

Workings:

Current Year (2021-22) (Amount in ₹ thousand)

	Financial Accounts	Cost Accounts
Opening Semi finished	31700	35210
Finished	83220	78590
Total	**114920**	**113800**
Closing semi finished	35260	39420
Finished	89320	80450
Total	**124580**	**119870**
Variation in inventory	9660	6070

Increase in Difference of stock valuation towards financial accounts = ₹3590

Illustration 5.

Auto Parts Manufacturing Company Ltd. showed a profit for the year 2021-22 as ₹ 35,46,700. During the course of Cost Audit, the followings transactions were noticed:

(i) an old machine with net value of ₹ 6,54,000 was sold off for ₹ 9,30,000,

(ii) dividend income was received amounting to ₹ 84,500 from investments,

(iii) a sum of ₹ 58,000 was spent towards CSR commitment,

(iv) the company was engaged in trading activity where purchase of goods was ₹13,50,000 and sales was ₹13,42,300, after incurring ₹ 40,800 as expenditure,

(v) some renovation work was carried out at a cost of ₹ 7,75,000 and its useful life was only for five years, and

(vi) the closing inventory of raw material was undervalued ₹ 29,600 and that of finished goods was overvalued ₹65,400 in the financial records. Work out the Profit as per the Cost Accounts.

Solution:

Reconciliation of Profit between Cost Accounts and the Financial Accounts of Auto Parts Manufacturing Company Ltd. for the year 2021-22.

Particulars	₹	₹
Profit as per the Financial Accounts		**35,46,700**
Add: Trading Loss	48,500	
4/5th of Renovation Expenses Amortized	6,20,000	
CSR Contribution	58,000	7,26,500
Less: Profit on Sale of Assets	2,76,000	
Income from Investments	84,500	
Net overvaluation of closing inventory in the Financial records ₹ (65,400 - 29,600)	35,800	(-) 3,96,300
Profit as per the Cost Accounts		**38,76,900**

Illustration 6.

The profit as per financial accounts of M/s Kalingpong Himalaya Private Company for the year 2021-22 was ₹1,54,28,642. The profit as per Cost Accounting Records for the same period was less. You are required to prepare a reconciliation statement and arrive at the profit as per Cost Records. The following details are collected from the financial schedules and cost accounting records:

	Financial Accounts	Cost Accounts
Valuation of Stock		
Opening: WIP	25,62,315	22,65,710
Finished Goods	2,65,47,520	2,92,18,950
Closing : WIP	42,75,640	37,36,346
Finished Goods	3,72,59,430	4,35,25,149
Interest income from inter-corporate deposits	6,15,340	—
Donations given	4,85,560	—
Loss on Sale of Fixed Assets	1,22,546	—
Value of cement taken for own consumption	3,82,960	3,65,426
Cost of Power drawn from own Wind Mill		
— At EB tariff	—	49,56,325
— At cost	36,20,370	—
Non-operating income	45,36,770.	—
Voluntary retirement compensation	16,76,540	—
Insurance claim relating to previous year received during the year	14,35,620	—

Solution:

Working:

Computation in difference in Valuation of Stock

	Financial Accounts	Cost Accounts
Opening (WIP & FG) Closing (WIP & FG)	2,91,09,835 4,15,35,070	3,14,84,660 4,72,61,495
	1,24,25,235	1,57,76,835

Reconciliation of Financial Profit and Costing Profit

	₹	₹
Profit as per Financial Accounts		1,54,28,642
Add: Difference in Stock Valuation	33,51,600	
Loss on Sale of Fixed Assets	1,22,546	
Donation not considered in Cost Records	4,85,560	
Voluntary retirement compensation not		
included in cost	16,76,540	56,36,246
		2,10,64,888
Less: Non-operating income	45,36,770	
Less: Interest income from intercorporate deposit	6,15,340	
Difference in value of cement taken for own consumption	17,534	
Difference in valuation of windmill power (₹49,56,325 – 36,20,370)	13,35,955	
Insurance claim relating to previous year	14,35,620	79,41,219
Profit as per Cost Accounts		1,31,23,669

Illustration 7.

The Cost Accountant of TRINCUS TEXTILES MILLS LTD. has arrived at a Profit of ₹ 20,10,500 based on Cost Accounting Records for the year ended March 31, 2022. Profit as per Financial Accounts is ₹ 22,14,100.

As a Cost Auditor, you find the following differences between the Financial Accounts and Cost Accounts:

		₹
(1)	Profit on Sale of Fixed Assets	2,05,000
(2)	Loss on Sale of Investments	33,600
(3)	Voluntary Retirement Compensation included in Salary & Wages in F/A	50,25,000
(4)	Donation Paid	75,000
(5)	Insurance Claim relating to previous year received during the year	5,08,700
(6)	Profit from Retail trading activity	32,02,430
(7)	Interest Income from Inter-Corporate Deposits	6,15,000
(8)	Decrease in value of Closing WIP and Finished goods inventory	
	as per Financial Accounts	3,82,06,430
	as per Cost Accounts	3,90,12,500

You are required to prepare a Reconciliation Statement between the two Accounts for the year ended March 31, 2022.

Solution:

Reconciliation of Profit between Cost and Financial Accounts

for the year ended March 31, 2022

		₹	₹
Profit as per Financial Accounts:			22,14,100
Add: Loss on sale of investments		33,600	
Add: Voluntary Retirement compensation included in salary		50,25,000	
and wages in F/A - Not included in cost A/c		75,000	51,33,600
Add: Donation paid			73,47,700
Less: Profit on Sale of Fixed Assets-Not considered in cost A/c		2,05,000	
Less: Receipts of insurance claim related to previous year		5,08,700	
Less: Profit from Retail trading activity		32,02,430	
Less: Interest income from inter-corporate deposit-not considered in cost accounts		6,15,000	
Less: Difference in valuation of stock:			
Decrease in inventories as per cost accounts	3,90,12,500		
Decrease in inventories as per financial accounts	(–) 3,82,06,430	8,06,070	53,37,200
Profit as per Cost Accounts			20,10,500

Illustration 8.

The Financial Profit and Loss of M/s. VGM Manufacturing company Ltd. for the year is ₹28,75,000. During the course of cost audit, it is noticed the followings:

(i) Some Old assets sold off which fetched a profit of ₹ 1,25,000

(ii) Interest was received amounting to ₹ 45,000 from outside the business investment.

(iii) Work-in-progress valuation for financial accounts does not as a practice take into account factory overhead. Factory overhead is ₹ 2,15,000 in opening W-I-P and ₹ 2,45,000 in closing W-I-P.

(iv) The Company was engaged in Trading activity by purchasing goods of ₹ 11,15,845 and selling at ₹ 13,12,850 after incurring ₹ 35,000 as expenditure.

(v) A major overhaul of machinery was carried out at a cost of ₹ 5,50,000 and next such overhaul will be done only after five years.

(vi) Opening stock of raw material and finished goods was overvalued for ₹ 2,00,000 and closing stock was overvalued ₹ 1,85,000 in financial records.

Work out the profit as per Cost Accounts.

Solution:

Reconciliation of Profit between Cost Accounts and Financial Accounts of M/s. VGM Manufacturing Company Ltd.

Particulars	₹	₹
Profit as per Financial Accounts		28,75,000
Add: Difference in valuation of W-I-P	30,000	
Proportionate charge i.e. four-fifth for overhaul of machinery	4,40,000	
Overvaluation of Opening Stock in the financial records	2,00,000	6,70,000
Less: Profit on sale of old assets not included in Cost A/cs	1,25,000	
Interest received from outside investment	45,000	
Trading profit not included in cost accounts	1,62,005	
Overvaluation of closing stock in the financial records	1,85,000	(-) 5,17,005
Profit as per Cost Accounts		**30,27,995**

Illustration 9.

(a) Ambica Textile Mills produced cloth and fabrics. In addition, they undertook customer's job order for processing of cloth towards optimum utilisation of its spare capacity and earned from loan licence. From the following Income figures.

Find out the turnover of the company as per the Companies (Cost Records and Audit) Rules:

Income	(₹ in lakh)
Sales	19,300
Trading Sales from Depots	1,250
Export Income	2,100
Export Duty	450
Income from Job Processing	1,100
Scrap Sale	235
Income from Loan Licence operations	560

(b) The financial profit and loss account for the year 2021-22 of a company shows a net profit of ₹29,60,000. During the course of Cost Audit, it was noticed that:

(i) The company was engaged in trading activity by purchasing goods at ₹ 6,00,000 and selling it for ₹7,50,000 after incurring repacking cost of ₹ 25,000,

(ii) Some discarded assets sold off with no scrap value for ₹ 90,000,

(iii) Some renovation of machinery was carried out at a cost of ₹ 6,00,000, having a productive life of five years, but entire amount was charged to financial accounts

(iv) Interest was received amounting to ₹ 1,40,000 from outside investments

(v) Voluntary Retirement payment of ₹3,50,000 was not included in the Cost Accounts,

(vi) Insurance claim of previous year was received to the extent of ₹ 2,50,000 but was not considered in the Cost Accounts.

(vii) Opening stock or raw materials and finished goods was overvalued by ₹ 2,40,000 and closing stock of finished goods was overvalued by ₹1,10,000 in the financial accounts, and

(viii) Donation of ₹80,000 towards CSR commitment was not considered in the Cost Accounts.

Work out the profit as per the Cost Accounts and briefly explain the adjustment, if any, carried out.

Solution:

(a) As per the Companies Act, 2013, Turnover means gross turnover made by the company from the sale or supply of all products and services during a financial year but excluding duties and taxes.

Income	₹ in Lakh
Sales	19,300
Trading Sales from Depots	1,250
Export Income	2,100
Income from Job Processing	1,100
Scrap Sale	235
Income from Loan License Operations	560
Total Turnover	24,545

(b) Profit Reconciliation as per Cost and Financial Records for the year 2021-22

	Particulars	**₹ in ’000**	**₹ in ’000**
1	Profit as per Financial Accounts for Audited Products		29,60,000
2	Less : Incomes not considered in the Cost Accounts		
	a) Trading Profit (7,50,000-6,00,000-25,000)	1,25,000	
	b) Profit on Sale of Old Assets	90,000	
	c) Interest received from Outside Investments	1,40,000	
	d) Insurance claim for previous year received	2,50,000	
	Total		(–) 6,05,000
3	Add : Expenses not considered in the Cost Accounts		
	a) Donation towards CSR Commitment	80,000	
	b) VRS Expenses	3,50,000	
	c) Renovation (4/5th Outlay of 600000)	4,80,000	
	Total		9,10,000
4	Valuation of stocks (240000-110000)(Overvaluation of opening stock and closing stock in financial accounts)		1,30,000
5	Other adjustments		—
	Profit as per the Cost Accounts		33,95,000

Solved Cases on Applicability of Rule 4 read with Rule 3 – coverage of Cost Audit under different turnover criteria

Case 1: M/s. XYZ & Co. Ltd. furnishes the following information in regard to the immediately preceding Financial Year:

Turnover of Table A Products under Rule 3 is ₹ 6 crore

Turnover of Table B Products under Rule 3 is ₹ 9 crore

Turnover of other products is ₹ 18 crore

Find out the applicability of :

(a) Cost Records under Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

(b) Cost Audit under Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

Solution:

In this case the following position emerges:

(a) Overall Turnover is ₹ 33 crore i.e. ≤ ₹ 35 crore. Therefore Cost Records are not required to be maintained for Table A and Table B Products.

(b) Since the Cost Records are not required to be maintained under Rule 3, the question of Cost Audit does not arise.

Case 2: M/s. ABC Ltd. furnishes the following information in regard to the immediately preceding Financial Year:

Turnover of Table A Products under Rule 3 is ₹ 7 crore

Turnover of Table B Products under Rule 3 is ₹ 8 crore

Turnover of other products is ₹ 24 crore

Find out the applicability of :

(a) Cost Records under Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

(b) Cost Audit under Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

Solution:

In this case the following position emerges:

(a) Overall Turnover is ₹ 39 crore i.e. ≥ ₹ 35 crore. Therefore Cost Records are required to be maintained for Table A and Table B Products irrespective of individual turnover of the products.

(b) Overall Turnover is ₹ 39 crore i.e ≤ ₹ 50 crore and aggregate Turnover of the Products under Rule 3 (Table A &Table B products) is Rs. 15 Crore, which is less than the threshold limit of ₹ 25 crore. Since the Conditions of Rule 4(1) and 4(2) of the Companies (Cost Records and Audit) Rules, 2014 (as amended) are not fulfilled, hence Cost Audit is not applicable for products either under Table A or Table B.

Case 3: M/s. B. K. Pvt. Ltd. furnishes the following information in regard to the immediately preceding Financial Year:

Turnover of Table A Products under Rule 3 is ₹ 11 crore

Turnover of Table B Products under Rule 3 is ₹ 14 crore

Turnover of other products is ₹ 28 crore

Find out the applicability of :

(a) Cost Records under Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

(b) Cost Audit under Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

Solution:

In this case the following position emerges:

(a) Overall Turnover is ₹ 53 crore i.e. ≥ ₹ 35 crore. Therefore Cost Records are required to be maintained for Table A and Table B Products.

(b) Overall Turnover is ₹ 53 crore i.e. ≥ ₹ 50 crore and aggregate Turnover of the Products under Rule 3 (Table A & Table B products) is ₹ 25 Crore. Since the conditions of Rule 4(1) of the Companies (Cost Records and Audit) Rules, 2014 (as amended) are fulfilled, therefore Cost Audit is applicable only for Table A Products.

Case 4: M/s. Sun Enterprise Ltd. furnishes the following information in regard to the immediately preceding Financial Year:

Turnover of Table A Products under Rule 3 is ₹ 19 crore

Turnover of Table B Products under Rule 3 is ₹ 15 crore

Turnover of other products is ₹ 76 crore

Find out the applicability of :

(a) Cost Records under Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

(b) Cost Audit under Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

Solution:

In this case the following position emerges:

(a) Overall Turnover is ₹ 110 crore i.e. ≥ ₹ 35 crore. Therefore Cost Records are required to be maintained for Table A and Table B Products.

(b) Overall Turnover is ₹110 crore i.e. ≥ ₹ 100 crore and aggregate Turnover of the Products under Rule 3 (Table A & Table B products) is ₹ 34 Crores i.e. ≥ ₹ 25 Crore but ≤ ₹ 35 crore. Conditions of Rule 4(1) of the Companies (Cost Records and Audit) Rules, 2014 (as amended) are fulfilled and cost audit is applicable for Table A Products.

Though the overall turnover is more than ₹ 100 crore, aggregate Turnover of the Products under Rule 3 (Table A & Table B products) is less than ₹ 35 crore [Rule 4(2)]. That is why, Table B products are not covered under cost audit.

Case 5: M/s. Alpha Pvt. Ltd. furnishes the following information in regard to the immediately preceding Financial Year:

Turnover of Table A Products under Rule 3 is ₹ 20 crore

Turnover of Table B Products under Rule 3 is ₹ 22 crore

Turnover of other products is ₹ 63 crore

Find out the applicability of :

(a) Cost Records under Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

(b) Cost Audit under Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 (as amended)

Solution:

In this case the following position emerges:

(a) Overall Turnover is ₹ 105 crore i.e. $\geq$ ₹ 35 crore. Therefore Cost Records are required to be maintained for Table A and Table B Products.

(b) Overall Turnover is ₹ 105 crores i.e. $\geq$ ₹ 100 crores and aggregate Turnover of the Products under Rule 3 (Table A & Table B products) is ₹ 42 Crores i.e. $\geq$ ₹ 35 crores. Since the conditions of Rule 4(1) and Rule 4(2) of the Companies (Cost Records and Audit) Rules, 2014 (as amended) are fulfilled, Cost Audit is applicable for both Table A and Table B Products.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. The applicability of cost audit under Companies (Cost Records & Audit) – Rules, 2014 for regulated industries having overall annual turnover during immediate preceding financial year is ____.

   (a) ₹25.00 crores or more

   (b) ₹35 .00 crores

   (c) ₹50.00 crores or more

   (d) ₹100.00 crores

2. The Company has to upload CRA-4 electronically to the MCA under the rule ______ of Companies (Cost Records & Audit) Rules, 2014

   (a) Rule 5 (1)

   (b) Rule 6 (2)

   (c) Rule 4 (6)

   (d) Rule 6 (6)

3. The form in which the cost records shall be maintained .

   (a) CRA-1

   (b) CRA-2

   (c) CRA-3

   (d) CRA-4

4. Which of the following type of Electricity Company is under the purview of regulated sector?

   (a) Engaged in Generation

   (b) Engaged in Transmission

   (c) Engaged in Distribution & Supply

   (d) All the above

5. Which one of the below is not a regulated industry?

   (a) Telecommunication

   (b) Electricity

   (c) Drugs & Pharmaceuticals

   (d) Automobile

6. Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal to be filled by the Board of Directors within __________days of occurrence of such vacancy.

   (a) 30 days

   (b) 60 days

   (c) 90 days

   (d) 7 days

State True or False

1. Micro enterprise or a small enterprise or a medium enterprise as per MSMED Act, 2006, with a overall turnover of ₹ 37.00 crores, have been taken out of the purview of Companies (Cost Records & Audit) Rules, 2014.

2. The requirement for maintenance of cost record under the rule 3 of Companies (Cost Records & Audit) Rules, 2014 shall apply to a company whose total revenue is ₹ 200 crores and revenue from exports, in foreign exchange, exceeds seventy-five per cent of its total revenue.

3. Every cost auditor shall forward his duly signed report to the Audit Committee of the company within a period of 180 days from the closure of the financial year.

4. The tenure of Cost Auditor expires on the completion of one hundred and eighty days from the closure of the financial year.

5. Provisions of section 139, 143, 144 and 145 of the Companies Act, 2013 is applicable to Cost auditor.

Fill in the Blanks

1. Every cost auditor, who conducts an audit of the cost records of a company, shall submit the cost audit report in form_____.

2. Company should furnish the Cost Audit report within a period of _____ days from the date of receipt of a copy of the cost audit report to the Central Government.

3. The cost auditor shall forward his duly signed report to the Board of Directors of the company within a period of 180 days from the closure of the financial year i.e. _______ September of the relevant financial year.

4. The maximum fine for default in provisions of section 148 of the Companies Act, 2013 is _______

Short Essay Type Questions

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

B. Practical Questions

- **Unsolved Case**

M/s Alfa Transformers Ltd. (ATL), a listed company manufacturing transformers under CTA code 8502 is having two manufacturing location one in SEZ and other in non-SEZ area

The details of turnover of above two units for F.Y.2021-22 is as follows

1. Location SEZ ₹ 75.00 crores
2. Location Non - SEZ ₹ 30.00 crores

The Managing Director of the company seeks your opinion with regard to maintenance of cost records and cost audit with respect to both the units.

Answer:

Multiple Choice Questions

1.	(c) ₹ 50.00 Crore
2.	(d) Rule 6 (6)
3.	(a) CRA-1
4.	(d) All the Above
5.	(d) Automobile
6.	(a) 30 days

State True or False

1.	False- As per Rule-3 of Companies (Cost Records & Audit) Rules, 2014 only a micro enterprise or a small enterprise as per MSMED Act, 2006 have been taken out of the purview.
2.	False- As per Rule-4 (3) of Companies (Cost Records & Audit) Rules, 2014 the requirement for cost audit shall **not** apply to a company whose revenue from exports, in foreign exchange, exceeds seventy-five per cent of its total revenue even though it is covered in rule 3.
3.	False- Every cost auditor shall forward his duly signed report to the Board of Directors of the company within a period of 180 days from the closure of the financial year.
4.	False- As per Rule-6 (3) of Companies (Cost Records & Audit) Rules, 2014, the tenure of Cost Auditor expires of one hundred and eighty days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.
5.	True (Ref. sec. 148(8)(B)

Fill in the Blanks

1.	CRA-3
2.	30 days
3.	27^{th} of September
4.	₹ 5.00 Lacs

Cost Auditor 3

This Module includes:

3.1 Definition

3.2 Cost Auditor's Eligibility, Qualifications, Disqualifications, Appointment, Registration, Rotation, Remuneration, Removal, Rights and Duties, Liabilities

3.3 Professional Ethics

3.4 Duties of a Cost Auditor to Report Fraud - Section 143 of the Companies Act 2013

3.5 Punishment for Fraud (Section 447 of the Companies Act, 2013)

3.6 Punishment for False Statement (Section 448 of the Companies Act, 2013)

Cost Auditor

SLOB Mapped against the Module

To gain in-depth knowledge about the statutory provisions of Companies (Cost Records and Audit) Rules to ensure adherence to the regulations in conducting cost audit. (CMLO 4a, b)

Module Learning Objectives:

This module helps to know about the Professional Behaviour of the cost auditor while meeting his responsibilities to clients, third parties, other members of the cost and management accounting profession, staff, employers and the general public. After studying this module, the students will be able to –

- Know about the Eligibility, Qualifications, Disqualifications, Appointment, Resignation, Rotation, Remuneration, Removal, Rights and Duties, Liabilities of a Cost Auditor
- Sustain the Professional Ethics of a Cost Auditor
- Identify the Duties of a Cost Auditor to Report Fraud
- Acquaint regarding the provisions associated with Punishment for Fraud and False Statement

Definition

3.1

Companies (Cost Records and Audit) Rules, 2014 defines Cost Auditor as under :

"Cost auditor" means a Cost Accountant in practice, as defined in clause (b), who is appointed by the Board; This definition is given under Rule 2(c).

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

Each and every member of the profession in practice is required to follow certain professional ethics and codeof conduct as prescribed by the Cost and Works Accountants Act, 1959 and Regulations there under.

Section 22 of the Cost and Works Accountants Act, 1959 defines that, the expression "professional or other misconduct" shall be deemed to include any act or omission provided in any of the Schedules but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under sub-section (1) of section 21 of the Cost and Works Accountants Act, 1959 to inquire into the conduct of any member of the Institute under any other circumstances.

This definition under section 22 of the Cost and Works Accountants Act, 1959 read with the two schedules to the Act clarifies or indicates that the schedules provide an illustrative list of acts and omissions constituting "professional or other misconduct".

These are in addition to duty of Cost Auditor to report fraud under Section 143 (12) of the Companies Act 2013.

Cost Auditor's Eligibility, Qualifications, Disqualifications, Appointment, Resignation, Rotation, Remuneration, Removal, Rights and Duties, Liabilities

3.2

Section 139 to 148 provide for the qualifications, disqualifications, appointment, removal, rights & duties and liabilities of company auditors to be read with Companies (Audit and Auditors) Rules, 2014. Some of the Rules are discussed hereunder. Section 148(5) provides the provisions applicable to statutory auditors will also apply to cost auditors.

Cost Auditor's Eligibility

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

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

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

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

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

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

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

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

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

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

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

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

(l) Any person whose subsidiary or associate company or any other form of entity, is engaged as on date of appointment in providing specialised services to the company and its subsidiary companies as below:

 (a) Accounting and book keeping services

 (b) Internal audit

 (c) Design and implementation of any financial information system

 (d) Actuarial services

 (e) Investment advisory services

 (f) Investment banking services

 (g) Rendering of outsourced financial services

 (h) Management services

 [Section 141(3)(i) and Section 144]

Qualifications

As per Section 141 of Companies Act, 2013, the following persons should be considered as qualified for being a company auditor:

(i) A person shall be eligible for appointment as an auditor of a company, only if he is a Chartered Accountant [Section 141(1)].

(ii) A firm can also be appointed by its firm name to act as the auditor of a company if majority of its partners practicing in India are qualified for appointment as company auditor [Section 141(1)].

(iii) Where a firm, including a limited liability partnership, is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorized to act and sign on behalf of the firm [Section 141(2)].

Note: In this context, the meaning of the term ‘Chartered Accountant’ shall be interpreted based on the provisions of The Chartered Accountants Act, 1949 as follows:

(i) “Chartered Accountant” means a person who is a member of the Institute [Section 2].

(ii) A person is a member of the Institute if his name appears in the Register of the Institute [Section 3].

(iii) The following persons shall be entitled to have his name entered in the Register [Section 4]:

 (a) any person who is a registered accountant or a holder of a restricted certificate at the commencement of this Act.

 (b) any person who has passed such examination and completed such training as may be prescribed for members of the Institute.

 (c) any person who has passed the examination for the Government Diploma in Accountancy or an examination recognized as equivalent thereto by the rules for the award of the Government Diploma in Accountancy before the commencement of this Act and fulfils such conditions as specified by the Central Government in this behalf.

(d) any person who, at the commencement of this Act, is engaged in the practice of accountancy in any State and fulfils such conditions as specified by the Central Government in this behalf.

(e) any person who has passed such other examination and completed such other training without India as is recognized by the Central Government or the Council as being equivalent to the examination and training prescribed for members of the Institute.

(f) any person domiciled in India, who at the commencement of this Act is studying for any foreign examination and is at the same time undergoing training, whether within or without India, have passed the examination or completes the training within five years after the commencement of this Act.

In order to become the member of the Institute, the aforesaid persons must reside in India or must be in practice in India. For any person outside India with all other requisite qualifications, the Central Government or the Institute may impose additional conditions. Moreover, any qualified persons will have to formally apply for the membership to the Institute with requisite fees. His name will be included in the Register only if the application is accepted.

Disqualifications

As per Section 141(3), read with Rule 10 of Company (Audit and Auditor) Rule 2014, the following persons shall not be eligible for appointment as an auditor of a company:

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company;

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

(d) a person who, or his relative or partner:

  (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company, of face value not exceeding rupees one lakh;

  (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh;

  (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees one lakh;

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

> **Note:** For this purpose, the term 'business relationship' shall be construed as any transaction entered into for a commercial purpose, except –
>
> (a) commercial transaction which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Companies Act, 2013 or the Chartered Accountants Act, 1949 and the rules or regulations made under those Acts;
>
> (b) commercial transactions which are in the ordinary course of business of the company at arm's length price–like sale of products or services to the auditor as customer.

(f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(i) a person who, directly or indirectly, renders any service referred to in Section 144 to the company or its holding company or its subsidiary company.

Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor [Section 141(4)].

Appointment

As per Section 148(3) of the Companies Act 2013, cost audit shall be conducted by a Cost Accountant who shall be appointed by the Board. No person appointed under Section 139 as an auditor of the company shall be appointed for conducting the audit of cost records. The auditor so appointed shall comply with the cost auditing standards

As per Rule 6 of the Companies (Cost Records & Audit) Rules 2014 (as amended)

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

Provided that before such appointment is made, the written consent of the cost auditor to such appointment, and a certificate from him or it, as provided in sub-rule (1A), shall be obtained

(1A) The cost auditor appointed under sub-rule (1) shall submit a certificate that—

(a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act, the Cost and Works Accountants Act, 1959(23 of 1959) and the rules or regulations made thereunder;

(b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Act, so far as may be applicable;

(c) the proposed appointment is within the limits laid down by or under the authority of the Act; and

(d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct."

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

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

Provided that the cost auditor appointed under these rules may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the Cost Auditor and recording the reasons for such removal in writing;

Provided further that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect;

Provided also that nothing contained in this sub-rule shall prejudice the right of the cost auditor to resign from such office of the company;

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

(3B) The cost statements, including other statements to be annexed to the cost audit report, shall be approved by the Board of Directors before they are signed on behalf of the Board by any of the director authorised by the Board, for submission to the cost auditor to report thereon

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

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

(6) Every company covered under these rules shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report alongwith full information and explanation on every reservation or qualification contained therein, in Form CRA-4in Extensible Business Reporting Language format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 alongwith fees specified in the Companies (Registration Offices and Fees) Rules, 2014.".

"Provided that the Companies which have got extension of time of holding Annual General Meeting under section 96(1) of the Companies Act, 2013, may file form CRA-4 within resultant extended period of filing financial statements under section 137 of the Companies Act, 2013".

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

Resignation

The auditor shall file within 30 days from the date of resignation, a statement in prescribed form with the company and the registrar;

If fails to comply with sub-section (2), punishable with fine not less than ₹50,000 but may extend to ₹5,00,000.

Rotation

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

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

Remuneration

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

Remuneration of the Cost Auditor:

For the purpose of sub-section (3) of section 148,—

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

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

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

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

Removal

The cost auditor may be removed before the term by Board resolution after giving reasonable opportunity of hearing and recording the reasons for removal.

As per Rule 6 of the Companies (Cost Records & Audit) Rules 2014 (as amended), any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal to be filled by the Board of Directors within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within thirty days of such appointment of cost auditor.

Rights and Duties

Under Section 143 of the Companies Act, 2013

(1) Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely:

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries and associates companies in so far as it relates to the consolidation of its financial statements with that of its subsidiaries and associates companies.

(2) The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as prescribed in rule 11 of chapter X under Act.

(3) the auditor's report shall also state—

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the report on the accounts of any branch office of the company audited under sub- section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls;

(j) such other matters as may be prescribed.

(4) Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons therefor.

(5) In the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Government, or partly by the Central Government and partly

by one or more State Government, the Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 and direct such auditor the manner in which the accounts of the company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

(6) The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report under sub-section (5) have a right to,

(a) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorise in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor- General of India may direct; and

(b) comment upon or supplement such audit report. Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub section (1) of section 136 and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

(7) Without prejudice to the provisions of this Chapter, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139 of Companies Act, 2013, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor- General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

(8) Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as prescribed in rule 12 of chapter X under the Act.

(9) Every auditor shall comply with the auditing standards.

(10) The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

(11) The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

Provided that until the National Financial Reporting Authority is constituted under section 132, the Central Government may hold consultation required under this sub- section with the Committee chaired by an officer of the rank of Joint Secretary or equivalent in the Ministry of corporate Affairs and the committee shall have the representatives from the Institute of Chartered Accountants of India and Industry Chambers and also special invitees from the National Advisory Committee on Accounting Standards and the office of the Comptroller and Auditor-General.

(12) Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as prescribed in rule 13 of chapter X under the act, is being or has been committed in the company by its officers or employees the auditor shall report the matter to the Central Government within such time and in such manner as prescribed in rule 13 of chapter X under the Act:

Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed in rule 13 of chapter X under the Act:

Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as prescribed in rule 13 of chapter X under the Act.

(13) provides that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.

(14) The provisions of this section shall mutatis mutandis apply to— (a) the cost accountant in practice conducting cost audit under section 148; or (b) the company secretary in practice conducting secretarial audit under section 204.

(15) If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12), he shall –

(a) in case of a listed company, be liable to a penalty of five lakh rupees; and

(b) in case of any other company, be liable to a penalty of one lakh rupees.

Companies Act, 2013 : Strategic Positions

Cost Accountant as a Key Managerial Person

- Section 203 provides for the appointment of Key Managerial Person
  - Managing Director or Chief Executive Officer or manager and in their absence, a whole time director;
  - Company Secretary; and
  - Chief Financial Officer.

  By virtue of qualification and experience, a Cost Accountant can become Key Managerial Person in the company.

Cost Accountant as an Independent Director

- Section 149 (4) provides that every listed public company shall have at least one third of total number of directors as independent directors.

- Rule 5 of the Companies (Appointment and Qualification of Directors) Rules, 2014 prescribes the qualification of an independent director who shall possess appropriate skills, experience and knowledge in one or more field of finance, law, management, sales, marketing, administration, research, Corporate Governance, technical operations or other disciplines related to the companies business.

  The Cost Accountant having expertise in most of the above fields can become independent director as stipulated in the Companies Act, 2013.

- **Technical Member of the Tribunal -** As per Section 409 (3) , a Cost Accountant in Practice having at least fifteen years service is eligible to be appointed as a Technical Member of the National Company Law Tribunal.

- **Technical Member of the Appellate Tribunal -** As per Section 411(3), a Cost Accountant, either in employment or in practice, who is having experience of more than 25 years in the prescribed areas is eligible to be appointed as Technical Member of the National Company Law Appellate Tribunal.

- **Company Liquidator -** Section 275 (2) provides that the provisional liquidator or the Company Liquidator, as the case may be, shall be appointed from a panel maintained by the Central Government consisting the names of Chartered Accountants, Advocates, Company Secretaries, **Cost Accountants** or firms or bodies corporate having at least 10 years experience in company affairs.

- **Administrator -** Section 259 (Chapter XIX dealing with revival of sick companies) of the Companies Act provides for the appointment of administrator. The said section provides that the interim administrator or the company administrator, as the case may be, shall be appointed by the Tribunal from a data bank maintained by the Central Government or any institute or agency authorized by the Central Government in a manner as may be prescribed consisting of the names of Company Secretaries, Chartered Accountants, **Cost Accountants** and such other professionals as may, by notification, be specified by the Central Government.

Cost Accountant as an Expert

- Section 2(38) defines the term 'expert' which includes an engineer, a valuer, a Chartered Accountant, a Company Secretary, a **Cost Accountant** and any other person who has the power or authority to issue a certificate in pursuance of any law for the time being in force.

- Section 211 (2) provides that the **Serious Fraud Investigation Officer** shall be headed by a Director and consists of such number of experts from the following fields to be appointed by the Central Government from amongst persons of ability, integrity and experience in-

  – banking;

  – corporate affairs;

  – taxation;

  – forensic audit;

  – capital market;

  – information technology;

  – law; or

  – such other fields as may be prescribed.

- **Cost Accountant by virtue of definition in Section 2(38) and having much experience in the above said field may be appointed as an expert.**

Registered Valuers

- Section 247 deals with registered valuers.
- Section 247(1) provides that where a valuation is required to be made in respect of any property, stocks, shares, debentures, securities or goodwill or any other assets or net worth of a company or its liabilities under the provision of this Act, it shall be valued by a person having such qualifications and experience and registered as a valuer ………….. as may be prescribed and appointed by the audit committee or in its absence by the Board of Directors of that company.
- **Rules for this purpose are yet to be notified.**
- Cost Accountant, by virtue of its qualification and experience, is likely to be included in the list of qualified professional for acting as a valuer.
- **Appearance before Tribunals -** The new Act replaces the Company Law Board and to establish National Company Law Tribunal and National Company Law Appellate Tribunal. Section 432 of the Act enables the Practicing Cost Accountant to appear before the Tribunal as well as before the Appellate Tribunal. The Tribunal to be established will take over the functions of the High Court in the matter of merger, amalgamations, winding up, revival of sick companies, etc. By this, the practicing area is going to be wide enough for the Cost Accountant in practice.
- **Mediation and Conciliation -** Section 442 provides that the Central Government shall maintain a panel of experts to be called as Mediation and Conciliation panel consisting of such number of experts having such qualifications as may be prescribed for mediation between the parties during the pendency of any proceedings before the Central Government or the Tribunal or the Appellate Tribunal under this Act. **Rules for this purpose are yet to be notified.** However we may have hope that the role of Cost Accountants will be there.

Liabilities

The duties of a company auditor have been specified in various provisions of the Act. Accordingly, if a company auditor fails to discharge his specified duties, he will be legally held liable. Moreover, there are a number of occasions where an auditor may be held liable to his appointing authority, the Government or any other persons.

The liabilities of an auditor may be discussed as follows:

A. Statutory Liabilities

I. Under Companies Act, 2013

- **Civil Liabilities:** The civil liabilities as per Companies Act, 2013 are stated below:

  (a) **For Misstatement in the Prospectus:** As per Section 35, where a person has subscribed for securities of a company acting on any statement included in the prospectus, or on the inclusion or omission of any matter in the prospectus which is misleading and thereby has sustained any loss or damage and where the auditor as an expert has either made such statement or has given written consent to the issue of the prospectus, he shall be held liable.

  (b) **Liability for Misfeasance:** Misfeasance implies breach of trust or negligence in the performance of duties. As per Section 340, a company auditor may be charged with misfeasance only at the time of liquidation of the company, if it is found that he -

  (i) has misapplied, or retained, or become liable or accountable for, any money or property of the company; or

(ii) has been guilty of any misfeasance or breach of trust in relation to the company.

- **Criminal Liability:** The criminal liabilities of an auditor under the Companies Act, 2013 are as follows:

  (a) Criminal Liability for Misstatement in the Prospectus: As per Section 34, where the auditor has authorised the issue of any prospectus which includes any statement which is untrue or misleading or where the prospectus has included or omitted any matter which may mislead, the auditor shall be held liable under Section 447.

  Accordingly (i.e., as per Section 447), for any fraud, involving an amount of at least ten lakh rupees or one per cent of the turnover of the company, whichever is lower, the auditor shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud. Moreover, where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

  However, where the fraud involves an amount less than ten lakh rupees or one per cent of the turnover of the company, whichever is lower, and does not involve public interest, any person guilty of such fraud shall be punishable with imprisonment for a term which may extend to five years or with fine which may extend to fifty lakh rupees or with both.

  (b) Punishment for Non-compliance with Sections 139, 144 and 145 of the Act: As per Section 147 -

  (i) If an auditor contravenes the provisions of Section 139, 144 or 145, he shall be punishable with fine which shall not be less than ₹25,000 but which may extend to ₹5,00,000 or four times the remuneration of the auditor, whichever is less.

  (ii) If an auditor has contravened the above provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to 1 year and with fine which shall not be less than ₹50,000 but which may extend to ₹25,00,000 or eight times the remuneration of the auditor, whichever is less.

  (iii) Convicted auditor shall be liable to refund the remuneration received by him from the company and pay for damages to the company, statutory bodies or authorities or to members or creditors of the company for loss arising out of incorrect or misleading statements of particulars made in his audit report.

  (iv) In case where the audit of a company is being conducted by an audit firm, if it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, the partner or partners concerned of the audit firm as well as the firm itself shall be liable for fine jointly and severally. However, for criminal liability other than fine, only the partner or partners will be liable.

  (c) Punishment for Refusal or Failure to Produce Documents: As per Section 217, if any auditor fails without reasonable cause or refuses to produce to an inspector or any person authorised by him in this behalf any book or paper, to furnish any information, to appear before the inspector personally when required, to answer any question which is put to him by the inspector, or to sign the notes of any examination referred to in sub-section (7) of Section 217, he shall be punishable with imprisonment for a term which may extend to six months and with fine ranging from twenty-five thousand rupees to one lakh rupees, and also with a further fine which may extend to two thousand rupees for every day after the first during which the failure or refusal continues.

(d) **Fraud in Relation to a Company in Winding-up:** As per Section 336, if any auditor is engaged in any fraudulent activities in relation to any company in winding up, he shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to five years and with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees.

(e) **Punishment for False Statement:** As per Section 448, if any auditor deliberately makes any false statement in any return, report, certificate, financial statement, prospectus, statement or other document required by the act or deliberately omits any material fact, he shall be liable under Section 447 and shall be subject to the punishment as stated earlier in point (a).

(f) **Punishment for False Evidence:** As per Section 449, if the auditor intentionally gives false evidence upon any examination on oath or solemn affirmation or in any affidavit, deposition or solemn affirmation, in or about the winding up of any company or about any matter under this Act, he shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to seven years and with fine which may extend to ten lakh rupees.

II. Under Other Acts

- **Liabilities under Income Tax Act, 1961:** As per Section 278 of the Act, if any auditor abets or induces in any manner another person to make and deliver an account, statement or declaration relating to any income chargeable to tax which is false and which the auditor either knows or does not believe to be true, the auditor shall be punished.
- **Liabilities under Chartered Accountants Act, 1949:** Schedule I and II of the Act contains a list of instances where a Chartered Accountant shall be held guilty of professional misconduct under Section 22 of the Act.
- **Liabilities under Life Insurance Act, 1956:** As per Section 104 of the Act, if an auditor makes any false statement in any return, report or other such forms to be issued under this Act, he shall be sentenced to imprisonment or fine or both.
- **Liabilities under Banking Regulation Act, 1949:** As per Section 46 of the Act, if an auditor in any return, balance sheet, or other document wilfully makes a statement, which is false in any material particulars, knowing it to be false, or wilfully omits to make a material statement, he shall be held liable.

B. Contractual Liabilities

The scope of any audit work is determined by the written contract entered into between the auditor and the client. Thus, if any of the terms of the said contract is contravened, the auditor may be held liable under the Indian Contract Act, 1872.

In case of absence of any written contract between the auditor and the appointing authority, the auditor is expected to conduct complete audit. Hence, if in such a circumstance, he conducts only partial audit and any error or fraud is discovered later on, he shall be held liable.

Moreover, an auditor shall also be held liable if he discloses any secret information of the client to any third party. In the case Wilde and Others vs. Cape and Dalgeish (1897) also, it was held that if the client suffers any loss due to the auditor not complying with the contract, the auditor will have to compensate the client for such loss.

Professional Ethics

3.3

Code of Professional Ethics

As professionals in the field of Cost and Management Accounting, the members of our Institute are bound by a code of professional ethics. This code stipulates and binds them to the highest level of care, duty and responsibility to their employers and clients, the public and their fellow professionals.

The objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement. These objectives require four basic needs to be met:

(a) Credibility in information and information systems;

(b) Professionalism identified by employers, clients and other interested parties;

(c) Quality of service carried out to the highest standards of performance; and

(d) Confidence that there is a framework of professional ethics to govern the provision of services.

In order to achieve the objectives of the accountancy profession, cost accountants have to observe fundamental principles, which are:

(a) Integrity

A cost accountant should be straightforward and honest in performing his services.

(b) Objectivity

A cost accountant should be fair and should not allow prejudice or bias or the influence of others to override objectivity.

(c) Competence

A cost accountant must refrain from performing any service which he is not competent to carry out unless proper advice and assistance is obtained to ensure that the service is performed to the satisfaction.

(d) Confidentiality

A cost accountant must not disclose information acquired during the course of his engagement and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

(e) Professional Behaviour

A cost accountant should act in a manner consistent with the good reputation of the profession.

In addition to the fundamental principles above a cost accountant in practice, should be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity, objectivity and independence.

Duties of a Cost Auditor to Report Fraud – Section 143 of the Companies Act, 2013

3.4

(i) According to Section 143(12) of the Companies Act 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.

(ii) Sub-Section 13 specifies that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (*12*) if it is done in good faith.

(iii) Sub-Section 14 makes it clear that the provisions of this section shall *mutatis mutandis* apply to the cost accountant in practice conducting cost audit under section 148.

(iv) According to Sub-Section 15 if any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (*12*), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

(v) Matter are required to be reported immediately but not later than 2 days of his knowledge specifying:

- (a) Nature of Fraud with description;
- (b) Approximate amount involved; and
- (c) Parties involved.

(vi) Following disclosures are required to be made in Board's Report:

- (a) Nature of Fraud with description;
- (b) Approximate Amount involved;
- (c) Parties involved, if remedial action not taken; and
- (d) Remedial actions taken.

Punishment for Fraud (Section 447 of the Companies Act, 2013)

3.5

Without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud:

Provided that where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

Explanation.—For the purposes of this section—

(*i*) "fraud" in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;

Punishment for False Statement (Section 448 of The Companies Act, 2013) 3.6

Save as otherwise provided in this Act, if in any return, report, certificate, financial statement, prospectus, statement or other document required by, or for, the purposes of any of the provisions of this Act or the rules made thereunder, any person makes a statement,—

(a) which is false in any material particulars, knowing it to be false; or

(b) which omits any material fact, knowing it to be material,

he shall be liable under section 447.

PROFESSIONAL AND OTHER MISCONDUCTS

THE COST AND WORKS ACCOUNTANTS ACT, 1959

It is an Act for the regulation of the profession of Cost Accountants. The regulation is exercised through the Institute. For the management of the affairs and for discharging the functions assigned to it by the Cost and Works Accountants Act, there is a Council of the Institute. The Council has been empowered to institute any enquiry into cases where it is prima facie of the opinion that a member is guilty of professional or other misconduct.

SCHEDULES TO THE ACT

THE FIRST SCHEDULE

PART I

PROFESSIONAL MISCONDUCT IN RELATION TO COST ACCOUNTANTS IN PRACTICE

A cost accountant in practice shall be deemed to be guilty of professional misconduct, if he:-

(1) allows any person to practise in his name as a cost accountant unless such person is also a cost accountant in practice and is in partnership with or employed by himself;

(2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional work, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner.

Explanation: In this item, "partner" includes a person residing outside India with whom a cost accountant in practice has entered into partnership which is not in contravention of item (4) of this part;

(3) accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute:

Provided that nothing herein contained shall be construed as prohibiting a member from entering into profit sharing or other similar arrangements, including receiving any share, commission or brokerage in the fees, with a member of such professional body or other person having qualifications, as is referred to in item (2) of this Part;

(4) enters into partnership, in or outside India, with any person other than a cost accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (iv) of sub-section (1) of section 4 or whose qualifications are recognised by the Central Government or the Council for the purpose of permitting such partnerships;

(5) secures, either through the services of a person who is not an employee of such cost accountant or who is not his partner or by means which are not open to a cost accountant, any professional business:

Provided that nothing herein contained shall be construed as prohibiting any arrangement permitted in terms of items (2), (3) and (4) of this Part;

(6) solicits clients or professional work, either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means:

Provided that nothing herein contained shall be construed as preventing or prohibiting-

(i) any cost accountant from applying or requesting for or inviting or securing professional work from another cost accountant in practice;

(ii) a member from responding to tenders or enquiries issued by various users of professional services or organisations from time to time and securing professional work as a consequence;

(7) advertises his professional attainments or services, or uses any designation or expressions other than cost accountant on professional documents, visiting cards, letter heads or sign boards, unless it be a degree of a University established by law in India or recognised by the Central Government or a title indicating membership of the [Institute of Cost Accountants of India] or of any other institution that has been recognised by the Central Government or may be recognised by the Council :

Provided that a member in practice may advertise through a write up, setting out the services provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council;

PART II

PROFESSIONAL MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE IN SERVICE

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person—

(1) pays or allows or agrees to pay, directly or indirectly, to any person any share in the emoluments of the employment undertaken by him;

(2) accepts or agrees to accept any part of fees, profit or gains from a lawyer, a cost accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

PART III

PROFESSIONAL MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE GENERALLY

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he—

(1) not being a fellow of the Institute acts as a fellow of the Institute;

(2) does not supply the information called for, or does not comply with the requirements asked for by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

(3) while inviting professional work from another cost accountant or while responding to tenders or enquiries or while advertising through a write up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

PART IV

OTHER MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE GENERALLY

A member of the institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if—

(1) he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months;

(2) in the opinion of the Council he brings disrepute to the profession or the institute as a result of his action whether or not related to his professional work.

THE SECOND SCHEDULE

[See sections 21(3), 21B(3) and 22]

PART I

PROFESSIONAL MISCONDUCT IN RELATION TO COST ACCOUNTANTS IN PRACTICE

A cost accountant in practice shall be deemed to be guilty of professional misconduct, if he:—

(1) discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client, or otherwise than as required by any law for the time being in force;

(2) certifies or submits in his name, or in the name of his firm, a report of an examination of cost accounting and related statements unless the examination of such statements has been made by him or by a partner or an employee in his firm or by another cost accountant in practice;

(3) permits his name or the name of his firm to be used in connection with an estimate of cost or earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast;

(4) expresses his opinion on cost or pricing statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest;

(5) fails to disclose a material fact known to him in a cost or pricing statement, which is not disclosed in a cost or pricing statement but disclosure of which is necessary in making such statement where he is concerned with such statement in a professional capacity;

(6) fails to report a material mis-statement known to him to appear in a cost or pricing statement with which he is concerned in a professional capacity;

(7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties;

(8) fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion;

(9) fails to invite attention to any material departure from the generally accepted procedure of costing and pricing applicable to the circumstances;

(10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

PART II

PROFESSIONAL MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE GENERALLY

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he-

(1) contravenes any of the provisions of this Act or the regulations made there-under or any guidelines issued by the Council;

(2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment, except as and when required by any law for the time being in force or except as permitted by the employer;

(3) includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false;

(4) defalcates or embezzles moneys received in his professional capacity.

PART III

OTHER MISCONDUCT IN RELATION TO MEMBERS OF THE INSTITUTE GENERALLY

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.]

CONSTITUTION OF DISCIPLINARY DIRECTORATE, BOARD OF DISCIPLINE AND DISCIPLINARY COMMITTEE

Section 21 (1) of the Cost and Works Accountants Act, 1959 provides for constitution of the Disciplinary Directorate, Board of Discipline and Disciplinary Committee. For purposes of provisions of this Act Disciplinary Directorate, Board of Discipline and Disciplinary Committee, and Director (Discipline) shall have same powers as are vested in a civil court under the Code of Civil Procedure.

PENALTIES UNDER THE ACT

Section 24 of the Cost and Works Accountants Act, 1959: Penalty for falsely claiming to be a member, etc.

Any person who,-

(i) not being a member of the Institute-

  (a) represents that he is a member of the Institute; or

  (b) uses the designation cost accountant; or

(ii) being a member of the Institute, but not having a certificate of practice, represents that he is in practice or practices as a cost accountant, shall be punishable on first conviction with fine which may extend to one thousand rupees, and on any subsequent conviction with imprisonment which may extend to six months, or with fine which may extend to five thousand rupees, or with both.

Section 25 of the Cost and Works Accountants Act, 1959: Penalty for using name of the Council, awarding degrees of cost accountancy, etc.

(1) Save as otherwise provided in this Act, no person shall,-

  (i) use a name or a common seal which is identical with the name or the common seal of the Institute or so nearly resembles it as to deceive or as is likely to deceive the public;

  (ii) award any degree, diploma or certificate or bestow any designation which indicates or purports to indicate the position or attainment of any qualification or competence in cost accountancy similar to that of a member of the Institute; or

  (iii) seek to regulate in any manner whatsoever the profession of [cost accountants.]

(2) Any person contravening the provisions of sub-section (1) shall, without prejudice to any other proceedings which may be taken against him, be punishable on first conviction with fine which may extend to one thousand rupees, and on any subsequent conviction with imprisonment which may extend to six months, or with fine which may extend to five thousand rupees, or with both.

(3) Omitted w.e.f. 8/8/2006

(4) If the Central Government is satisfied that any diploma or certificate or any designation granted or conferred by any person other than the Institute, which purports to be a qualification in cost accountancy but which, in the opinion of the Central Government, falls short of the standard of qualifications prescribed for cost accountants and does not in fact indicate or purport to indicate the position or attainment of any qualification or competence in cost accountancy similar to that of a member of the Institute, it may, by notification in the Official Gazette and subject to such conditions as it may think fit to impose, declare that this section shall not apply to such diploma or certificate or designation.

Section 26 of the Cost and Works Accountants Act, 1959: Companies not to engage in cost accountancy.

(1) No company, whether incorporated in India or elsewhere, shall practice as cost accountants.

(2) Any contravention of the provisions of sub-section (1) shall be punishable on first conviction with fine which may extend to one thousand rupees, and on any subsequent conviction to five thousand rupees.

[Explanation: For the removal of doubts, it is hereby declared that the ''company'' shall include any limited liability partnership which has company as its partner for the purposes of this section.]

Section 27 of the Cost and Works Accountants Act, 1959: Unqualified persons not to sign documents.

(1) No person other than a member of the Institute shall sign any document on behalf of a cost accountant in practice or a firm of such cost accountants in his or its professional capacity.

[(2) Any person who contravenes the provisions of sub-section (1) shall, without prejudice to any other proceedings which may be taken against him, be punishable on first conviction with a fine not less than five thousand rupees but which may extend to one lakh rupees, and in the event of a second or subsequent conviction with imprisonment for a term which may extend to one year or with a fine not less than ten thousand rupees but which may extend to two lakh rupees or with both.]

Section 28 of the Cost and Works Accountants Act, 1959: Offences by companies.

- If the person committing an offence under this Act is a company, the company as well as every person in charge of, and responsible to, the company for the conduct of its business at the time of the commission of the offence shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly : Provided that nothing contained in this sub-section shall render any such person liable to any punishment if he proves that the offence was committed without his knowledge or that he exercised all due diligence to prevent the commission of such offence. (2) Notwithstanding anything contained in sub-section (1), where an offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or that the commission of the offence is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly.
- **Explanation:** For the purposes of this section,- (a) "company", with respect to an offence under section 24, section 25 or section 27, means any body corporate and includes a firm or other association of individuals; and with respect to an offence under section 26 means a body corporate; and (b) "director", in relation to a firm, means a partner in the firm.

Section 29 of the Cost and Works Accountants Act, 1959: Sanction to prosecute.

- No person shall be prosecuted under this Act except on a complaint made by or under the order of the Council or of the Central Government.

Solved Case

ABC a public limited company manufacturing productcomes under Non-Regulated Sector and classified products under CTA. The total Turnover of the Company for the financial year 2021-22 is ₹159.00 Crores as per details below.

Sr. No.	CTA Heading	Additional Details	Turnover (₹/Crores)
1.	7401	Waste & Scrap	46
2.	7405	PRODUCT(s) Manufactured	57
3.	7406	By Product	56
TOTAL			159

The company seeks your opinion whether the provisions of maintenance of cost records and audit there of applicable particularly in view of turnover of all the product group individually is below the ₹ 100.00 crores.

Solution:

To

The Managing Director

M/s ABC Limited

Dear Sir

This has reference to query vide your letter dated ———— seeking opinion on applicability of the provisions of maintenance of cost records and audit thereof.

My opinion on your query is as follows.

As the turnover of the main product manufactured by company is more than ₹ 35.00 crores and the total turnover of the company is above ₹100.00 crores, the provisions of maintenance of cost records and audit thereof is applicable to the companyas per the provisions of The Companies (Cost Records and Audit) Rules, 2014 (as amended). However, the same is applicable of the main product only i.e CTA code 7405.

Further Waste and scrap are generated out of a manufacturing process. For payment of duty, it gets classified under a CTA Code. It is not a product and hence cost audit of scrap is meaningless and not applicable. Therefore, the Cost Audit is not applicable to the Waste and scrap are generated.

Same is the case with By-Product. It is not a product by itself but comes out of a manufacturing process. In case the By-Product is sold as such without any further processing, the realisable value is usually credited to cost of production of the main product. In such a case, preparation of a separate cost statement does not arise.

However, where there is further processing of the By-product before being sold, then there would be a separate cost statement to arrive at a profit/loss arising on such By-product. Such cost statement would form part of the cost audit report.

Hope you will find the above in order.

Thanking You

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. The appointment of Cost Auditor is defined under section _________ of the Companies Act, 2013.
   (a) Section 148(2)
   (b) Section 148(3)
   (c) Section 144(3)
   (d) Section 139

2. A cost accountant who fails comply with the provisions of sub-section (12) of Sec. 143 of the Companies Act, 2013, shall be punishable with fine of maximum ₹ _________.
   (a) ₹ 5.00 lakhs
   (b) ₹ 25.00 lakhs
   (c) ₹ 1.00 lakhs
   (d) ₹ 10.00 lakhs

3. Cost auditor to report fraud under section_________ of Companies Act, 2013.
   (a) Section 140(12)
   (b) Section 148(2)
   (c) Section 144(10)
   (d) Section 143(12)

State True or False

1. Cost audit shall be conducted by a Cost Accountant who shall be appointed by the Board of the company under section 139 of the Companies Act, 2013.
2. A company can rotate a Cost Auditor as per the provisions of section 139(3) of the Companies Act, 2013.
3. Mr. A who was a cost auditor of a company was convicted by a court for an offence involving fraud and a period of 5 years have elapsed from the date of such conviction can be re-appointed as cost auditor of a company.
4. A cost auditor appointed by a company may be removed from his office before the expiry of his term, by Audit committee of the company after giving a reasonable opportunity of being heard to the Cost Auditor and recording the reasons.
5. The remuneration recommended by the Audit Committee shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders.

Fill in the Blanks

1. Rights and Duties of a Cost auditor is defined under section ______of the Companies Act, 2013.
2. A Company is prohibited under section_______ of the Cost and Works Accountants Act, 1959 to practice as Cost Accountants.
3. A Cost Auditor found guilty of deliberately providing false report and certificate will be liable for punishment under section _____ the Companies Act, 2013.
4. Relatives of any partner of the firm holding any security of or interest in the company of face value exceeding ₹ _______ lakh can not be appointed as the Cost Auditor of that company.
5. The casual vacancy caused due to death of cost auditor to filled within _______ days.

Short Essay Type Questions

1. Write in brief about the procedure for appointment of Cost Auditor.
2. Write a short note on Code of Professional Ethics which need to be followed in the field of Cost and Management Accounting.
3. Discuss about the fundamental principles to be observed by the Cost Accountants.

Answer:

Multiple Choice Questions

1.	(b) Section 148(3)
2.	(b) ₹ 25.00 lakhs.
3.	(d) Section 143(12)

State True or False

1.	False-Cost audit shall be conducted by a Cost Accountant who shall be appointed by the Board of the company under section 148(3) of the Companies Act 2013.
2.	False- As per the Companies act, 2013, there is no such statutory provision for rotation of cost auditors however the individual companies may do so as a part of their policy.
3.	False - As per the Companies act, 2013, A person who has been convicted by a court for an offence involving fraud and a period of ten years has elapsed from the date of such conviction than only can be re-appointed as cost auditor of a company.
4.	False - A cost auditor appointed can be removed from his office before the expiry of his term, only by Board through a board resolution after giving a reasonable opportunity of being heard to the Cost Auditor and recording the reasons.
5.	True.

Fill in the Blanks

1.	Section 143
2.	Section 26
3.	Section 447
4.	1 (one)
5.	30

Overview of Cost Accounting Standards and GACAP

4

This Module includes:

OVERVIEW OF COST ACCOUNTING STANDARDS AND GACAP

SLOB Mapped against the Module

To develop detail understanding of Cost Accounting Standards to ensure appropriate evaluation of cost records maintained. (CMLO 4a, b)

Module Learning Objectives:

This module helps to know about the conceptual frame work of cost accounting standards. 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. After studying this module, the students will be able to –

- Learn about the Cost Accounting Standards
- Familiarise with the Guidance Notes on Cost Accounting Standards
- Recognize the Generally Accepted Cost Accounting Principles (GACAP)

Cost Accounting Standards

4.1

Cost Accounting Standards are guidelines for the companies [for the management] that specify the cost accounting treatment for various cost elements, minimum disclosure requirements and ensure the comparability, consistency, and completeness of cost records. These standards are designed to achieve uniformity and consistency in cost accounting principles and practices.

The Institute of Cost Accountants of India, recognizing the need for structured approach to the measurement of cost in manufacture or service sector and to provide guidance to the user organizations, government bodies, regulators, research agencies and academic institutions to achieve uniformity and consistency in classification, measurement and assignment of cost to product and services, has constituted Cost Accounting Standards Board (CASB) with the objective of formulating the Cost Accounting Standards. Keeping in view latest legal and contemporary developments, the Cost Accounting Standards Board develops Cost Accounting Standards.

Utilities of Cost Accounting Standards

The Cost Accounting Standards:

(i) provide a structured approach to measurement of costs in manufacturing process or service industry;

(ii) integrate, harmonize, and standardize cost accounting principles and practices;

(iii) provide guidance to users to achieve uniformity and consistency in classification, measurement, assignment, and allocation of costs to products and services;

(iv) arrive at the basis of computing the cost of product, activity, or service where required by legal or regulatory bodies;

(v) enable practicing members to make use of Cost Accounting Standards in the attestation of General Purpose Cost statements; and

(vi) assist in clear and uniform understanding of all the related issues by various user organizations, Government Bodies, regulators, research agencies, and academic institutions.

List of Cost Accounting Standards [CASs]

The structure of Cost Accounting Standard consists of Introduction, Objectives of issuing standards, Scope of standard, Definitions and explanations of the terms used in the standard, Principles of Measurement, Assignment of Cost, Presentation and Disclosure.

So far, the Institute has released 24 Cost Accounting Standards [CASs].

A list of these standards is tabulated below:

LIST OF COST ACCOUNTING STANDARDS (CAS) AND CORRESPONDING GUIDANCE NOTES ISSUED AS ON DATE			
CAS No.	**Title**	**Effective Date (For the period commencing from)**	**Guidance Note**
CAS 1 (Revised 2015)	Classification of Cost	1st April 2015	
CAS 2 (Revised 2015)	Capacity Determination	1st April 2016	Guidance Note on Capacity Determination CAS-2 (Revised 2015)
CAS 3 (Revised 2015)	Production and Operation Overheads	1st April 2016	
CAS 4 (Revised 2018)	Cost of Production/ Acquisition/ Supply of Goods/ Provision of Service	1st March 2019	
CAS 5	Average (Equalized) Cost of Transportation	1st April 2010	
CAS 6	Material Cost	1st April 2010	Guidance Note on Material Cost (CAS-6)
CAS 7	Employee Cost	1st April 2010	Guidance Note on Employee Cost (CAS-7)
CAS 8	Cost of Utilities	1st April 2010	Guidance Note on Cost of Utilities (CAS-8)
CAS 9	Packing Material Cost	1st April 2010	Guidance Note on Packing Material Cost (CAS-9)
CAS 10	Direct Expenses	1st April 2010	Guidance Note on Direct Expenses (CAS-10)
CAS 11	Administrative Overheads	1st April 2010	Guidance Note on Administrative Overheads (CAS-11)
CAS 12	Repairs and Maintenance Cost	1st April 2010	Guidance Note on Repairs and Maintenance Cost (CAS-12)
CAS 13	Cost of Service Cost Centre	1st April 2011	Guidance Note on Cost Accounting Standard on Cost of Service Center (CAS-13)
CAS 14	Pollution Control Cost	1st April 2012	
CAS 15	Selling and Distribution Overheads	1st April 2013	
CAS 16	Depreciation and Amortisation	1st April 2014	
CAS 17	Interest and Financing Charges	1st April 2014	

CAS 18	Research and Development Costs	1st April 2014	
CAS 19	Joint Costs	1st April 2014	
CAS 20	Royalty and Technical Know-How Fee	1st April 2014	
CAS 21	Quality Control	1st April 2014	
CAS 22	Manufacturing Cost	1st April 2015	
CAS 23	Overburden Removal Cost	1st April 2017	
CAS 24	Treatment of Revenue in Cost Statements	1st April 2017	

Notes:

1. **Introduction** of the standard explains as to what the subject matter that the standard deals with.
2. **Objective** of the standard explains the way of bringing uniformity and consistency in the principles of Cost for disclosure and presentation in the cost statements of a product or service.
3. **Scope** of the standard specifies that it shall be applied to cost statements, which require classification, presentation and disclosure of cost including those requiring attestation.
4. **Definitions** are the terms that are being used in the standard with their meanings specified**.**
5. **Principles of Measurement** specify the way of determining the value of various elements of cost. E.g. commonly, any element of cost shall not include, abnormal costs, imputed cost etc.
6. **Assignment** refers to the assignment of any element of cost to the cost of production, commonly, like "Cause and Effect", "Benefits received" etc. Costs shall be directly traced to a Cost object to the extent it is economically feasible any if not, shall be assigned to the cost object on appropriate basis.
7. **Presentation** refers to the principle of whether an element of cost shall be presented as separate cost head or as a part of a class or group of costs, mostly indirect. This depends on the classification of the specific element of cost as direct or indirect.
8. **Disclosures** specify the details of the disclosures to be made in the cost statements in respect of the specific elements of cost.
9. **Effective date** for all the standards, commonly, will be given at the end, which is the specific date of its commencement / enforcement.

Students are advised to thoroughly go through all the standards, along with the guidance notes, on specific standards, issued by the Institute, for a comprehensive understanding. In view of the mandatory application of these standards, in conducting cost audits, it is essential to ensure that in the preparation and presentation of the cost statements, annexures to the cost audit report are in full compliance of these standards.

COST ACCOUNTING STANDARDS AND GACAP

CAS –1

(REVISED 2015)

COST ACCOUNTING STANDARD ON

"CLASSIFICATION OF COST

The following is the COST ACCOUNTING STANDARD - 1 (CAS - 1) (Revised 2015) issued by the Council of the Institute of Cost Accountants of India for determination of **"CLASSIFICATION OF 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 the principles of Classification of Cost for determining the cost of product or service.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles of Classification of Cost for disclosure and presentation in the cost statements of a product or service.

3. Scope

This standard shall be applied to cost statements, which require classification, presentation and disclosure of 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 ***Administrative Overheads: Cost of all activities relating to general management and administration of an entity.***

Administrative overheads shall exclude production overheads, marketing overheads and interest and finance charges. Administrative overheads do not include administration cost relating to production, factory, works or manufacturing.

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

4.4 ***Conversion cost: Conversion cost is the production cost excluding the cost of direct materials.***

4.5 ***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. The type of cost often referred to in the costing system depends on the purpose for which cost is incurred. For example, material cost is the price of materials consumed for manufacturing a product or for rendering a service.

4.6 *Cost Centre: Any unit of an entity selected with a view to accumulating all cost under that unit. The unit can be division, department, section, group of plant and machinery, group of employees or combination of several units.*

Cost Centre is the logical unit for accumulation of cost. Cost Centre may be of two types –personal and impersonal cost centres. Personal cost centre consists of a person or a group ofpersons. Cost centres which are not personal cost centres are impersonal cost centres. Cost centres may also be classified into broad types i.e. Operating Cost Centres and Support- Service Cost Centres. Operating Cost Centres are those which are in the chain of operations like machine shop, welding shop, assembly shop, operation theatre, callcentre and so on. Support-service Cost centres are for rendering services to operating cost centre like power house, maintenance, stores, help desk, transport for call centre staff and so on.

4.7 *Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.*

4.8 *Cost of Production: Cost of production of a product or a service consists of cost of materials consumed, direct employee costs, direct expenses, production overheads, quality control costs, packing costs, research and development costs and administrative overheads relating to production.*

Cost of production of a service means cost of the service rendered. To arrive at cost of production of goods, including those dispatched for captive consumption, adjustment for stock of work-in-process, finished goods, recoveries for sales of scrap, wastage and the like, shall be made.

4.9 *Cost of Transportation: Cost of Transportation comprises of the cost of freight, cartage, transit insurance and cost of operating fleet and other incidental charges whether incurred internally or paid to an outside agency for transportation of goods but does not include detention and demurrage charges.*

Cost of transportation is classified as inward transportation cost and outward transportation cost.

4.10 *Cost Unit: Cost Unit is a form of measurement of volume of production of a product or a service. Cost Unit is generally adopted on the basis of convenience and practice in the industry concerned*.

Examples:

- Power - MW
- Cement - MT
- Automobile - Number
- Transportation - Tonne- Kilometre

4.11 *Development Cost: Development cost is the cost for application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.*

4.12 *Direct Employee Cost: Employee costs, which can be attributed to a cost object in an economically feasible way.*

4.13 *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:

- Royalties charged on production
- Job charges
- Hire charges for use of specific equipment for a specific job
- Software services specifically required for a job

4.14 ***Direct Materials: Materials, the costs of which can be attributed to a cost object in an economically feasible way.***

4.15 ***Distribution Overheads: Distribution overheads, also known as distribution costs, are the costs incurred in handling a product or service from the time it is ready for despatch or delivery until it reaches the ultimate consumer including the units receiving the product or service in an inter-unit transfer.***

The cost of any non manufacturing operations such as packing, repacking and labelling at an intermediate storage location will be part of distribution cost.

Examples:

- Secondary packing
- Outward transportation cost
- Warehousing cost
- Cost of delivering the products to customers
- Clearing and forwarding charges
- Cost of mending or replacing packing materials at distribution point.

4.16 ***Employee Cost: Benefits paid or payable for the services rendered by employees (including temporary, part time and contract employees) of an entity.***

Explanation:

1 Contract employees include employees engaged by the employer on contract basis; either directly or through a contractor but does not include employees of any contractor engaged in the entity for a contractual job.

2 Compensation paid to employees for the past period on account of any dispute / court orders in the current period shall form part of employee cost, but not a part of production cost.

3 Short provisions of prior period employee cost in current period shall form part of the employee cost in the current period, but not a part of production cost.

Employee cost includes payment made in cash or kind.

4.17 ***Fixed Costs: Fixed costs are costs which do not vary with the change in the volume of activity. Fixed indirect costs are termed fixed overheads.***

4.18 ***Indirect Employee Cost: Employee cost, which cannot be directly attributed to a particular cost object.***

4.19 ***Indirect Expenses: Expenses, which cannot be directly attributed to a particular cost object.***

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

4.21 ***Marketing overheads: Marketing Overheads comprise of selling overheads and distribution overheads.***

4.22 ***Material Cost: The cost of material used for the purpose of production of a product or rendering a service.***

4.23 ***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.***

The above definition is also applicable for normal capacity in relation to a service being rendered.

4.24 ***Overheads: Overheads comprise costs of indirect materials, indirect employees and indirect expenses.***

4.25 ***Packing Material Cost: The cost of material of any nature used for the purpose of packing of a product.***

Packing material can be classified into primary packing material and secondary packing material. Primary packing material is essential to hold and preserve the product for its use by the customer and secondary packing material enables to store, transport, inform the customer, promote and otherwise make the product marketable.

4.26 ***Prime cost: Prime cost is the aggregate of direct material cost, direct Employee cost and direct expenses.***

4.27 ***Production Overheads: Indirect costs involved in the production of a product or in rendering service.***

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning. Production overheads include administration costs relating to production, factory, works or manufacturing.

4.28 ***Research Cost: Research cost is the cost of original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.***

4.29 ***Selling Overheads: Selling overheads are the expenses related to sale of products or services and include all indirect expenses incurred in selling the products or services.***

Selling overheads are also known as selling costs.

4.30 ***Semi Variable Costs: Semi Variable Costs are the costs that contain both fixed and variable elements. They partly change with the change in the level of activity.***

4.31 ***Support-Service Cost Centre: The cost centre which primarily provides auxiliary services across the entity.***

The cost centre which provides services to production, operation or other service cost centre but not directly engaged in manufacturing process or operation or in rendering a service is a support-service cost centre. A support-service cost centre renders services to other cost centre's/other units and in some cases to outside parties.

Examples:

- Engineering
- Workshop
- Quality control
- Quality assurance
- Designing
- Laboratory
- Help desk
- Transport for call centre staff

4.32 ***Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions***.

Standard costs are used as scale of reference to compare the actual cost with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them.

4.33 ***Variable Costs: Variable costs are the cost which tends to directly vary with the volume of activity.***

Variable indirect costs are termed as variable overheads.

5. Principles of Classification of Costs

5.1 ***Costs shall be classified by the process of grouping the components of cost under a common designation on the basis of similarities of nature, attributes or relations.*** **Items grouped together under common heads shall be further classified according to their fundamental differences**.

It is the process of identification of each item and the systematic placement of like items together according to their common features. The same costs may appear in several different classifications depending on the purpose of classification.

Cost is classified normally in terms of 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.

Cost may be classified with reference to the nature of expense, its traceability to a cost object (direct/indirect), its relation to functions /activities, its behaviour (fixed, semi-variable or variable)and its relationship to production process.

5.2 ***Scheme of classification shall be such that every item of cost is classified***.

6. Classification of Costs

6.1 *By Nature of expenses*

6.1.1 Items of costs differ on the basis of their nature. Costs shall be gathered together in their natural groupings such as material, employee and expenses. The elements of cost can be classified in the following three categories :

i) Material

ii) Employee

iii) Expenses

6.1.2 Material Costs are cost of materials used for the purpose of production of a product or rendering of a service, net of trade discounts, rebates, taxes and duties refundable that can be quantified with reasonable accuracy.

6.1.3 Employee Costs are consideration, including benefits paid or payable to employees, permanent or temporary, for the purpose of production of a product or rendering of a service.

It is the aggregate of all kinds of consideration paid and payable for the services rendered by employees of an entity (including temporary, part time and contract employees). Consideration includes wages, salaries, and other payments, including benefits, as applicable.

6.1.4 Expenses are costs other than material cost and employee cost for the purpose of production of a product or rendering of a service.

Examples:

- Cost of utilities
- Payment for bought out services
- Job processing charges

6.2 *By nature of traceability to a cost object*

6.2.1 **Classification shall be on the basis of method of assigning cost to a cost object. If a cost can be assigned to a cost object in an economically feasible way, it shall be termed as direct to that cost object. A cost that cannot be assigned directly shall be indirect cost.**

***6.2.2 Direct Material Costs are the cost of materials which can be assigned to a cost object in an economically feasible way*.**

Raw materials consumed for production of a product or rendering of a service which are identifiable to the product or service form the direct material cost. Direct material cost includes cost of procurement, freight inward, taxes & duties and insurance directly attributable to the acquisition of the material. Trade discounts, rebates, duty drawbacks, refunds of duties/taxes and other similar items are deducted in determining the costs of direct material.

***6.2.3 Direct Employee Cost are employee costs, which can be assigned to a cost object in an economically feasible way*.**

Example :

The cost of wages of those workers who are readily identified or linked with a cost centre or cost object, including the fringe benefits like provident fund contribution, gratuity, ESI, overtime, incentives, bonus, ex-gratia, leave encashment and wages for holidays and idle time.

6.2.4 ***Direct Expenses are expenses, which can be assigned to a cost object.***

Examples:

- 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

6.2.5 ***Indirect Material Costs are cost of materials, which cannot be directly assigned to a particular cost object in an economically feasible way.***

Examples:

- Consumable spares and parts
- Lubricants
- Cost of computer stationary for administrative function

6.2.6 ***Indirect Employee costs are employee costs, which cannot be directly assigned to a particular cost object in an economically feasible way.***

Examples:

- Salaries of security staff
- Operating manager's salary

6.2.7 ***Indirect Expenses are expenses, which cannot be directly assigned to a particular cost object in an economically feasible way.***

Examples:

- Insurance
- Rates and Taxes

6.3 By function

6.3.1 ***Costs shall be classified according to major functions viz:***

- ***Production/ Project;***
- ***Administration;***
- ***Selling;***

- *Distribution;*
- *Research;*
- *Development;*

6.4 By nature of behaviour

6.4.1 Costs shall be classified based on behaviour in response to the changes in the activity levels such as, fixed cost, variable cost and semi-variable cost.

6.5 By nature of production or operation process

6.5.1 Costs shall also be classified on the basis of nature of production or operation process.

6.5.2 Batch Cost shall be the aggregate cost related to a cost unit which consist of a group of similar articles or services which maintain its identity throughout one or more stages of production or operation.

6.5.3 Process cost shall be the cost of production or operation process where goods are produced or services rendered from a sequence of continuous or repetitive operations or processes during a period.

6.5.4 Operation Cost shall be the cost a specific operation involved in production of goods or rendering of services.

6.5.5 Contract cost shall be the cost of a contract agreed upon between the contractee and the contractor.

6.5.6 Joint costs are the costs of common resources used for producing two or more products or rendering two or more services simultaneously.

7. Presentation

7.1 The cost items in the cost statement shall be presented on 'basis of relevant classification'.

7.2 The classification of cost items shall be followed consistently from period to period.

8. Disclosure

8.1 Any change in classification of cost shall be made only if it is required by law or for compliance with a Cost Accounting Standard or such change would result in a more appropriate preparation or presentation of cost statements of an entity.

8.2 Any change in classification of cost which has a material effect on the cost of the product shall be disclosed in the cost statements. Where the effect of such change is not ascertainable wholly or partly, the fact shall be indicated in the cost statement.

CAS – 2

(REVISED 2015)

COST ACCOUNTING STANDARD ON CAPACITY DETERMINATION

The following is the Cost Accounting Standard - 2 (Revised 2015) on **"CAPACITY DETERMINATION"** issued by the Council of the Institute of Cost Accountants of India. This standard replaces CAS-2 (Revised 2012) on Capacity Determination. In this Standard, the standard portions have been set in ***bold italic*** type. These are to be read in the context of the background material, which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the capacity of a facility for producing goods or providing services by an entity.

1.2 ***This standard deals with the principles and methods of classification and determination of capacity of an entity for ascertainment 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 determination of capacity with reasonable accuracy.

3. Scope

This standard shall be applied to the cost statements, including those requiring attestation, which require determination of capacity for assignment of overheads.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal Idle Capacity: Abnormal idle capacity is the difference between normal capacity and actual capacity utilization where the actual capacity is lower than the normal capacity.

4.2 Actual capacity utilization: Actual capacity utilization is measured in terms of volume of production achieved or service provided in a specified period.

Volume may be measured in terms of units produced or services provided or equivalent machine or man hours, as applicable.

Actual capacity utilization is usually expressed as a percentage of installed capacity.

4.3 Cost Object: An activity, contract, cost Centre, customer, process, product, project, service or any other object for which costs are ascertained.

4.4 Installed capacity: Installed capacity is the maximum capacity of producing goods or providing services, determined either based on technical specification of the facility or through a technical evaluation.

4.5 Normal Capacity: Normal capacity is the volume of production or services achieved or achievable on an average over a period under normal circumstances taking into account the reduction in capacity resulting from planned maintenance.

4.6 Normal Idle Capacity: Normal idle capacity is the difference between installed and normal capacity.

5. ***Determination of Capacity:***

5.1 Capacity shall be determined in terms of units of production or services or equivalent machine or man hours.

5.2 ***Installed capacity***

Installed capacity is usually determined based on:

i) Technical specifications of facility.

ii) Technical evaluation.

iii) Capacities of individual or interrelated production or operation Centres.

iv) Operational constraints or capacity of critical machines or equipment.

v) Number of shifts or machine hours or man hours.

In case technical specifications of facility are not available, the estimates by technical experts on capacity under ideal conditions shall be considered for determination of installed capacity.

In case the installed capacity is assessed as per direction of the Government or regulator it shall be in accordance with the said directives.

5.3 Reassessment of Installed Capacity:

Installed capacity shall be reassessed in case of any change due to addition, deletion, modification or for any other reason from the date of such change.

In case the installed capacity is reassessed as per direction of the Government or regulator it shall be in accordance with the said directives.

5.4 Normal Capacity:

Normal capacity is determined after suitable adjustments to the Installed Capacity.

The adjustments may be of the following nature:

(i) Time lost due to scheduled preventive or planned maintenance

(ii) Number of shifts or machine hours or man hours.

(iii) Holidays, normal shut down days, normal idle time,

(iv) Normal time lost in batch change over

6. *Presentation*

6.1 *Cost Statements shall present Installed capacity, normal capacity and actual production of goods or services provided, in absolute terms.*

6.2 *Actual Capacity utilization shall be presented as a percentage of installed capacity.*

7. Disclosures:

7.1 The cost statements shall disclose the following:

a. Basis for arriving at different types of capacity.

b. Changes in the installed capacity or normal capacity with reason thereof.

c. Capacity enhanced through outsourcing.

d. Capacity outsourced to others.

e. Details of actual production of goods or services provided.

a) Self-Manufactured goods or services provided through in-house facility

b) Goods Produced or services provided through outsourcing

f. *Reasons for low capacity utilization.*

g. Abnormal cost due to under-utilization of capacity.

7.2 Disclosures shall be made only where material, significant and quantifiable.

7.3 Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.

8. Effective date

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April 2016 for being applied for the preparation and certification of General Purpose Cost Accounting Statement.

CAS-3 (REVISED 2015)

COST ACCOUNTING STANDARD ON "PRODUCTION AND OPERATION OVERHEADS"

The following is the Cost Accounting Standard on **PRODUCTION AND OPERATION OVERHEADS** (CAS-3) (Revised 2015) issued by the Council of the Institute of Cost Accountants of India. This standard replaces CAS-3 (Revised 2011) on Overheads. In this Standard, the standard portions have been set in ***bold italic*** type. This standard shall be read in the context of the background material, which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the Production or Operation Overheads.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of Production or Operation Overheads, for determination of the cost of goods produced or services provided and for the presentation and disclosure in cost statements***.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Production or Operation Overheads with reasonable accuracy.

3. Scope

This standard shall be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of Production or Operation 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 or due to some abnormal situation of the production or operation.***

4.2 **Absorption of Production or Operation Overheads:** ***Assigning of Production or Operation Overheads to cost objects by means of appropriate absorption rate.***

Overhead Absorption Rate = Production or Operation Overheads of the Activity divided by the volume of activity.

For example the rate obtained by dividing the overheads of a Machine Shop by machine hours.

4.3 ***Administrative Overheads: Cost of all activities relating to general management and administration of an entity.***

Administrative overheads shall exclude production overheads, marketing overheads and finance cost. Production overheads includes administration cost relating to production, factory, works or manufacturing.

4.4 ***Cost Centre: Any unit of an entity selected with a view to accumulating all costs under that unit. The unit can be division, department, section, group of plant and machinery, group of employees or combination of several units.***

A cost centre includes a process, function, activity, location, item of equipment, group of persons or any other unit in relation to which costs are accumulated.

4.5 Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.

4.6 Fixed costs: Fixed costs are costs which do not vary with the change in the volume of activity. Fixed indirect costs are termed fixed overheads.

4.7 Imputed Cost: Notional cost, not involving cash outlay, computed for any purpose.

4.8 Indirect Employee Cost: Employee cost, which cannot be directly attributed to a particular cost object.

4.9 Indirect Expenses: Expenses, which cannot be directly attributed to a particular cost object.

4.10 Indirect Material Cost: Material cost that cannot be directly attributed to a particular cost object.

4.11 Normal capacity: Normal capacity is the volume of production or services achieved or achievable on an average over a period under normal circumstances taking into account the reduction in capacity resulting from planned maintenance (In line with paragraph 4.5 of CAS – 2 (Revised 2015)).

4.12 Production or Operation Overheads: Indirect costs involved in the production of a product or in providing service.

The terms Production Overheads, Operation Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

Production or Operation Overheads include administration cost relating to production, factory, works or manufacturing and providing of services.

In addition Production or Operation Overheads shall also be classified on the basis of behaviour such as variable Production or Operation Overheads, semi-variable Production or Operation Overheads and fixed Production or Operation Overheads.

- Variable Production or Operation Overheads comprise of expenses which vary in proportion to the change of volume of production or activity or services provided.
- Semi Variable Costs are the costs that contain both fixed and variable elements. They partly change with the change in the level of activity.
- Fixed overhead are indirect costs which do not vary with the change in the volume of production or activity or service provided.

4.13 Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions.

Standard costs are used as scale of reference to compare the actual cost with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

4.14 Variable costs: Variable costs are the cost which tends to directly vary with the volume of activity.

5. Principles of Measurement:

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

5.2 Production or Operation Overheads other than those referred to in paragraph 5.1 shall be determined on the basis of cost incurred in connection therewith.

In case of machinery spare fabricated internally or a repair job carried out internally, it will include cost incurred on material, employees and expenses.

5.3 Any abnormal cost where it is material and quantifiable shall not form part of the Production or Operation Overheads.

5.4 Production or Operation Overheads shall not include imputed cost.

5.5 Production or Operation Overhead variances attributable to normal reasons shall be treated as part of Production or Operation Overheads. Overhead variances attributable to abnormal reasons shall be excluded from Production or Operation Overheads.

5.6 Any subsidy, Grant, Incentive or amount of similar nature received or receivable with respect to Production or Operation Overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

5.7 Fines, penalties, damages and similar levies paid or payable to statutory authorities or other third parties shall not form part of the Production or Operation Overheads.

5.8 Credits or recoveries relating to the Production or Operation Overheads, material and quantifiable, shall be deducted from the total Production or Operation overheads to arrive at the net Production or Operation Overheads. Where the recovery exceeds the total Production or Operation Overheads, the balance recovery shall be treated as other income.

5.9 Any change in the cost accounting principles applied for the measurement of the Production or Operation Overheads shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an entity.

6. Assignment

6.1 *While assigning Production or Operation Overheads, traceability to a cost object in an economically feasible manner shall be the guiding principle. The cost which can be traced directly to a cost object shall be directly assigned.*

6.2 Assignment of Production or Operation 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 – Production Overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

In case of facilities created on a standby or ready to serve basis, the cost shall be assigned on the basis of expected benefits instead of actual.

6.3 Absorption of Production or Operation Overheads shall be as follows:

6.3.1 The variable Production or Operation Overheads shall be absorbed to products or services based on actual production.

6.3.2 The fixed Production or Operation Overheads shall be absorbed based on the normal capacity.

7. Presentation

7.1 Production or Operation Overheads shall be presented as separate cost head.

7.2 If material, element wise and behaviour wise details of the Production or Operation Overheads shall be presented.

7.3 Any under-absorption or over-absorption of Production or Operation Overheads shall be presented in the reconciliation statement.

8. Disclosures

8.1 The cost statements shall disclose the following:

1. *The basis of assignment of Production or Operation Overheads to the cost objects.*
2. *Production or Operation Overheads incurred in foreign exchange.*
3. *Production or Operation Overheads relating to resources received from or supplied to related parties (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).*
4. *Any Subsidy, Grant, Incentive or any amount of similar nature received or receivable reduced from Production or Operation Overheads.*
5. *Credits or recoveries relating to the Production or Operation Overheads.*
6. *Any abnormal cost not forming part of the Production or Operation Overheads.*
7. *Any unabsorbed Production or Operation 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 Production or Operation Overheads during the period covered by the cost statement which has a material effect on the Production or Operation 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 2016 for being applied for the preparation and certification of General Purpose Cost Accounting Statement.

CAS-4 (REVISED 2018)

COST ACCOUNTING STANDARD ON COST OF PRODUCTION / ACQUISITION / SUPPLY OF GOODS / PROVISION OF SERVICES

The following is the Cost Accounting Standard (CAS-4) (Revised 2018) on "**COST OF PRODUCTION/ ACQUISITION/ SUPPLY OF GOODS / PROVISION OF SERVICES**" issued by the Council of the Institute of Cost Accountants of India. This Standard replaces CAS-4 on Cost of Production for Captive Consumption issued earlier. The CAS-4 (Revised 2018) deals with the determination of cost of production or acquisition or supply of goods or provision of services or both. 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. Cost Accounting Standard 4 (CAS-4) was issued to specify the principles for determination of cost of production for valuation of goods meant for captive consumption, as required under the Central Excise Valuation (Determination of Price of Excisable Goods) Rules 2000. CBEC, vide circular No. 692/8/2003-CX dated 13-2-2003 had clarified that in case of captive consumption, cost calculation should be as per CAS-4 only.

1.2. With the introduction of Goods and Services Tax [GST] with effect from July 1, 2017, the concept of 'captive consumption' is no more relevant for computing the tax incidence. However, the concept of cost of production or manufacture is relevant under the GST laws where the value of supply of goods or services or both are determined based on cost.

1.2.1. As per section 15(1) of the CGST Act, where the supplier and the recipient of the supply are not related and price is the sole consideration for the supply, the value of supply of goods or services or both shall be the transaction value. Section 15(4) provides that where the value of the supply of goods or services or both cannot be determined under sub-section (*1*), the same shall be determined in such manner as may be prescribed. These have been prescribed under Chapter IV of the CGST Rules, 2017.

1.2.2. Rules 27, 28, & 29 of the CGST Rules provide for methodologies for determination of value of supply under certain situations.

As per Rule 27, where the supply of goods or services is for a consideration not wholly in money, the value of the supply shall be the open market value of such supply; or the sum total of consideration in money and equivalent; or the value of supply of goods or services or both of like kind and quality.

As per Rule 28, value of the supply of goods or services or both between distinct or related persons other than where the supply is made through an agent, shall be the open market value of such supply; or the value of supply of goods or services of like kind and quality.

Proviso to Rule 28 provides that where goods are intended for further supply as such by the recipient, the value shall be an amount equivalent to 90% of the price charged for the supply of goods of like kind and quality by the recipient to his customer not being a related person.

Where a recipient is eligible for input tax credit, the value declared in the invoice shall be deemed to be the open market value of the goods or services.

As per Rule 29, value of supply of goods between the principal and his agent shall be the open market value of the goods being supplied, or at the option of the supplier, be 90% of the price charged for the supply of goods of like kind and quality by the recipient to his customer not being a related person, where the goods are intended for further supply by the said recipient.

1.2.3. Rules 27, 28, & 29, however, further provide that if the value of supply is not determinable under the said Rules, the same shall be determined by the application of Rule 30 or Rule 31 in that order.

As per Rule 30, the value shall be one hundred and ten percent of the cost of production or the cost of acquisition of such goods or the cost of provision of such services.

Rule 31 specifies residual method for determination of value of supply of goods or services or both. Where the value of supply of goods or services or both cannot be determined under Rule 27 to 30, the same shall be determined using reasonable means consistent with the principles and the general provisions of section 15 and the provisions of Chapter-IV of CGST Rules.

In the case of supply of services, the supplier may opt directly for Rule 31, ignoring Rule 30.

1.3. ***This Standard deals with the principles and methods of classification, measurement and assignment for the determination of cost of production or acquisition or supply of goods or provision of services as required under the provisions of GST Acts/Rules.***

2. Objective

The objective of this Standard is to bring uniformity and consistency in the principles and methods of determining the cost of production or acquisition or supply of goods or provision of services as required under the provisions of GST Acts/Rules.

The cost statements prepared based on this Standard will be used for determination of value of supply of goods or services or both. This Standard and its disclosure requirement will provide transparency in the valuation of goods and services.

This standard shall further ensure adequate accuracy in computing Transaction Value of supply for goods or services or both, where the open market value of supply of goods and services or value of supply of goods or services of like kind and quality are not available or same is not verifiable.

3. Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation, and disclosure of related costs for determination of the following under the relevant provisions of GST Acts/Rules.

(i) Determination of cost of production of goods;

(ii) Determination of cost of acquisition of goods;

(iii) Determination of cost of supply of goods;

(iv) Determination of cost of provision/supply of services ; and

(v) **Determination of** ***value of supply of goods or services as per open market value or as per goods or services of like kind and quality.***

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. ***Actual Capacity Utilization: Actual capacity utilization is the volume of production achieved or services provided in a specified period, expressed as a percentage of installed capacity.***

Volume may be measured in terms of units produced or services provided or equivalent machine or man hours, as applicable.

Actual capacity utilization is usually expressed as a percentage of installed capacity.

4.3. ***Administrative Overheads: Cost of all activities relating to general management and administration of an entity.***

Administrative overheads shall exclude production overheads, marketing overheads and finance cost. Production overheads include administration cost relating to production, factory, work or manufacturing.

4.4. ***Allocation of Overheads: Allocation of overheads is assigning total amount of an item of cost directly to a cost object.***

4.5. ***Amortization: Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.***

4.6. ***Apportionment of Overheads: Distribution of overheads to more than one cost objects on some equitable basis.***

4.7. ***By-product: Product with relatively low value produced incidentally in the manufacturing of the product or service.***

4.8. ***Cost: Cost is a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services.***

4.9. ***Cost of Purchase/ Acquisition: The costs of purchase/ acquisition of Goods comprise the purchase price, import duties and other taxes (net of trade discounts, rebate, taxes and duties), and transport, handling, storage and other costs directly attributable to the acquisition of goods and services.***

Cost of acquisition of goods or services is conceptually synonymous to cost of purchase of goods.

4.10. ***Cost of Production of goods: Cost of production of a product consists of materials consumed, Direct Wages and Salaries, direct expenses, works overheads, quality control costs, research and development costs, packing costs, administrative overheads relating to production.***

To arrive at cost of production of goods dispatched for captive consumption, adjustment for stock of Work-in-progress, finished goods, recoveries for sales of scrap, wastages etc. shall be made.

The terms Cost of Production or Cost of Manufacturing or Cost or Processing denote the same meaning and are used interchangeably.

4.11. ***Cost of Provision of Service*: *Cost of provision of services consists of cost of materials consumed, direct employee costs, direct expenses, quality control costs, research and development costs, operation overheads and administrative overheads relating to provision of services.***

4.12. ***Defectives: Materials Product or intermediate products that do not meet quality standards. This may include reworks or rejects.***

An intermediate product is a product that might require further processing before it is saleable to the ultimate consumer.

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

Rework includes repairs, reconditioning, retro-fitment and refurbishing.

4.12.2. ***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.

4.13. ***Depreciation: Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.***

4.13.1 ***Depreciable amount: The cost of an asset, or other amount substituted for cost in the financial statement, less its residual value.***

4.13.2 ***Depreciable property, plant and equipment are tangible assets that:***

(a) ***are held for use in the production of goods or supply of services, for rental to other, for administrative, selling or distribution purposes; and***

(b) ***are expected to be used during more than one accounting period.***

Land is not a depreciable asset as it does not have a defined useful life.

4.13.3 ***Useful life of asset: Useful life of asset is either:***

(a) ***the period over which a asset is expected to be available for use by an entity: or***

(b) ***the number of production or similar units expected to be obtained from use of the asset by the entity.***

4.14. ***Development Cost: Development cost Development cost is the cost for application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.***

4.15. ***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.***

4.16. ***Employee Cost: Employee Benefits paid or payable in all forms of consideration given for the service rendered by employees (including temporary, part time and contract employees) of an entity.***

Explanation:

1. Contract employees include employees directly engaged by the employer on contract basis but does not include employees of any contractor engaged in the organisation.

2. Compensation paid to employees for the past period on account of any dispute / court orders shall not form part of Employee Cost.

3. Short provisions of prior period made up in current period shall not form part of the employee cost in the current period. Employee cost includes payment made in cash or kind.

4.16.1. ***Direct Employee Cost: Employee cost, which can be attributed to a Cost object in an economically feasible way.***

4.16.2. ***Indirect Employee Cost: Employee cost, which cannot be directly attributed to a particular cost object.***

4.17. ***Excess Capacity Utilization: Excess capacity utilization is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is more than installed capacity.***

4.18. ***Idle Capacity: Idle capacity is the difference between installed capacity and the actual capacity utilization when actual capacity utilization is less than installed capacity.***

4.18.1. ***Abnormal Idle Capacity: Abnormal idle capacity is the difference between normal capacity and actual capacity utilization where the actual capacity is lower than the normal capacity.***

4.18.2. ***Normal Idle Capacity: Normal idle capacity is the difference between installed capacity and normal capacity.***

4.19. ***Installed Capacity: Installed capacity is the maximum capacity of producing goods or providing services, according to the manufacturer's specifications or determined through an expert study.***

4.20. ***Interest and Finance Costs: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the arrangements.***

Examples are:

1. Interest and commitments charges on bank borrowings, other short term and long term borrowings:
2. Financing charges in respect of finance leases and other similar arrangements: and
3. Exchange difference arising out from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms interest and financing charges, finance costs and borrowing costs are used interchangeably.

4.21. ***Joint Costs: Joint costs are the cost of common resources used to produce two or more products or services simultaneously.***

4.22. ***Joint Product: Products or services that are produced simultaneously, by the same process, identifiable at the end of the process and recognised as main products or services having sufficient value.***

4.23. ***Material Consumed: Material Consumed includes materials directly identified for production of goods or provision of Services such as:***

(a) Indigenous materials;

(b) Imported materials;

(c) Bought out items;

(d) Self-manufactured items;

(e) Process materials and other items;

(f) Materials received free of cost or at concessional value from the buyer;

(g) Accessories which are supplied along with the final product.

Cost of material consumed consists of cost of material, freight inwards, insurance and other expenditure directly attributable to procurement and goods used for providing free warranty. (Net off duties and taxes, Trade discount, rebates, subsidies and other similar items)

4.24. ***Materials Cost: The cost of material used for the purpose of production of a product or rendering a service.***

4.24.1. ***Direct Materials: Materials, the costs of which can be attributed to a cost object in an economically feasible way.***

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

4.25. ***Normal Capacity: Normal Capacity is the production achieved or achievable on an average over a numbers of period or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance.***

4.26. ***Overheads: Overheads comprise costs of indirect materials, indirect employees and indirect expenses.***

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

4.28. ***Packing Material Cost: The cost of material of any nature used for the purpose of packing of product.***

4.29. ***Production or Operation Overheads: Indirect costs involved in the production of a product or in providing service.***

The terms Production Overheads, Operation Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denotes the same meaning and are used interchangeably.

Production or Operation Overheads shall include administration cost relating to production, factory, works or manufacturing and providing of services.

In addition, Production or Operation Overheads shall be classified on the basis of behaviour such as variable Production or Operation Overheads, semi-variable Production or Operation Overheads and fixed Production or Operation Overheads.

- Variable Production or Operation Overheads comprise of expenses which vary in proportion to the change of volume of production or activity or services provided.
- Semi-variable Costs are the costs that contain both fixed and variable elements. They partly change with the change in the level of activity.
- Fixed Overheads are the costs which do not vary with the change in volume of production or activity or service provided.

4.30. ***Quality Control Cost: Cost of resources consumed towards quality control procedures.***

4.31. ***Repairs & Maintenance Cost: Cost of all activities which have the objective of maintaining or restoring an asset in or to a state in which it can perform its required function at intended capacity and efficiency.***

4.32. ***Research cost: Research cost is the cost of original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.***

4.33. *Royalty: Royalty is any consideration for the use of asset (tangible and/or intangible) to the owner.*

4.34. *Scrap: Discarded material having no or insignificant value and which is usually either disposed of without further treatment (other than reclamation and handling) or reintroduced in place of raw material.*

4.35. *Selling Overheads: Selling overheads are the expenses related to sale of products or services and include all indirect expenses incurred in selling the products or services.*

4.36. *Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions.*

4.37. *Support Service Cost Centre: The cost centre which primarily provides auxiliary services across the entity.*

4.38. *Technical Know-how Fee: Technical Know-how Fee is a lump sum or periodical amount payable to provider of Technical Know-how in the form of design, drawings, training of personnel, or practical knowledge, skills or experience.*

4.39. *Waste and Spoilage:*

4.39.1. *Waste: Material lost during production or storage and discarded material which may or may not have any value.*

4.39.2. *Spoilage: Production that does not meet the quality requirements or specification cannot be rectified economically*

5. Principles of Measurement

5.1. *Cost of production or acquisition of goods or provision of services shall be measured for each type of goods or services separately.*

5.2. *Cost of production or acquisition or supply of each type of goods shall be the aggregate of direct and indirect costs relating to the production or acquisition or supply activity of those goods.*

5.3. *Cost of provision of each type of service shall be the aggregate of direct and indirect cost relating to that service activity.*

5.4. *Material cost shall be measured separately for each type of material, that is, for indigenous material, imported material, bought out components, process materials, self-manufactured items, and accessories for each type of goods or services.*

5.5. *The material cost of normal scrap/defectives which are rejects shall be included in the material cost of goods produced or services provided. The material cost of actual scrap/ defectives, not exceeding the normal quantity shall be adjusted in the material cost of good production. Realized or realizable value of scrap or waste shall be deducted for determination of cost of production or acquisition of goods or provision of services. Material Cost of abnormal scrap /defectives should not be included in material cost but treated as loss after deducting the realisable value of such scrap / defectives.*

5.6. *Employee Cost for each type of goods or services shall be measured separately.*

5.7. *The cost of utilities consumed for the production or acquisition or supply of each type of goods or provision of services shall be measured for each type of utility separately i.e. power, electricity, water, steam & gas.*

5.8. ***Cost of packing material used for the production or acquisition or supply of goods or provision of services shall be measured for each type of goods or services separately.***

If goods are transferred / dispatched or supplied duly packed, the cost of such packing shall be included in the cost of goods transferred/dispatched or supplied.

5.9. ***Direct Expenses for the production or acquisition or supply of goods or provision of services shall be measured for each type of goods or services separately.***

5.10. ***High value spare shall be recognised as property, plant and equipment when they meet the definition of property, plant and equipment and depreciated accordingly. Otherwise, such items are classified as inventory and recognised in cost as and when they are consumed.***

5.11. ***Repairs and maintenance cost for the production or acquisition or supply of goods or provision of services shall be measured for each type of goods or services separately.***

5.12. ***Depreciation and Amortisation cost for the production or acquisition or supply of goods or provision of services shall be measured for each type of goods or services separately.***

Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

5.13. ***Research & Development cost for the production or acquisition or supply of goods or provision of services shall be measured for each type of goods or services separately.***

5.14. ***Cost incurred for the production or acquisition or supply of goods or provision of services after split-off point shall be measured for each type of Joint/By-Product or service for the resources consumed.***

In case the production process generates scrap or waste, realized or realizable value net of cost of disposal, of such scrap and waste shall be deducted from the cost of Joint Product.

5.15. ***Royalty and Technical Know-how Fee for production or acquisition or supply of goods or provision of services paid or incurred in lump-sum or which are in the nature of 'one-time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from the related Technical Know-how.***

5.16. ***Royalty paid as a consideration for use of asset or on technology transfer, in any form, will form part of cost, however royalty paid on brand usage shall not form part of cost of production.***

5.17. ***Quality Control cost incurred in-house for the production or acquisition or supply of goods or provision of services shall be the aggregate of the cost of resources used in the Quality Control activities in relation to each type of goods or service. The cost of resources procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts, taxes and duties refundable or to be credited as input tax credit.***

5.18. ***Production or Operation Overheads representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts; taxes and duties refundable or to be credited as input tax credit. Production or Operation Overheads other than those referred to above shall be determined on the basis of cost incurred in connection therewith.***

Industry Specific Operating Expenses: In case of process peculiarity of a particular industry, it may not be easily practicable to determine element- wise conversion cost of a product. In such situation, the company may calculate cost center/cost object-wise conversion cost. It may be summarized under 'industry specific operating expenses', instead of element-wise conversion cost e.g. Textile industry-spinning, weaving, processing.

5.19. ***Any abnormal cost, where it is material and quantifiable, shall not form part of the cost of production or acquisition or supply of goods or provision of service.***

5.20. ***Interest and other Finance costs shall not form part of cost of production or acquisition of goods or provision of services.***

5.21. ***Impairment loss on assets shall not form part of cost of production or acquisition or supply of goods or provision of services.***

5.22. ***Imputed costs shall not form part of cost of production or acquisition or supply of goods or provision of services.***

5.23. ***Cost of production or acquisition or supply of goods or provision of services shall include cost of inputs received free of cost or at concessional value, net of input tax credit, from the recipient of goods or services and amortisation cost of free tools, pattern, dies, drawings, blue prints, technical maps, charts, engineering, development, art work, design work, plans, sketches, and the like necessary for the production or acquisition or supply of goods or provision of services.***

5.24. ***Cost of production or acquisition or supply of goods or provision of services shall also include cost of rework, reconditioning, retro-fitment, production or operation overheads and other costs allocable to such activity, adjustment for stock of work-in-process and recoveries from sales of scrap and wastages and the like necessary for the production or acquisition or supply of goods or provision of services.***

5.25. ***Subsidy or Grant or Incentive or any such payment received or receivable, from any entity other than the recipient of goods or service, with respect to any element of cost shall be deducted for ascertainment of the cost of production or acquisition or supply of goods or provision of services to which such amounts are related.***

5.26. ***Any Grants recognized as deferred income in the financial statements shall also be reduced from the relevant element of cost of production or acquisition or supply of goods or provision of services.***

5.27. ***The cost of production or acquisition or supply of goods or provision of services shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost.***

5.28. ***Fines, penalties, damages, demurrage and similar levies paid to statutory authorities or other third parties shall not form part of the cost of production or acquisition or supply of goods or provision of services.***

5.29. ***The forex component of imported material or other element of cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the cost of production or acquisition or supply of goods or provision of services.***

5.30. ***Credits or recoveries relating to any element of cost including the facilities provided to outside parties, which are material and quantifiable, shall be deducted from the total cost of production or acquisition or supply of goods or provision of services.***

5.31. ***Work in process/progress stock shall be measured at cost computed for different stages of completion.***

Stock of work-in-process/progress shall be valued at cost on the basis of stages of completion as per cost accounting principles. Opening and closing stock of work-in-process/progress shall be adjusted for computation of cost of production or acquisition of goods or provision of services.

6. Assignment of Cost

6.1. ***Cost of production or acquisition or supply of goods or provision of services shall be determined on 'normal cost' basis. For this purpose, any abnormal and non-recurring costs, abnormally low plant utilization, abnormal rejections, accidents, strikes, fires, unexpected Court orders etc. shall be ignored.***

6.2. ***While assigning various elements of cost, traceability to goods or services in an economically feasible manner shall be the guiding principle. The cost which can be traced directly to each type of goods or services shall be directly assigned.***

6.3. ***Assignment of cost of producing or acquisition or supply of goods or providing services, which are not directly traceable to the goods or services shall be based on either of the following two principles;***

6.3.1. ***Cause and Effect – Cause is the process or operation or activity and effect is the incurrence of cost.***

6.3.2. ***Benefits received – to be apportioned to various cost objects in proportion to the benefits received by them.***

6.4. ***The variable production or operation overheads shall be absorbed based on actual production.***

6.5. ***The fixed production or operation overheads and other similar item of fixed costs such as quality control cost, research and development costs and administrative overheads relating to manufacturing shall be absorbed in the cost of production or acquisition or supply of goods or provision of services on the basis of the normal capacity or actual capacity utilization of the plant or service centre, whichever is higher.***

6.6. ***In case a production process results in more than one product being produced simultaneously, treatment of joint products and by-products shall be as under:***

6.6.1. ***In case joint products are produced, joint costs incurred upto the split off point are allocated between the products on a rational, equitable, and consistent basis.***

Joint cost incurred shall be assigned to the joint products based on benefits received measured by using the physical unit method or equivalent cost or net realisable value at split off point. Net realisable value for this purpose means the net selling price per unit multiplied by quantity sold, adjusted for the post-split off costs.

6.6.2. ***In case by-products are produced, the net realisable value of by-products is credited to the manufacturing cost of the main product.***

6.7. ***In case a process results in more than one service being produced simultaneously, joint costs incurred upto the split off point are allocated between the services on a rational, equitable, and consistent basis.***

6.8. ***Miscellaneous Income relating to production or operations shall be adjusted in the determination of cost of production or acquisition or supply of goods or of cost of providing a service.***

For example, income from sale of empty containers used for procurement of raw material shall be deducted in determination of manufacturing cost.

7. Presentation

7.1. ***Cost Statements should be prepared as per the applicable format given in the Appendix to this Standard or as near thereto as possible, as listed below:***

7.1.1. ***Appendix-1: Statement of Cost of Production of the taxable goods***

7.1.2. ***Appendix-2: Statement of Cost of Provision/Supply of the taxable Services***

7.1.3. ***Appendix-3: Statement of Cost of Acquisition of taxable goods***

7.1.4. ***Appendix-4: Statement of Open Market Value / Value as per Goods or Services of like kind and quality***

7.2. ***Companies covered under the Companies (Cost Records and Audit) Rules, 2014 issued under section 148 of the Companies Act 2013 shall prepare and present the cost records and cost statements in compliance with the said Rules, applicable Cost Accounting Standards, and Generally Accepted Cost Accounting Principles issued by the Institute.***

7.3. ***Companies not covered under these Rules and all other entities shall prepare and present the cost records and cost statements in compliance with the applicable Cost Accounting Standards and Generally Accepted Cost Accounting Principles issued by the Institute.***

7.4. ***Cost Statements as certified by the Cost Accountant in practice should enable the business entity to determine value of taxable goods or services at the time of supply and issue of tax invoice as required under section 31 of the CGST Act.***

7.5. ***In cases where it may not be possible to determine true and fair cost of goods or services at the time of supply of such goods or services or both, the company should compute the cost on budgeted/ estimated/standard cost basis and the Cost Accountant may issue provisional Cost certificate on such basis. In such cases, final certificate shall be issued after costs are finalized. In case of any variations in the costs and hence the value of goods or services, the supplier shall issue a Debit or Credit Note as per provisions of section 34 of the CGST Act.***

Examples of such cases are – Input costs or prices based on the LME prices; existence of cost escalation clauses in the supply contract; or where future costs of inputs and input services are unpredictable, uncertain and volatile, etc.

7.6. ***Certified Cost Statements shall be presented with the following periodicity:***

7.6.1. ***In case of registered person, whose aggregate turnover in the preceding financial year did not exceed the limits prescribed in Section 10 (1) of the CGST Act 2017, the Certified Cost Statement shall be issued for a six month period. For example costs for April to September shall be certified in March of the same year.***

7.6.2. ***In case of registered person, whose aggregate turnover in the preceding financial year exceeds the limits prescribed in Section 10 (1) of the CGST Act 2017, Certified Cost Statement shall be issued on quarterly basis e.g. costs for July to September shall be certified in June of the same year.***

7.6.3. *Certified Cost Statement shall also be issued for the completed financial year, annually based on audited accounts on or before 31st December of the next financial year.*

7.7. *The cost statements shall be prepared by the Management and authenticated & signed by any Key Management Personnel in case of company, partner in case of partnership firm and proprietor in case of proprietary firm.*

7.8. *The statement shall be certified by a Cost Accountant in practice after the same is duly authenticated as above. The certificate may contain any qualification or disclosures as required.*

8. Disclosures

8.1. *Disclosure shall be made only where material, significant, and quantifiable.*

8.2. *If there is any change in cost accounting principles and practices during the period under review which may materially affect the cost of production or acquisition of goods or provision services in terms of comparability with previous period(s), the same shall be disclosed.*

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

8.4. *Any fact which may have material impact on the costs as certified should be disclosed.*

9. Effective date

This Cost Accounting Standard shall be effective from 1st March 2019 and will apply for preparation and certification of Cost Statements for determining the Cost of Production / Acquisition / Supply of Goods / Provision of Services as required under the provisions of GST Act/Rules, from the financial year 2018-19.

Let us give an example:

A production process has three stages.

Stage	Input material cost	Processing cost	Total
	(₹ / MT)	(₹ / MT)	(₹ / MT)
1	2000	500	2500
2	2500	1000	3500
3	3500	1000	4500

If during the production process at stage, 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.

Appendix-I

Statement of Cost of Production of the taxable goods

(refer Rule 30 of the CGST Rules, 2017)

A	**General Information**					
1	Name of the Manufacturer					
2	Address of the Manufacturer					
3	GSTIN of the Manufacturer					
4	Description of the Product					
5	HSN Code of the Product					
6	Period of validity of Cost Statement					
B	**Quantitative Information**				**Unit**	**Quantity**
1	Quantity produced					
C	**Cost Information**	**Unit**	**Quantity**	**Rate**	**Amount**	**Cost per Unit**
1	Cost of Material (Specify)					
	A.					
	B.					
	C.					
	Others					
2	Process Materials/Chemicals					
3	Cost of Utilities (Specify)					
	A.					
	B.					
	C.					
4	Direct Employee Cost					
5	Direct Expenses					
6	Consumable Stores and Spares					
7	Repairs and Maintenance Cost					
8	Quality Control Cost					
9	Reserach & Development Cost					
10	Technical Know-how Fee/Royalty, if any					
11	Depreciation / Amortization					
12	Other Production Overheads					
13	Administrative Overheads relating to cost of Production					

14	Industry specific Operating Expenses					
15	Total(1 to 14)					
16	Work-in-Progress Adjustments					
17	Less: Credit for Recoveries, if any					
18	Net Amount (15+/-16-17)					
19	Packing Cost					
20	Cost of Inputs received free or at concessional value from or on behalf the recipient of the taxable goods (net of input tax credit)					
21	Amortised cost of moulds, tools, dies and patterns, etc. received free of cost from or on behalf of the recipient of the taxable goods.					
22	Cost of Production (18 to 21)					

We hereby affirm as follows –

1. We have maintained the cost records as required.
2. The cost statement has been prepared in compliance with the applicable Cost Accounting Standards and generally accepted cost accounting principles.

Date: Seal & Signature of the Company's Authorised Representative

I/We have verified the aforesaid cost 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 our test checks performed and on the basis of Cost Accounting Standards and generally accepted cost accounting principles and practices followed by the Industry, I/we certify that the above cost data reflects true and fair view of the cost of production or manufacture of the above good.

Date: Seal & Signature of the Cost Accountant

Place: Membership No.: Firm Reg. No.:

Note:

1. Separate Cost Statement(s) shall be prepared for each type of goods.

2. Any other material and significant fact in relation to compilation of the cost statement (s) should be disclosed by way of Notes.

Appendix-II

Statement of Cost of Production of the taxable Service

(refer Rule 30 of the CGST Rules, 2017)

A	**General Information**					
1	Name of the Supplier of Service					
2	Address of the Supplier of Service					
3	GSTIN of the Supplier of Service					
4	Description of the Service					
5	Service Code					
6	Period of validity of Cost Statement					
B	**Quantitative Information (if applicable)**				**Unit**	**Quantity**
	Quantum of Service Provided					
C	**Cost Information**	**Unit**	**Quantity**	**Rate (₹)**	**Amount (₹)**	**Cost per Unit (₹)**
1	Materials consumed (Specify major items)					
	A.					
	B.					
	C.					
	Others					
2	Utilities (Specify)					
	A.					
	B.					
	C.					
3	Direct Employee Cost					
4	Direct Expenses					
5	Consumable Stores and Spares					
6	Repairs and Maintenance					
7	Quality Control Expenses					
8	Reserach & Development Expenses					
9	Technical Know-how Fee/Royalty					
10	Depreciation / Amortization					
11	Operation Overheads relating to provision of services					
12	Administrative Overheads relating to Supply of Service					
13	Industry specific Operating Expenses					

14	Free supplies received from recipient or supplied on behalf of recipient, if any (net of input tax credit)					
15	Total (1 to 14)					
16	Less Credit for Recoveries, if any					
17	Cost of Services Provided (15-16)					

We hereby affirm as follows –

1. We have maintained the cost records as required.
2. The cost statement has been prepared in compliance with the applicable Cost Accounting Standards and generally accepted cost accounting principles.

Date: Seal & Signature of the Company's Authorised Representative

I/We have verified the aforesaid cost 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 our test checks performed and on the basis of Cost Accounting Standards and generally accepted cost accounting principles and practices followed by the Industry, I/we certify that the above cost data reflects true and fair view of the cost of providing the above taxable service.

Date: Seal & Signature of the Cost Accountant

Place: Membership No.: Firm Reg. No.:

Note:

1. **Separate Cost Statement(s) shall be prepared for each service.**
2. **Any other material and significant fact in relation to compilation of the cost statement (s) should be disclosed by way of Notes**

Appendix -III

Statement showing Cost of Acquisition of the taxable Goods

(refer Rule 30 of the CGST Rules, 2017)

A	**General Information**					
1	Name of the Acquirer					
2	Address of the Acquirer					
3	GSTIN of the Acquirer					
4	Description of the Product acquired					
5	HSN Code of the Product					
6	Period during which the goods were acquired					
7	Source by which acquired	Indigenous / Imported				
B	**Quantitative Information**				**Unit**	**Quantity**
1	Opening Stock of acquired Goods					
2	Goods acquired during the period					
3	Closing Stock of acquired goods					
4	Quantity of acquired goods sold					
C	**Cost Information (when acquired from Indigenous sources)**	**Unit**	**Quantity**	**Rate (₹)**	**Amount (₹)**	**Cost per Unit (₹)**
1	Purchase Cost of the Goods acquired					
2	Inward Freight					
3	Inward Insurance					
4	Packing cost charged by the Supplier					
5	Incidental Expenses charged by the Supplier					
6	Commission charged by the Supplier					
7	Taxes, duties, cesses, fees and charges levied under any law other than the GST Laws					
8	Interest or late fee or penalty for delayed payment charged by the Supplier					
9	Less : Subsidy/Grants etc. received from the Government					

10	Storage Charges					
11	Administrative Overheads relating to acquisition of goods					
12	L/C Commission and other expenses directly connected with acquisition of goods					
13	Total (1 to 12)					
14	Less: Trade Discount or Rebate given by the Supplier					
15	Less: Credit for Recoveries, if any					
16	Less: Input Tax Credit availed					
17	Cost of Acquisition (13 to 17)					
D	**Cost Information (when acquired from Foreign sources)**	**Unit**	**Quantity**	**Rate (₹)**	**Amount (₹)**	**Cost per Unit (₹)**
1	Purchase Cost of the Goods acquired					
2	Inward Ocean/sea Freight from out of India to customs port					
3	Maritime Insurance					
4	Clearing & Forwarding Charges					
5	Inland Inward Freight					
6	Inward Insurance within India					
7	Packing cost charged by the Supplier					
8	Incidental Expenses charged by the Supplier					
9	Commission charged by the Supplier					
10	Taxes, duties, cesses, fees and charges levied under any law other than the GST Laws, where Input Tax Credit is not available					
11	Interest or late fee or penalty for delayed payment charged by the Supplier					
12	Subsidy/Grant etc. paid by person other than Government					
13	Storage Charges					
14	Administrative Overheads relating to acquisition of goods					
15	L/C Commission Charged					

16	Total (1 to 15)					
17	Less: Trade Discount or Rebate given by the Supplier					
18	Less: Credit for Recoveries, if any					
19	Less: Input Tax Credit availed					
20	Cost of Acquisition (16 to 19)					

We hereby affirm that we have maintained the cost records as required.

Date: Seal & Signature of the Company's Authorised Representative

I/We have verified the aforesaid cost 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 our test checks performed and on the basis of Cost Accounting Standards and generally accepted cost accounting principles and practices followed by the Industry, I/we certify that the above cost data reflects true and fair view of the cost of acquisition of the above taxable good.

Date: Seal & Signature of the Cost Accountant

Place: Membership No.: Firm Reg. No.:

Note:

1. Separate Cost Statement(s) shall be prepared for each type of goods.
2. Any other material and significant fact in relation to compilation of the cost statement (s) should be disclosed by way of Notes.

Appendix-IV

Statement of Open Market Value / Value as per Goods or Services of like kind and quality

(refer Rules 27 to 29 of the CGST Rules, 2017)

A	**General Information**	
1	Name of the Supplier of goods or services or both*	
2	Address of the Supplier of goods or services or both*	
3	GSTIN of the Supplier of goods or services or both*	
4	Description of the Product / Service*	
5	HSN Code of the Product / Service Code*	
6	Period of validity of the Cost Statement	
7	List of Documents Verified	

On the basis of aforesaid documents and other details available with us, we hereby affirm that the open market value / value as per goods or services or both of the like kind and quality as stated above is ₹ _______________ .

Date: Seal & Signature of the Company's Authorised Representative

I/We have verified the aforesaid documents on test check basis.

Based on the information and explanations given to me/us, and our test checks performed, I/we certify that the above value reflects true and fair value of the above taxable goods or services or both.

Date: Seal & Signature of the Cost Accountant

Place: Membership No.: Firm Reg. No.:

Note:

1. **Separate Statement(s) shall be prepared for each goods or for each service.**
2. **Any other material and significant fact in relation to compilation of the cost statement (s) should be disclosed by way of Notes**

***strike off whatever not relevant**

CAS -5

COST ACCOUNTING STANDARD

ON DETERMINATION OF

AVERAGE (EQUALIZED) COST OF TRANSPORTATION

The following is the text of the Cost Accounting Standard 5 (CAS-5) issued by the Council of the Institute of Cost & Works Accountants of India on **"DETERMINATION OF AVERAGE (EQUALIZED) COST OF TRANSPORTATION"**. This standard deals with the determination of average transportation cost of a product. In this standard the standard portions have been set in ***bold italic*** type. These are to be read in the context of the background material which has been set in the normal type.

1. Introduction:

1.1 The cost accounting principles for tracing/identifying an element of cost, its allocation/apportionment to a product or service are well established. Transportation cost is an important element of cost for procurement of materials for production and for distribution of product for sale. Therefore, Cost Accounting Records should present transportation cost separately from the other cost of inward materials or cost of sales of finished goods. The Finance Act, 2003 also specifies the certification requirement of transportation cost for claiming deduction while arriving at the assessable value of excisable goods cleared for home consumption/ export. There is a need to standardize the record keeping of expenses relating to transportation and computation of transportation cost.

2. Objective

2.1 To bring uniformity in the application of principles and methods used in the determination of averaged/ equalized transportation cost.

2.2 To prescribe the system to be followed for maintenance of records for collection of cost of transportation, its allocation/apportionment to cost centres, locations or products.

For example, transportation cost needs to be apportioned among excisable, exempted, non-excisable and other goods for arriving at the average of transportation cost of each class of goods.

2.3 To provide transparency in the determination of cost of transportation.

3. Scope

3.1 This standard should be applied for calculation of cost of transportation required under any statute or regulations or for any other purpose. For example, this standard can be used for :

(a) determination of average transportation cost for claiming the deduction for arriving at the assessable value of excisable goods

(b) Insurance claim valuation

(c) Working out claim for freight subsidy under Fertilizer Industry Coordination Committee

(d) Administered price mechanism of freight cost element

(e) Determination of inward freight costs included or to be included in the cost of purchases attributable to the acquisition.

(f) Computation of freight included in the value of inventory for accounting on inventory or valuation of stock hypothecated with Banks / Financial Institution, etc.

4. Definitions

The following terms are used in this standard with the meaning specified :

4.1 ***Cost of Transportation comprises of the cost of freight, cartage, transit insurance and cost of operating fleet and other incidental charges whether incurred internally or paid to an outside agency for transportation of goods but does not include detention and demurrage charges.***

Explanation :

Cost of transportation is classified as inward transportation cost and outward transportation Cost.

4.2 Inward Transportation cost is the transportation expenses incurred in connection with materials / goods received at factory or place of use or sale/removal.

4.3 Outward Transportation cost is the transportation expenses incurred in connection with the sale or delivery of materials or goods from factory or depot or any other place from where goods are sold / removed

4.4 Freight is the charges paid or payable for transporting materials/ goods from one location to another.

4.5 Cartage is the expenses incurred for movement of goods covering short distance for further transportation for delivery to customer or storage.

4.6 Transit insurance cost is the amount of premium to be paid to cover the risk of loss /damage to the goods in transit.

4.7 Depot is the bounded premises/place managed internally or by an agent, including consignment agent and C&F agent, franchisee for storing of materials/goods for further dispatch including the premises of Consignment Agent and C&F Agent for the purpose.

Depot includes warehouses, godowns, storage yards, stock yards etc.

4.8 Equalized transportation cost means average transportation cost incurred during a specified period.

4.9 Equalized freight means average freight.

5. Maintenance of records for ascertaining Transportation Cost

5.1 Proper records shall be maintained for recording the actual cost of transportation showing each element of cost such as freight, cartage, transit insurance and others after adjustment for recovery of transportation cost. Abnormal costs relating to transportation, if any, are to be identified and recorded for exclusion of computation of average transportation cost.

5.2 In case of a manufacturer having his own transport fleet, proper records shall be maintained to determine the actual operating cost of vehicles showing details of various elements of cost, such as salaries and wages of driver, cleaners and others, cost of fuel, lubricant grease, amortized cost of tyres and battery, repairs and maintenance, depreciation of the vehicles, distance covered and trips made, goods hauled and transported to the depot.

5.3 In case of hired transport charges incurred for despatch of goods, complete details shall be recorded as to date of despatch, type of transport used, description of the goods, destination of buyer, name of consignee, challan number, quantity of goods in terms of weight or volume, distance involved, amount paid, etc.

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

5.5 Separate records shall be maintained for identification of transportation cost towards inward movement of material (procurement) and transportation cost of outward movement of goods removed /sold for both home consumption and export.

5.6 Records for transportation cost from factory to depot and thereafter shall be maintained separately.

5.7 Records for transportation cost for carrying any material / product to job-workers place and back should be maintained separately so as include the same in the transaction value of the product.

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

5.9 Records of transportation cost directly allocable to a particular category of products should be maintained separately so that allocation in appendix –3 can be made.

5.10 For common transportation cost, both for own fleet or hired ones, proper records for basis of apportionment should be maintained.

5.11 Records for transportation cost for exempted goods, excisable goods cleared for export shall be maintained separately.

5.12 Separate records of cost for mode of transportation other than road like ship, air etc are to be maintained in appendix –2 which will be included in total cost of transportation.

6. Treatment of cost:

6.1 Inward transportation costs shall form the part of the cost of procurement of materials which are to be identified for proper allocation/ apportionment to the materials / products.

6.2 Outward transportation cost shall form the part of the cost of sale and shall be allocated / apportioned to the materials and goods on a suitable basis.

Explanation :

Outward transportation cost of a product from factory to depot or any location of sale shall be included in the cost of sale of the goods available for sale.

6.3 The following basis may be used, in order of priority, for apportionment of outward transportation cost depending upon the nature of products, unit of measurement followed and type of transport used:

(i) Weight

(ii) Volume of goods

(iii) Tonne-Km

(iv) Unit / Equivalent unit

(v) Value of goods

(vi) Percentage of usage of space

Once a basis of apportionment is adopted, the same should be followed consistently.

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

6.5 Abnormal and non recurringcost shall not be a part of transportation cost.

Explanation

Penalty, detention charges, demurrage and cost related to abnormal break down will not be included in transportation cost.

7. Cost Sheet

The cost sheets shall be prepared and presented in a form as per Appendices 1,2 and 3 or as near thereto. Appendix 1 and Appendix 2 show the details of information to be maintained for compilation of transport cost for own fleet and hired transportation charges respectively. Appendix 1 is applicable where the organization is having its own fleet.

The directly allocable cost of own fleet (outward) shall be identified against different categories of products as shown in Appendix 3 and same shall be indicated there. Similarly, total common cost of own fleet (outward) shall be apportioned to different categories of products as shown in Appendix 3 on a basis which should be specified. The basis of apportionment may be adopted depending on the nature of product as indicated in para 6.3. Similar approach shall also be applied for hired outward transport charges.

More columns may be required to be shown in Appendix 3 specifying different types of transactions. For example : Sale on specific rate basis, sale of waste, scrap, return from customer, goods sent for job work, goods received after job work etc.

Unit of Measurement (UM) may vary depending upon the nature of the product. For example, Number, MT, Meter, Litre etc.

Proper records shall be maintained to show separately the Transportation Cost relating to sending of jobs to job contractors/convertors and receipt back of processed jobs/converted materials.

An enterprise shall be required to maintain cost records and other books of account in a manner which would facilitate preparation and verification of cost of transportation and other related charges and its apportioning to various products.

8. Transaction value :

'Transaction value' shall have the meaning assigned to it in Section 4 of The Central Excise Act, 1944 or Section 14 of The Customs Act , 1962 or as defined in any other Act or Regulations as the case may be.

9. The standard will be operative from the date of issue.

Appendix-I

Name of the Manufacturer:

Address of the Manufacturer:

Statement of Operating Cost of own Fleet for the period…….

Sl No		
A	**QUANTITATIVE INFORMATION**	
A1	Number of Vehicles	
A2	Number of trips	
A3	Goods Transported – inward (UM)	
A4	Goods transported – outward (UM)	
A5	Goods transported – inward – Km	
A6	Goods transported – outward – Km	
A7	Total Goods transported inward – basis of apportionment (Specify)	
A8	Total Goods transported outward – basis of apportionment (Specify)	
A9	**Total (A7+A8)**	
B	**COST INFORMATION**	(₹)
	Cost of Operation	
	Variable Cost	
B1.	Salaries & Wages of Drivers, Cleaners and others	
B2.	Fuel & Lubricants	
B3.	Consumables	
B4.	Amortized cost of Tyre, Tube & Battery	
B5.	Spares	
B6.	Repair & Maintenance	
B7.	Other Variable Cost (specify)	
B8.	**Total Variable Cost (B1 to B7)**	
	Fixed Cost	
B9.	Insurance	
B10.	Licence Fee, Permit Fee and Taxes	
B11.	Depreciation	
B12.	Other Fixed Costs (Specify)	
B13.	**Total Fixed Cost (B9 to B12)**	
B14.	**Total Operating Cost (B8+B13)**	
C	**APPORTIONMENT (Basis to be specified) - usage**	
C1.	Inward Transport Cost (B14 × A7/ A9)	
C2.	Outward Transport Cost (B14 × A8/A9)	
C3.	Transit insurance for inward movement	
C4.	Transit insurance for outward movement	
C5.	Total transportation cost for inward movement (C1 + C3)	
C6.	Total transportation cost for outward movement (C2 + C4)	

Note :

1. Cost of Battery, and Tyres and Tubes shall to be amortised over its useful life.
2. Asset Register shall be maintained for determination of depreciation and amortization cost.
3. Separate Cost Sheet shall be prepared for different types of vehicles

Appendix-II

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**	**Goods Cleared from Depot to Customer**	**Others**
			Product-Group 1	Product-Group 2	Product-Group 3							
A1	Goods transported Outwards (UM *)											
A2	Goods Transported Outward (KM)											
B	**Outward Transport Cost (₹)**											
B1	Directly allocated own fleet transportation cost (₹)											

B2	Basis of Apportionment of own fleet Cost (Specify)											
B3	Common own fleet transport cost to be apportioned											
B4	Directly allocated hired transportation charges (₹)											
B5	Basis of Apportionment of hired transportation cost (Specify)											
B6	Common hired transport charges to be apportioned											
B7	Total Transport Cost (B1+ B3+ B4 + B6)											
B8	Averaged transport cost per unit (B7/ A1) (₹)											

* UM is the Unit of measurement

Seal and signature of Company's authorized representative

I /We, have verified above data and calculation in the appendix 1, 2 and 3 on test check basis with reference to the books of account, cost accounting records and other records. Based on the information and explanations given to me/us, and on the basis of generally accepted cost accounting principles and practices followed by the industry, I / We certify that the above cost data reflect true and fair view of averaged transport cost.

Date: Seal & Signature of Cost Accountant

Place: Membership No. ....

CAS-6

COST ACCOUNTING STANDARD ON MATERIAL COST

(Revised 2017)

The following is the COST ACCOUNTING STANDARD 6 (CAS 6) issued by the Council of The Institute of Cost 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 (Adapted fromCAS-1 Para 6.5.19).***

4.2 **Administrative overheads:** ***Cost of all activities relating to general management and administration of an entity.***

4.3 **Cost Object:** ***An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.4 **Defectives: Ma*terials, products or intermediate products that do not meet quality standards. This may include reworks or rejects.***

*4.4.1 **Reworks:*** **De*fectives 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 Intermediate Product: An intermediate product is a product that requires further processing before it is saleable.

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 (Adapted from CAS 1-6.2.3).

4.6.2 Indirect Materials: Materials, the costs of which cannot be directly attributed to particular cost object (Adapted from CAS 1– 6.2.8).

4.7 Material Cost: The cost of material used for the purpose of production of a product or rendering a service.

4.8 Production overheads: Indirect costs involved in the production of a product or in rendering service

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

4.9 Property, plant and equipment are tangible assets that:

(a) are held for use in the production of goods or supply of services, for rental to others, for administrative, selling or distribution purposes; and

(b) are expected to be used during more than one accounting period.

4.10 Scrap: Discarded material having no or insignificant value and which is usually either disposed off without further treatment (other than reclamation and handling) or reintroduced into the process in place of raw material.

4.11 Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions

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 (Adapted from CAS 1_ Para 6.7.5). 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.

4.12 Waste and spoilage:

4.12.1 Waste: ***Material lost during production or storage and discarded material which may or may not have any value.***

4.12.2 Spoilage: ***Production that does not meet the quality requirements or specifications and cannot be rectified economically.***

5. Principles of Measurement

5.1. Principle of valuation of receipt of materials:

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

Examples of taxes and duties to be deducted from cost are cenvat credits, credit for countervailing customs duty, sales tax set off/ vat credits and other similar items of credit recovered/ recoverable.

5.1.2 ***Finance costs incurred in connection with the acquisition of materials shall not form part of material cost.***

5.1.3 ***Self manufactured materials shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads. In case of captive consumption, the valuation shall be in accordance with Cost Accounting Standard 4.***

5.1.4 **Items such as spare parts, stand-by equipment and servicing equipment are recognised as property, plant and equipment when they meet the definition of property, plant and equipment and depreciated accordingly. Otherwise, such items are classified as inventory and recognised in cost as and when these are consumed.**

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.*

5.3 *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, machineryspares, 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 (Related party as per the applicable legal requirements relating to the cost statement as on the date of statements)shall be disclosed***

8.8 ***Disclosures shall be made only where significant, material and quantifiable.***

8.9 ***Disclosures may be made in the body of the Cost statement or as a footnote or as a separate schedule.***

CAS – 7

COST ACCOUNTING STANDARD ON EMPLOYEE COST

(Revised 2017)

The following is the COST ACCOUNTING STANDARD 7 (CAS - 7) issued by the Council of The Institute of Cost 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 (Adapted from CAS 1 paragraph 6.5.19).

4.2 Abnormal Idle time: An unusual or atypical idle time occurrence of which is irregular and unexpected or due to some abnormal situations.

E.g.: Idle time due to a strike, lockout or an accident

4.3 Administrative overheads: Cost of all activities relating to general management and administration of an entity.

4.4 Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.

4.5 Direct Employee Cost: Employee cost, which can be attributed to a Cost object in an economically feasible way (Adapted from CAS 1 paragraph 6.2.4 (Direct labour cost)).

4.6 Distribution Overheads: Distribution overheads, also known as distribution costs, are the costs incurred in handling a product or service from the time it is ready for despatch or delivery until it

reaches the ultimate consumer including the units receiving the product or service in an inter-unit transfer

The cost of any non manufacturing operations such as packing, repacking, labelling, etc. at an intermediate storage location will be part of distribution cost.

4.7 ***Employee cost: Employee benefits paid or payable in all forms of consideration given for the services rendered by employees (including temporary, part time and contract employees)of an entity.***

Explanation:

1. Contract employees include employees directly engaged by the employer on contract basis but does not include employees of any contractor engaged in the organisation.
2. Compensation paid to employees for the past period on account of any dispute / court orders shall not form part of Employee Cost.
3. Short provisions of prior period made up in current period shall not form part of the employee cost in the current period.

Employee cost includes payment made in cash or kind.

For example:

Employee cost

- Salaries, wages, allowances and bonus / incentives.
- Contribution to provident and other funds.
- Employee welfare
- Other benefits

Employee cost – Future benefits

- Gratuity.
- Leave encashment.
- Other retirement/separation benefits.
- VRS/ other deferred Employee cost.
- Other future benefits

Benefits generally include

- 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.
- Interest free or subsidised loans.
- Any other free or subsidised facility.
- Cost of Employees' stock option.

4.8 Idle time: The difference between the time for which employees are paid /payable to employees and the employees' time booked against cost objects.

The time for which the employees are paid includes holidays, paid leave and other allowable time offs such as lunch, tea breaks.

4.9 Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.

4.10 Indirect Employee Cost: Employee cost, which can not be directly attributed to a particular cost object (Adapted from CAS 1 paragraph 6.2.10).

4.11 Marketing overheads: Marketing overheads comprise of selling overheads and distribution overheads.

4.12 Overtime Premium: The extra amount payable beyond the normal wages and salaries for beyond the normal working hours.

4.13 Production Overheads: Indirect costs involved in the production of a product or in rendering service.

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

4.14 Selling Overheads: Selling overheads are the expenses related to sale of products or services and include all indirect expenses incurred in selling the products or services.

4.15 Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions.

Standard costs are used as scale of reference to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

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 (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).***
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.***

CAS-8

COST ACCOUNTING STANDARD ON COST OF UTILITIES

(Revised 2017)

The following is the COST ACCOUNTING STANDARD – 8 (CAS-8) issued by the Council of The Institute of Cost 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 (Adapted from CAS 1 paragraph 6.5.19).

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

4.3 Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.

4.4 Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.

4.5 Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings;
2. Financing Charges in respect of finance leases and other similar arrangements; and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

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 (Adapted from CAS 2 paragraph 4.4).***

In case of any standby utility the normal capacity will be the same as actual production of the utility.

The normal capacity of a utility meant for captive consumption would be based on the normal capacity for the production facility of the end product of the consuming unit.

4.7 ***Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

4.8 ***Stand-by utilities: Any utility created as backup against any failure of the main source of utilities.***

4.9 ***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.***

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.***

5.2.1 ***Cost of self generated utilities for own consumption shall comprise direct material cost, direct employee cost, direct expenses and factory overheads.***

5.2.2 ***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.***

5.2.3 ***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.***

5.2.4 ***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.

5.3 ***Finance costs incurred in connection with the utilities shall not form part of cost of utilities.***

5.4 ***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.

5.5 ***Cost of utilities shall not include imputed costs.***

5.6 ***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.***

5.7 ***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.***

5.8 ***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 (Adapted from paragraph 5.7 of CAS 3). Cost of a Stand-by Utility shall include the committed costs of maintaining such a utility.***

5.9 ***Any abnormal cost where it is material and quantifiable shall not form part of the cost of utilities.***

5.10 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of utilities.***

5.11 ***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.***

5.12 ***Any change in the cost accounting principles applied for the measurement of the cost of utilities should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***While assigning cost of utilities, traceability to a cost object in an economically feasible manner shall be the guiding principle.***

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

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

7. Presentation

7.1 *Utilities costs shall be presented as a separate cost head for each type of utility in the cost statement, if material.*

7.2 *Where separate cost statements are prepared for utilities, cost of utilities shall be classified as purchased or generated. Such statement shall also include cost of utilities consumed along with quantitative information by individual consuming units, inter unit transfers, inter company transfers and sale to outside parties wherever applicable.*

8. Disclosures

8.1 *The cost statements shall disclose the following:*

1. *The basis of distribution of Cost of Utility to the consuming centres.*
2. *The cost of purchase, production, distribution, marketing and price with reference to sales to outside parties.*
3. *Where cost of utilities is disclosed at standard cost, the price and usage variances.*
4. *The cost and price of Utility received from/supplied to related parties (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).*
5. *The cost and price of Utility received from/supplied as inter unit transfers and intercompany transfers*
6. *Cost of utilities incurred in foreign exchange.*
7. *Any Subsidy/Grant/Incentive and any such payment reduced from Cost of utilities.*
8. *Credits/recoveries relating to the Cost of utilities.*
9. *Any abnormal cost excluded from Cost of utilities.*
10. *Penalties and damages paid etc excluded from cost of utilities.*

8.2 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the Cost of utilities during the period covered by the cost statement which has a material effect on the Cost of utilities. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

8.3 *Disclosures shall be made only where material, significant and quantifiable.*

8.4 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule*.

CAS 9

COST ACCOUNTING STANDARD ON PACKING MATERIAL COST

(Revised 2017)

The following is the COST ACCOUNTING STANDARD - (CAS - 9) issued by the Council of The Institute of Cost 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 (Adapted from CAS 1 Para 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 entity.*** Administrative overheads shall exclude any overhead relating to production, operations and marketing**.**

4.3 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.4 ***Direct Employee Cost: Employee cost, which can be attributed to a cost object in an economically feasible way (Adapted from CAS 7 Para 4.6).***

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 (Adapted from CAS 1 Para 6.2.6 and also proposed in the CAS on Direct Expenses)***. 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 in an economically feasible way.***

4.7 ***Distribution Overheads: Distribution overheads, also known as distribution costs, are the costs incurred in handling a product or service from the time it is ready for despatch or delivery until it reaches the ultimate consumer including the units receiving the product or service in an inter-unit transfer.***

For example:

- Secondary packing
- Transportation cost
- Warehousing cost
- Cost of delivering the products to customers etc.
- Clearing and forwarding charges
- Cost of mending or replacing packing materials at distribution point.

4.8 ***Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose***.

For example: packing material supplied by the customer.

4.9 ***Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.***

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

4.10 ***Marketing overheads: Marketing Overheads comprise of 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.***

4.11.1 Defectives: Materials, products or intermediate products 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 (Adapted from CAS 6 Para 4.4.1).

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 (Adapted from CAS 6 Para 4.4.2).

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 and preserve the product for its use by the customer.

For example:

- Pharmaceutical industry: Insertions related to product, Foils for strips of tablets/capsules, vials.
- Industrial gases: Cylinders / bottles used for filling the gaseous products
- Confectionary Industry: Butter paper and wrappers.

4.11.4 Reusable Packing Material: Packing materials that are used more than once to pack the product.

4.11.5 Scrap: Discarded material having no or insignificant value and which is usually either disposed off without further treatment (other than reclamation and handling) or reintroduced into the process in place of raw material.

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 of a product or in rendering service.

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably. Production overheads shall include administration cost relating to production, factory, works or manufacturing.

4.14 Selling Overheads: Selling overheads are the expenses related to sale of products or services and include all indirect expenses incurred in selling the products or services.

4.15 Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions.

Standard costs are used as scale of reference to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

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 (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).***
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

(Revised 2017)

The following is the COST ACCOUNTING STANDARD – 10 (CAS-10) issued by the Council of The Institute of Cost Accountants of India on **"DIRECT EXPENSES"**, for comments. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the Direct Expenses.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of Direct Expenses, for determination of the cost of product or service, and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Direct Expenses with reasonable accuracy.

3. Scope

This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of Direct Expenses including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 ***Abnormal cost: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation (Adapted from CAS 1 paragraph 6.5.19).***

4.2 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.3 ***Direct Employee Cost: Employee cost, which can be directly attributed to a cost object in an economically feasible way (Adapted from CAS 1 paragraph 6.2.4 (Direct labour cost)).***

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 (Adapted from CAS 1 paragraph 6.2.6).***

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 (Adapted from CAS 1-6.2.3).***

4.6 ***Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.***

4.7 ***Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.***

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

4.8 ***Overheads: Overheads comprise costs of indirect materials, indirect employees and indirect expenses.***

4.9 ***Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions***.

Standard costs are used as scale of reference to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

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 (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).

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

(Revised 2017)

The following is the COST ACCOUNTING STANDARD – (CAS-11) issued by the Council of The Institute of Cost 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 (Adapted from CAS 1 Para 6.5.19).

4.2 Absorption of overheads: Assigning of overheads to cost objects by means of appropriate absorption rate.

Overhead Absorption Rate = Overheads of the Cost object / Quantum of base.

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

Administrative overheads shall exclude production overheads (Paragraph reference 4.13 CAS -9), marketing overheads (Paragraph reference 4.11 CAS -7) and finance cost. Production overheads includes administration cost relating to production, factory, works or manufacturing.

4.4 Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.

4.5 Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.

4.6 Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

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 (Adapted from CAS 2 Para 4.4).

4.8 Overheads: Overheads comprise costs of indirect materials, indirect employees and indirect expenses.

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 customized), 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 (Adapted from of CAS 3 Para 5.1).

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 (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).***
- ***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

(Revised 2017)

The following is the COST ACCOUNTING STANDARD – 12 (CAS - 12) issued by the Council of The Institute of Cost 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: An activity, contract, cost centre, customer, process, product, project, service or any other object for 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 ***Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.***

4.4 ***Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.***

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

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 (Adapted from CAS 2 paragraph 4.4).***

4.6 ***Production overheads: Indirect costs involved in the production of a product or in rendering service.***

The terms Production Overheads, Factory Overheads, Works overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

Production overheads shall include administration cost relating to production, factory, works or manufacturing.

4.7 **Property, plant and equipment are tangible assets that:**

(a) are held for use in the production of goods or supply of services, for rental to others, for administrative, selling or distribution purposes; and

(b) are expected to be used during more than one accounting period.

4.8 ***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.

4.9 ***Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

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, shall be recognised as property, plant and equipment when they meet the definition of property, plant and equipment and depreciated accordingly. Otherwise, such items are classified as inventory and recognised in cost as and when they are consumed.***

Example:

A company purchased equipment for ₹ 10 crore and insurance spare for ₹ 1 crore. If the company is covered under IndAS, such spare is capitalized as Property, Plant & Equipment. After use for five years, the equipment broke down and a part was replaced with the aforesaid insurance spare. After five years, the depreciated value of equipment is ₹ 5 crore. As property, plant and equipment are depreciated when they are available for use, accordingly the depreciated value of new spare is ₹ 50 lakhs. The old spare was reconditioned and the cost of reconditioning is ₹ 10 lakh. As per estimated life of the old spare for future economic benefits, the current market value of the reconditioned old spare has been estimated at ₹ 25 lakhs. The amount to be treated in repairs and maintenance is ₹ 35 lakhs as follows:

		₹ In Crore	
A.	Equipment Cost	10.00	
B.	Cost of New Spare	1.00	
	Total Cost (A+B)	11.00	
	Depreciation for 5 years	5.50	
	Depreciated value of Equipment & Spare	**5.50**	
	Reconditioning cost of old Spare		0.10
	Depreciated Value of old Spare		0.50
	Book Value of Reconditioned spare		**0.60**
	Less: Current market value of reconditioned spare to be restated in Book of Account		0.25
	Amount to be treated in Repairs and Maintenance		**0.35**

5.9 ***The cost of major overhaul shall be amortized on a rational basis.***

5.10 ***Finance costs incurred in connection with the repairs and maintenance activities shall not form part of Repairs and maintenance costs.***

5.11 ***Repairs and maintenance costs shall not include imputed costs.***

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

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

5.14 ***Any repairs and maintenance cost resulting from some abnormal circumstances, if material and quantifiable, shall not form part of the repairs and maintenance cost.***

Example: Major fire, explosions, flood and similar events are abnormal circumstances referred above.

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

Example: A penalty imposed by a regulatory authority for wrongful construction or damages paid to third party for the loss caused due to improper working of property, plant & equipment, should not be included in repairs and maintenance cost.

5.16 ***Credits/ recoveries relating to the repairs and maintenance activity, material and quantifiable, shall be deducted to arrive at the net repairs and maintenance cost.***

5.17 ***Any change in the cost accounting principles applied for the measurement of the repairs and maintenance cost should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Repairs and maintenance costs shall be traced to a cost object to the extent economically feasible.***

6.2 ***Where the repairs and maintenance cost is not directly traceable to cost object, it shall be assigned based on either of the following two principles;***

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

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

6.3 ***If the repairs and maintenance cost (including the share of the cost of reciprocal exchange of services) is shared by several cost objects, the related cost shall be measured as an aggregate and distributed among the cost objects as per principles laid down in Cost Accounting Standard – 3.***

7. Presentation

7.1 Repairs and maintenance cost, if material, shall be presented in the cost statement as a separate item of cost.

7.2 Asset category wise details of repairs and maintenance cost, if material, shall be presented separately.

7.3 Activity wise details of repairs and maintenance cost, if material, shall be presented separately.

8. Disclosures

8.1 *The cost statements shall disclose the following:*

1. The basis of distribution of repairs and maintenance cost to the cost objects/ cost units.

2. Where standard cost is applied in repairs and maintenance cost, the price and usage variances.

3. Repairs and maintenance cost of Jobs done in-house and outsourced separately.

4. Cost of major overhauls, asset category wise and the basis of amortisation.

5. Repairs and maintenance cost paid/ payable to related parties (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).

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.*

CAS – 13

COST ACCOUNTING STANDARD ON COST OF SERVICE COST CENTRE

(Revised 2017)

The following is the COST ACCOUNTING STANDARD – 13 (CAS - 13) issued by the Council of The Institute of Cost 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 (Adapted from CAS 1 paragraph 6.5.19).***

4.2 ***Administrative Overheads: Cost of all activities relating to general management and administration of an entity.***

Administrative overheads shall exclude production overheads (Paragraph reference 4.13 CAS -9), marketing overheads (Paragraph reference 4.11 CAS -7)and finance cost. Production overheads includes administration cost relating to production, factory, works or manufacturing.

4.3 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.4 ***Distribution Overheads: Distribution overheads, also known as distribution costs, are the costs incurred in handling a product or service from the time it is ready for despatch or delivery until it reaches the ultimate consumer including the units receiving the product or service in an inter-unit transfer.***

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 ***Imputed Cost: Notional cost, not involving cash outlay, computed for any purpose.***

4.6 ***Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.***

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

4.7 ***Marketing overheads: Marketing overheads comprise of selling overheads 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 (Adapted from CAS 2 paragraph 4.4).***

4.9 ***Production Overheads: Indirect costs involved in the production of a product or in rendering service.***

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

4.10 ***Selling Overheads: Selling overheads are the expenses related to sale of products or services and include all indirect expenses incurred in selling the products or services.***

4.11 ***Standard Cost: A predetermined cost of a product or service based on technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

4.12 ***Stand-by service: Any facility created as backup against any failure of the main source of service.***

4.13 ***Support-Service Cost Centre: The cost centre which primarily provides auxiliary services across the entity***.

The cost centre which provides services to Production, Operation or other Service Cost Centre but not directly engaged in manufacturing process or operation is a service cost centre. A service cost centre renders services to other cost centres / other units and in some cases to outside parties.

Examples of service cost centres are engineering, workshop, research & development, quality control, quality assurance, designing, laboratory, welfare services, safety, transport, Component, Tool stores, Pollution Control, Computer Cell, dispensary, school, crèche, township, Security etc.

Administrative Overheads include cost of administrative Service Cost Centre.

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 (Adapted from Paragraph 5.7 of CAS 3). 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 (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).*
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

(Revised 2017)

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. Ob*jective*

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: 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 (Section 2 (a) of The Air (Prevention and Control of Pollution) Act, 1981).***

4.2 ***Air Pollution: Air pollution means the presence in the atmosphere of any air pollutant (Section 2 (b) of The Air (Prevention and Control of Pollution) Act, 1981).***

4.3 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for 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 (Adapted from Paragraph 4.4 of CAS - 10).***

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 (Section 2 (a) of The Environment (Protection) Act, 1986).***

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 (Section 2 (b) of The Environment (Protection) Act, 1986).***

4.7 ***Environment Pollution: Environmental pollution means the presence in the environment of any environmental pollutant (Section 2 (c) of The Environment (Protection) Act, 1986).***

4.8 ***Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.***

4.9 ***Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.***

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

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 (Adapted from CAS 2 paragraph 4.4).***

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 of a product or in rendering service.***

The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

Production overheads shall include administration cost relating to production, factory, works or manufacturing.

4.13 ***Soil Pollutant: Soil Pollutant is a substance 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 a product or service based on technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

4.16 ***Water pollution: Water pollution means such contamination of water or such alteration of the physical, chemical or biological properties of water or such discharge of any sewage or trade effluent or of any other liquid, gaseous or solid substance into water (whether directly or indirectly) as may, or is likely to, create a nuisance or render such water harmful or injurious to public health or safety, or to domestic, commercial, industrial, agricultural or other legitimate uses, or to the life and health of animals or plants or of aquatic organisms (Section 2 (e) of The Water (Prevention and Control of Pollution) Act, 1974).***

5. Principles of Measurement:

5.1 ***Pollution Control costs shall be the aggregate of direct and indirect cost relating to Pollution Control activity.***

Direct cost includes the cost of materials, consumable stores, spares, manpower, equipment usage, utilities, resources for testing & certification and other identifiable resources consumed in activities such as waste processing, disposal, remediation and others.

Indirect cost includes the cost of resources common to various Pollution Control activities such as Pollution Control Registration and such like expenses.

5.2 ***Costs of Pollution Control which are internal to the entity should be accounted for when incurred. They should be measured at the historical cost of resources consumed.***

5.3 ***Future remediation or disposal costs which are expected to be incurred with reasonable certainty as part of Onerous Contract or Constructive Obligation, legally enforceable shall be estimated and accounted based on the quantum of pollution generated in each period and the associated cost of remediation or disposal in future.***

For example future disposal costs of solid waste generated during the current period should be estimated on, say, a per tonne basis.

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

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

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

5.5 ***Cost of in-house Pollution Control activity shall include cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other resources used in such activity.***

5.6 ***Cost of Pollution Control activity carried out by outside contractors inside the entity shall include charges payable to the contractor and cost of materials, consumable stores, spares, manpower, equipment usage, utilities, and other costs incurred by the entity for such jobs.***

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

5.8 ***Cost of Pollution Control jobs carried out by outside contractors shall include charges made by the contractor and cost of own materials, consumable stores, spares, manpower, equipment usage, utilities and other costs used in such jobs.***

5.9 ***Each type of Pollution Control e.g. water, air, soil pollution shall be treated as a distinct activity, if material and identifiable.***

5.10 ***Finance costs incurred in connection with the Pollution Control activities shall not form part of Pollution Control costs.***

5.11 ***Pollution Control costs shall not include imputed costs.***

5.12 ***Price variances related to Pollution Control, where standard costs are in use, shall be treated as part of Pollution Control cost. The portion of usage variances attributable to normal reasons shall be treated as part of Pollution Control cost. Usage variances attributable to abnormal reasons shall be excluded from Pollution Control cost.***

5.13 ***Subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to Pollution Control activity, if any, shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.***

5.14 ***Any Pollution Control cost resulting from abnormal circumstances, if material and quantifiable, shall not form part of the Pollution Control cost.***

5.15 ***Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the Pollution Control cost.***

5.16 ***Credits / recoveries relating to the Pollution Control activity, material and quantifiable, shall be deducted to arrive at the net Pollution Control cost.***

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

5.18 ***Any change in the cost accounting principles applied for the measurement of the Pollution Control cost should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Pollution Control costs shall be traced to a cost object to the extent economically feasible.***

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

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

6.2 ***Where the Pollution Control cost is not directly traceable to cost object, it shall be treated as overhead and assigned based on either of the following two principles;***

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

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

Typical of such costs are costs such as administration costs relating to pollution control activities, costs of certification such as ISO 14000 and registration fees payable to pollution control authorities

6.3 ***If the Pollution Control cost (including the share of the cost of reciprocal exchange of services) is shared by several cost objects, the related cost shall be measured as an aggregate and distributed among the cost objects as per principles laid down in Cost Accounting Standard – 3.***

7. Presentation

7.1 *Pollution Control cost, if material, shall be presented in the cost statement as a separate item of cost.*

7.2 *Pollution control costs shall be presented duly classified as follows:*

(a) *Direct and Indirect cost*

(b) *Internal and External costs*

(c) *Current and future costs*

(d) *Domain area e.g. water, air and soil.*

7.3 *Activity wise details of Pollution Control cost, if material, shall be presented separately.*

8. Disclosures

8.1 *The cost statements shall disclose the following:*

1. *The basis of distribution of Pollution Control cost to the cost objects/ cost units.*
2. *Where standard cost is applied in Pollution Control cost, the price and usage variances.*
3. *Pollution Control cost of Jobs done in-house and outsourced separately.*
4. *Pollution Control cost paid/ payable to related parties (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement)*
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 (CAS 3 (Revised 2011) Para 4.1).***

4.2 ***Absorption of overheads: Assigning of overheads to cost objects by means of appropriate absorption rate.***

Overhead Absorption Rate = Overheads of the Cost object / Quantum of base**.**

4.3 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.4 ***Distribution overheads: Distribution overheads, also known as distribution costs, are the costs incurred in handling a product or service from the time it is ready for despatch or delivery until it reaches the ultimate consumer including the units receiving the product or service in an inter-unit transfer.***

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.

4.5 ***Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.***

4.6 ***Indirect expenses: Expenses which cannot be directly attributed to a particular cost object.***

4.7 ***Marketing Overheads: Marketing overheads comprise of selling overheads and distribution overheads.***

4.8 ***Overheads: Overheads comprise costs of indirect materials, indirect employees and indirect expenses.***

4.9 ***Selling Overheads: Selling overheads are the expenses related to sale of products or services and include all indirect expenses incurred in selling the products or services.***

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

5. Principles of Measurement

5.1 ***Selling and Distribution Overheads shall be the aggregate of the cost of resources consumed in the selling and distribution activities of the entity. The cost of resources procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited by the Tax Authorities.***

Post sales costs such as warranty cost, product liability cost, after sales service shall be estimated on a reasonable basis.

5.2 ***Selling and Distribution Overheads, the benefits of which are expected to be derived over a long period, shall be amortised on a rational basis.***

5.3 ***Selling and distribution overheads shall not include imputed cost.***

5.4 ***Cost of after Sales Service provided in terms of sale agreement for a class of transactions, shall be determined on rational and scientific basis, net of any recovery on the service.***

5.5 *Any Subsidy / Grant / Incentive or any such payment received / receivable with respect to any Selling and Distribution Overheads shall be reduced from the cost of the sales of the cost object.*

5.6 *Any abnormal cost relating to selling and distribution activity shall be excluded from the Selling and Distribution Overheads.*

5.7 *Any demurrage or detention charges, or penalty levied by transportation or other authorities in respect of distribution activity shall not form part of the Selling and Distribution Overhead.*

5.8 *Penalties and damages paid to statutory authorities or other third parties shall not form part of the Selling and Distribution Overheads.*

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 (Related party as per the*

applicable legal requirements relating to the cost statement as on the date of the statement).

4. ***Any Subsidy / Grant / Incentive and any such payment reduced from Selling and Distribution Overheads.***

5. ***Credits / recoveries relating to the Selling and Distribution Overheads.***

6. ***Penalties and damages excluded from the Selling and Distribution Overheads.***

8.2 ***Disclosures shall be made only where material and significant.***

8.3 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Selling and Distribution Overheads during the period covered by the cost statement which has a material effect on the Selling and Distribution Overheads shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

9. Effective date:

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April 2013 for being applied for the preparation and certification of General Purpose Cost Accounting Statements.

CAS -16

COST ACCOUNTING STANDARD ON DEPRECIATION AND AMORTISATION

(Revised 2017)

The following is the COST ACCOUNTING STANDARD – 16 (CAS – 16) issued by the Council of The Institute of Cost Accountants of India on **"DEPRECIATION AND AMORTISATION"**. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

This standard deals with the principles and methods of measurement and assignment of Depreciation and Amortisation for determination of the cost of product or service, and the presentation and disclosure in cost statements.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Depreciation and Amortisation with reasonable accuracy.

3. Scope

This standard shall be applied to cost statements which require measurement, assignment, presentation and disclosure of Depreciation and Amortisation, including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified:-

4.1 ***Amortisation: Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.***

It refers to expensing the acquisition cost minus the residual value of intangible assets such as Franchise, Patents and Trademarks or Copyrights in a systematic manner over their estimated useful economic life so as to reflect their consumption in the production of goods and services.

4.2 ***Asset: An Asset is a resource;***

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. In case of some assets which are acquired for safety or environmental reasons, the acquisition of such assets may not provide future economic benefits directly but may be necessary for an entity to obtain the future economic benefits from other assets. Such items also qualify for recognition as assets.

4.3 *Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.*

4.4 *Current asset: An entity shall classify an asset as current when :*

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

(b) it holds the asset primarily for the purpose of trading;

(c) it expects to realise the asset within twelve months after the reporting period; or

(d) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

4.5 *Depreciation: Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.*

4.6 *Depreciable amount: The cost of an asset, or other amount substituted for cost in the financial statement, less its residual value.*

4.7 *Depreciable property, plant and equipment are tangible assets that:*

(a) are held for use in the production of goods or supply of services, for rental to others, for administrative, selling or distribution purposes; and

(b) are expected to be used during more than one accounting period.

Land is not a depreciable asset as it does not have a defined useful life.

4.8 *Impairment Loss: An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.*

4.9 *Intangible Asset: An intangible asset is an identifiable non-monetary asset without physical substance.*

4.10 *Residual (salvage) value: The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the assets were already of the age and in the condition expected at the end of its useful life.*

4.11 *Useful life of asset: Useful life of asset is either:*

(a) the period over which a asset is expected to be available for use by an entity ; or

(b) the number of production or similar units expected to be obtained from use of the asset by the entity.

5. Principles of Measurement

5.1 *Depreciation and Amortisation shall be measured based on the depreciable amount and the useful life.*

The residual value of an intangible asset shall be assumed to be zero unless:

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

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

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

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

3. The residual value of a property, plant and equipment shall be considered as zero if the entity is unable to estimate the same with reasonable accuracy.

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

5.2 ***In case of regulated industry the amount of depreciation shall be the same as prescribed by the concerned regulator.***

5.3 ***While estimating the useful life of a depreciable asset, consideration shall be given to the following factors:***

(a) Expected physical wear and tear;

(b) Obsolescence; and

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

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

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

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

5.5 ***Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.***

An asset which is used only when the need arises but is always held ready for use.

Example: fire extinguisher, stand by generator, safety equipment shall be considered to be an asset available for use.

Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) or the date that the asset is de-recognized.

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

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

5.8 ***The impact of higher depreciation due to revaluation of assets shall not be assigned to cost object.***

5.9 ***Impairment loss on assets shall be excluded from cost of production.***

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

5.11 ***An entity can use any of the methods of depreciation to assign depreciable amount of an asset on a systematic basis over its useful life.***

For example:

(a) Straight-line method;

(b) Diminishing balance method; and

(c) Units of production method.

5.12 ***The method of amortisation of intangible asset shall reflect the pattern in which the economic benefits are expected to be consumed by the entity.***

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

5.14 ***Items such as spare parts, stand-by equipment and servicing equipment are recognised as property, Plant and Equipment when they meet the definition of Property, Plant and Equipment and depreciated accordingly. Otherwise, such items are classified as inventory and recognised in cost as and when they are consumed.***

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

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

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

6. Assignment of Costs

6.1 ***Depreciation shall be traced to the cost object to the extent economically feasible.***

6.2 ***Where the depreciation is not directly traceable to cost object, it shall be assigned based on either of the following two principles:***

i. Cause and effect - cause is a process or operation or activity and effect is the incurrence of cost.

ii. Benefits received– depreciation is to be apportioned to the various cost objects in proportion to the benefits received by them.

6.3 *Depreciation on an asset which if remains idle or temporarily retired from production of goods and services or remains idle shall be considered as abnormal cost for the period when the asset is not in use.*

6.4 *The depreciation charged for a period is usually recognised in cost of goods or services.*

6.5 *Similarly, wherever the property plant & equipment are used for producing another asset, the related depreciation shall form part of cost of such asset.*

7. Presentation

Depreciation and Amortisation, if material, shall be presented in the cost statement as a separate item of cost.

8. Disclosures

8.1 *The cost statement shall disclose the following:-*

1. *The basis of distribution of Depreciation and Amortisation to the cost objects.*
2. *Any credits / recoveries relating to Depreciation and Amortisation.*
3. *Additional Depreciation on account of revaluation of asset, which is not included in cost.*
4. *Amount of depreciation that is not included in cost because of temporary retirement of assets from production of goods and services.*

8.2 *Disclosure shall be made only where material, significant and quantifiable.*

8.3 *Disclosures shall be made in the body of the cost statement or as a foot note or in a separate schedule.*

8.4 Any change in the cost accounting principles and methods applied for the measurement and assignment of Depreciation and Amortisation during the period covered by the cost statement which has a material effect on Depreciation and Amortisation shall be disclosed. Where the effect of such change is not ascertainable wholly or partly, the fact shall be indicated.

CAS-17

COST ACCOUNTING STANDARD ON INTEREST AND FINANCING CHARGES

[Revised 2017]

The following is the Cost Accounting Standard (CAS 17) issued by the Council of The Institute of Cost Accountants of India for determination of **"INTEREST AND FINANCING CHARGES".** In this Standard, the standard portions have been set in ***bold italic*** type. These are to be read in the context of the background material which has been set in normal type.

1. Introduction

This standard deals with the principles and methods of classification, measurement and assignment of Interest and Financing Charges.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles, methods of determining and assigning the Interest and Financing Charges with reasonable accuracy.

3. Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Interest and Financing Charges including those requiring attestation.

This standard does not deal with costs relating to risk management through derivatives.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 ***Asset: An Asset is a resource;***

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

4.2 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.3 ***Current asset: An entity shall classify an asset as current when :***

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

(b) it holds the asset primarily for the purpose of trading;

(c) it expects to realise the asset within twelve months after the reporting period; or

(d) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

4.4 ***Current Liabilities: An entity shall classify a liability as current when :***

(a) it expects to settle the liability in its normal operating cycle;

(b) it holds the liability primarily for the purpose of trading;

(c) the liability is due to be settled within twelve months after the reporting period ; or

(d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

4.5 Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.

4.6 *Intangible Asset: An intangible asset is an identifiable non-monetary asset without physical substance.*

4.7 *Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.*

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

4.8 *Net current asset: Net current asset is the excess of current assets over current liabilities*

Current Liabilities shall include s*hort term borrowings and that part of long term borrowings which are classified as current liabilities*

Short term borrowing is the borrowing which is repayable within one year from the date of disbursal as per Loan Agreement.

Long term borrowing is the borrowing which is repayable after one year from the date of disbursal as per Loan Agreement.

5. Principles of Measurement:

5.1 *Interest and Financing Charges shall be measured in accordance with the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules 2006 or with the Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules 2015, as applicable.*

5.2 *Interest and Financing Charges incurred shall be identified for :*

(a) acquisition / construction/ production of qualifying assets; and

(b) Other finance costs for production of goods/ operations or services rendered which cannot be classified as qualifying assets.

5.3 *Interest and Financing Charges directly attributable to the acquisition /construction/ production of a qualifying asset shall be included in the cost of the asset.*

5.4 *Interest and Financing Charges shall not include imputed costs.*

5.5 *Subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to Interest and Financing Charges if any, shall be reduced to ascertain the net interest and financing charges.*

5.6 *Penal Interest for delayed payment, Fines, penalties, damages and similar levies paid to statutory*

authorities or other third parties shall not form part of the Interest and Financing Charges.

In case the company delays the payment of Statutory dues beyond the stipulated date, interest paid for delayed payment shall not be treated as penal interest.

5.7 ***Interest paid for or received on investment shall not form part of the other financing charges for production of goods / operations or services rendered;***

6. Assignment of costs

6.1 ***Assignment of Interest and Financing Charges to the cost objects shall be based on either of the following principles;***

(a) Cause and effect- cause is the process or operation or activity and effect is the incurrence of cost.

(b) Benefits received- Interest and Financing Charges are to be apportioned to the various cost objects in proportion to the benefits received by them.

7. Presentation

Interest and Financing Charges shall be presented in the cost statement as a separate item of cost of sales.

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

1. The basis of distribution of Interest and Financing Charges to the cost objects/ cost units.

2. Where predetermined cost is applied in Interest and Financing Charges, the rate and usage variances.

3. Interest and Financing Charges paid/ payable to related parties.

4. Interest and Financing Charges incurred in foreign exchange.

5. Any Subsidy / Grant / Incentive or any amount of similar nature received / receivable reduced Interest and Financing Charges.

8.2 ***Disclosures shall be made only where material, significant and quantifiable.***

8.3 ***Interest and Financing Charges incurred relating to prior periods and taken to reconciliation directly shall be disclosed separately.***

8.4 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.5 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Interest and Financing Charges during the period covered by the cost statement which has a material effect on the Interest and Financing Charges shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

CAS -18

COST ACCOUNTING STANDARD ON RESEARCH AND DEVELOPMENT COSTS

The following is the Cost Accounting Standard-18 (CAS-18) issued by the Council of The Institute of Cost Accountants of India for determination of "**RESEARCH AND DEVELOPMENT COSTS".** In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. ***Introduction***

This standard deals with the principles and methods of determining the Research, and Development Costs and their classification, measurement and assignment for determination of the cost of product or service, and the presentation and disclosure in cost statements.

2. ***Objective***

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Research, and Development Costs with reasonable accuracy and presentation of the same.

3. ***Scope***

This standard should be applied to cost statements that require classification, measurement, assignment, presentation and disclosure of Research, and Development Costs including those requiring attestation.

4. **Definitions**

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal cost: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation (Adapted from CAS 1 paragraph 6.5.19).

4.2 Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.

4.3 Direct Employee Cost: Employee cost, which can be attributed to a Cost Object in an economically feasible way (Adapted from CAS 1 Para 6.2.4 (Direct labour cost)).

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 or direct employee cost (Adapted from CAS 1 Para 6.2.6).

Examples of Direct Expenses are royalties charged on production, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling Expenses for a specific job.

4.5 Direct Materials: Materials, the cost of which can be attributed to a cost object in an economically feasible way (Adapted from CAS 1-6.2.3).

4.6 Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose

4.7 Indirect Employee Cost: The employee cost which cannot be directly attributed to a particular cost object.

4.8 Indirect Material Cost: Material cost that cannot be directly attributed to a particular cost object.

4.9 Indirect expenses: Expenses which cannot be directly attributed to a particular cost object.

4.10 Overheads: Overheads comprise costs of indirect materials, indirect employees and indirect expenses.

4.11 Research and Development:

4.11.1 Research: Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding (Adapted AS 26).

4.11.2 Development cost: Development cost is the cost for application of research finding or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems, or services before the start of commercial production or use.

4.11.3 Research Cost: Research cost is the cost of original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

5. *Principles of Measurement*

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

1. The cost of materials and services consumed in Research, and Development activities.
2. Cost of bought out materials and hired services as per invoice or agreed price including duties and taxes directly attributable thereto net of trade discounts, rebates, taxes and duties refundable or to be credited.
3. The salaries, wages and other related costs of personnel engaged in Research, and Development activities;
4. The depreciation of equipment and facilities, and other tangible assets, and amortisation of intangible assets to the extent that they are used for Research, and Development activities;
5. Overhead costs, other than general administrative costs, related to Research, and Development activities.
6. Costs incurred for carrying out Research, and Development activities by other entities and charged to the entity; and
7. Expenditure incurred in securing copyrights or licences
8. Expenditure incurred for developing computer software
9. Costs incurred for the design of tools, jigs, moulds and dies
10. Other costs that can be directly attributed to Research, and Development activities and can be identified with specific projects.

5.2 ***Subsidy / Grant / Incentive or amount of similar nature received / receivable with respect to Research, and Development Activity, if any, shall be reduced from the cost of such Research, and Development Activity.***

5.3 ***Any abnormal cost where it is material and quantifiable shall not form part of the Research, and Development Cost.***

5.4 ***Fines, penalties, damages and similar levies paid to statutory authorities or other third parties shall not form part of the Research, and Development Cost.***

5.5 ***The amortisation of an intangible asset arising from the development activity shall be treated as set out in the CAS 16 relating to Depreciation and Amortisation.***

5.6 ***Research, and Development costs shall not include imputed costs.***

5.7 ***Credits/recoveries relating to Research, and Development cost, if material and quantifiable, including from the sale of output produced from the Research and Development activity shall be deducted from the Research and Development cost.***

6. Assignment of costs

6.1 ***Research, and Development costs attributable to a specific cost object shall be assigned to that cost object directly.***

Research, development costs that are not attributable to a specific product or process shall not form part of the product cost.

6.2 ***Development cost which results in the creation of an intangible asset shall be amortised over its useful life***

6.3 ***Assignment of Development Costs shall be based on the principle of "benefits received".***

6.4 ***Research and Development Costs incurred for the development and improvement of an existing process or product shall be included in the cost of production.***

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

6.5 ***Development costs attributable to a saleable service e.g providing technical know-how to outside parties shall be accumulated separately and treated as cost of providing the service.***

7. *Presentation*

7.1 ***Research and Development costs relating to improvement of the process or products or services shall be presented as a separate item of cost in the cost statement under cost of production.***

7.2 ***Research, and Development costs which are not related to improvement of the process, materials, devices, processes, systems, product or services shall be presented as a part of the reconciliation statement.***

8. *Disclosures*

8.1 ***The cost statements shall disclose the following:***

1. ***The basis of accumulation and assignment of Research and Development costs.***

2. ***The Research, and Development costs paid to related parties(Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).***

3. ***Credit/recoveries from related parties***

4. ***Research, and Development cost incurred in foreign exchange.***

5. ***Any Subsidy/Grant/Incentive and any such payment reduced from Research, and Development cost.***

6. ***Credits/recoveries deducted from the Research, and Development cost.***

7. ***Any abnormal cost excluded from Research, and Development cost including cost of abandoned projects and research activities considered abnormal.***

8. ***Penalties and damages paid etc. excluded from Research, and Development cost.***

8.2 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Research, and Development cost during the period covered by the cost statement that has a material effect on the Research, and Development cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

8.3 ***Disclosures shall be made only where material, significant and quantifiable.***

8.4 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

CAS-19

COST ACCOUNTING STANDARD ON JOINT COSTS

The following is the Cost Accounting Standard – 19 (CAS - 19) issued by the Council of The Institute of Cost Accountants of India for determination of **"JOINT COSTS"**. 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 standard deals with the principles and methods of measurement and assignment of Joint Costs and the presentation and disclosure in cost statement.

2. Objective

The objective of this standard is to bring uniformity, consistency in the principles, methods of determining and assigning Joint Costs with reasonable accuracy.

3. Scope

The standard shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Joint Costs including those requiring attestation.

4. Definitions

The following terms are being used in this standard within the meaning specified.

4.1 ***By-Product: Product with relatively low value produced incidentally in the manufacturing of the product or service.***

4.2 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.3 ***Imputed Cost: Notional cost, not involving cash outlay, computed for any purpose***

4.4 ***Joint Costs: Joint costs are the cost of common resources used to produce two or more products or services simultaneously.***

4.5 ***Joint product: Products or services that are produced simultaneously, by the same process, identifiable at the end of the process and recognised as main products or services having sufficient value.***

4.6 ***Scrap: Discarded material having no or insignificant value and which is usually either disposed off without further treatment (other than reclamation and handling) or reintroduced into the process in place of raw material.***

4.7 ***Split off point: The point in the production process at which joint products become separately identifiable.***

The terms split off point and separation point are used interchangeably.

4.8 *Waste: Material lost during production or storage and discarded material which may or may not have any value.*

5. Principles of Measurement

5.1 *The principles and methods for measuring Joint costs upto the split off point will be the same as stipulated in other cost accounting standards.*

5.2 *Cost incurred after split-off point on product separately identifiable shall be measured for the resources consumed for each Joint/By-Product.*

5.3 *Cost incurred after split- off point for further processing of joint product/By-Product shall be the aggregate of direct and indirect costs.*

5.4 *Cost of further processing of joint product/By-Product carried out by outside parties shall be determined at invoice or agreed price including duties and taxes, net of discounts (other than cash discount) taxes and duties refundable or to be credited and other expenditure directly attributable to such processing. This cost shall also include the cost of resources provided to outside parties.*

5.5 In case the production process generates scrap or waste, realized or realizable value, net of disposal cost, of scrap and waste shall be deducted from the cost of Joint Product.

5.6 Any Subsidy / Grant / Incentive or any such payment received / receivable with respect to any joint product /By-Product shall be reduced for ascertainment of the cost to which such amounts are related.

5.7 Penalties, damages paid to statutory authorities or other third parties shall not form part of the cost of the joint product /By-Product.

6. Assignment of Costs

6.1 Joint cost incurred shall be assigned to joint products based on benefits received, which is measured using any of the following methods:

(a) Physical Units Method.

(b) Net Realisable Value at split-off point.

Net realisable value for this purpose means the net selling price per unit multiplied by quantity (Quantity sold). Net realizable value is to be adjusted for the post- split off costs.

(c) Technical estimates

6.2 The value of By-Product shall be estimated using any of the following methods for adjusting joint costs :

a. Net realizable value

Net realizable value for this purpose means the net selling price per unit multiplied by quantity (Quantity sold). Net realizable value is to be adjusted for the post- split off costs.

b. ***Technical Estimates***

This method may be adopted where the By-Product is not saleable in the condition in which it emerges or comparative prices of similar products are not available.

7. ***Presentation***

The Cost Statement shall present the element wise cost of individual products produced jointly and the value assigned to By-Products.

8. Disclosures

8.1 ***The Cost statement shall disclose the basis of allocation of Joint costs to individual products and the value assigned to the By-Products***

8.2 ***The Cost statement shall also disclose:***

8.3 ***The disclosure should be made only where material, significant & quantifiable.***

8.4 ***Disclosures shall be made in the body of Cost Statements or as a foot note or as a separate schedule.***

8.5 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Joint costs and the value assigned to by-product during the period covered by the cost statement which has a material effect on the Joint/ By-Products shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

9. Effective date:

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April, 2014 for being applied for the preparation and certification of General Purpose Cost Accounting Statements.

CAS-20

COST ACCOUNTING STANDARD ON ROYALTY AND TECHNICAL KNOW-HOW FEE

[Revised 2017]

The following is Cost Accounting Standard- (CAS-20) issued by the council of The Institute of Cost Accountants of India for determination of "**ROYALTY AND TECHNICAL KNOW-HOW FEE**". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the amount of Royalty and Technical Know-how Fee.

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment of the amount of Royalty and Technical Know-how Fee, for determination of the cost of product or service, and their presentation and disclosure in cost statements***.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the amount of Royalty and Technical Know-how Fee with reasonable accuracy.

3. Scope

This standardshouldbe applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of the amount of Royalty and Technical Know-how Fee including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.2 ***Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose.***

4.3 ***Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.***

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

4.4 ***Royalty: Royalty is any consideration for the use of asset (tangible and/or intangible) to the owner.***

Royalty is often expressed as a percentage of the revenues obtained by use of the owners asset (tangible and/or intangible); per unit of production or sales value. It may relate to use of: Non-renewable resource (petroleum and mineral resources); Patents; Trade marks; Franchise rights; Copy rights; art-work, software and the like.

The terms Assets, tangible assets and intangible assets will have the same meaning as in the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006.

4.5 ***Technical service fee: Technical service fee is any consideration payable to provider of technical or managerial services.***

5. Principles of Measurement:

5.1 ***Royalty and Technical Know-how Fee paid or incurred in lump-sum or which are in the nature of 'one – time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from the related asset.***

Examples: Amortisation of the amount of Royalty or Technical Know-how fee paid for which the benefit is ensued in the current or future periods shall be determined based on the production / service volumes estimated for the period over which the asset is expected to benefit the entity .

5.2 ***Amount of the Royalty and Technical Know-how Fee shall not include finance costs and imputed costs.***

5.3 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to amount of Royalty and Technical Know-how fee shall be reduced to measure the amount of royalty and technical know- how fee.***

5.4 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the amount of Royalty and Technical Know-how fee.***

5.5 ***Credits/ recoveries relating to the amount Royalty and Technical Know-how fee, material and quantifiable, shall be deducted to arrive at the net amount of Royalty and Technical Know-how fee.***

5.6 ***Any change in the cost accounting principles applied for the measurement of the amount of Royalty and Technical Know-how Fee should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Royalty and Technical Know-how fee that is directly traceable to a cost object shall be assigned to that cost object. In case such fee is not directly traceable to a cost object then it shall be assigned on any of the following basis:***

a. Units produced

b. *Units sold*

c. *Sales value*

6.2 *The amount of Royalty fee paid for mining rights shall form part of the cost of material.*

6.3 *The amount of Royalty and Technical Know-how fee shall be assigned on the nature/ purpose of such fee.*

The amount of royalty and technical know-how fee related to product or process know how shall be treated as cost of production; if it is related to trademarks or brands shall be treated as cost of sales.

7. Presentation

7.1 *The amount Royalty and Technical Know-how fee shall be presented as a separate cost head with suitable classification.*

8. Disclosures

8.1 *The cost statements shall disclose the following:*

1. *The basis of distribution of the amount Royalty and Technical Know-how fee to the cost objects/ cost units.*

2. *Quantity and the related rate of items of the amount of Royalty and Technical Know-how fee, as applicable.*

3. *Royalty and Technical Know-how fee paid/ payable to related parties (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement) .*

4. *Royalty and Technical Know-how fee incurred in foreign exchange.*

5. *Any Subsidy/Grant/Incentive and any such payment reduced from the amount of Royalty and Technical Know-how fee.*

6. *Credits/recoveries relating to the amount of Royalty and Technical Know-how fee.*

7. *Penalties and damages excluded from the amount of Royalty and Technical Know-how fee*

8.2 *Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.*

8.3 *Any change in the cost accounting principles and methods applied for the measurement and assignment of the amount Royalty and Technical Know-how fee during the period covered by the cost statement which has a material effect on the amount Royalty and Technical Know-how fee. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

CAS-21

COST ACCOUNTING STANDARD ON QUALITY CONTROL

[Revised 2017]

The following is the Cost Accounting Standard (CAS -21) issued by the Council of The Institute of Cost Accountants of India for determination of "**QUALITY CONTROL** ". In this standard, the standard portions have been set in ***bold italic*** type. These are to be read in context of the background material which has been set in normal type.

1. Introduction

The standard deals with the principles and methods of measurement and assignment of Quality Control cost and the presentation and disclosure in cost statement.

2. Objective

The objective of this standard is to bring uniformity, consistency in the principles, methods of determining and assigning Quality Control cost with reasonable accuracy.

3. Scope

The standards shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Quality Control cost including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 ***Abnormal cost: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/ or due to some abnormal situation of the production or operation (Adopted from CAS 1 paragraph 6.5.19).***

4.2 ***Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.***

4.3 ***Defectives: Materials, products or intermediate products that do not meet quality standards. This may include reworks or rejects.***

4.3.1 Rework: Defectives which can be brought up to the standards by putting in additional resources.

Rework includes repairs, reconditioning and refurbishing.

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

Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

4.4 ***Imputed Costs: Notional cost, not involving cash outlay, computed for any purpose***

4.5 ***Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.***

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:

2. Financing Charges in respect of finance leases and other similar arrangements: and

3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

4.6 ***Overheads: Overheads comprise costs of indirect materials, indirect employees and indirect expenses.***

4.7 ***Quality: Quality is the conformance to requirements or specifications.***

The quality of a product or service is fitness of that product or service for meeting its intended use as required by customer.

4.8 ***Quality control: A procedure or a set of procedures exclusively designed to ensure that the manufactured products or performed service adhere to a defined set of quality criterion or meets requirement of the client or the customer.***

4.9 ***Quality Control cost: Cost of resources consumed towards quality control procedures***

4.10 ***Scrap: Discarded material having no or insignificant value and which is usually either disposed off without further treatment (other than reclamation and handling) or reintroduced into the process in place of raw material.***

4.11 ***Waste and spoilage:***

4.11.1 ***Waste: Material lost during production or storage and discarded material which may or may not have any value.***

4.11.2 ***Spoilage: Production that does not meet the quality requirements or specifications and cannot be rectified economically.***

5. Principles of Measurement:

5.1 ***Quality Control cost incurred in-house shall be the aggregate of the cost of resources consumed in the Quality Control activities of the entity. The cost of resources procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discounts), taxes and duties refundable or to be credited by the Tax Authorities.***

Such cost shall include:

- Cost of conformance to quality: (a) prevention cost; and (b) appraisal cost.

5.2 ***Identification of Quality Control costs shall be based on traceability in an economically feasible manner.***

5.3 ***Quality Control costs other than those referred to in paragraph 5.2 shall be determined on the basis of amount incurred in connection therewith.***

5.4 ***Finance costs incurred in connection with the self generated or procured resources shall not form part of Quality Control cost.***

5.5 ***Quality Control costs shall not include imputed costs.***

5.6 ***Any Subsidy/Grant/Incentive or any such payment received/receivable with respect to any Quality Control cost shall be reduced for ascertainment of the cost of the cost object to which such amounts***

are related.

5.7 ***Any abnormal portion of the Quality Control cost where it is material and quantifiable shall not form part of the Cost of Quality Control.***

5.8 ***Penalties, damages paid to statutory authorities or other third parties shall not form part of the Quality Control cost.***

5.9 ***Any change in the cost accounting principles applied for the measurement of the Quality Control cost shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organisation.***

6. Assignment of costs

6.1 ***Quality Control cost that is directly traceable to the cost object shall be assigned to that cost object.***

6.2 ***Assignment of Quality Control cost to the cost objects shall be based on benefits received by them.***

(i) ***Benefits received – Quality Control cost is to be apportioned to the various cost objects in proportion to the benefits received by them.***

For example : On the basis of number of tests performed for a product.

7. Presentation

7.1 ***Quality Control cost, if material, shall be presented as a separate cost head with suitable classification.***

8. Disclosures

8.1 ***The cost statements shall disclose the following:***

8.1.1 ***The basis of distribution of Quality Control cost to the cost objects/ cost units.***

8.1.2 ***Quantity and Cost of resources used for Quality Control cost as applicable.***

8.1.3 ***Quality Control cost paid/ payable to related parties (Related party as per the applicable legal requirements relating to the cost statement as on the date of the statement).***

8.1.4 ***Quality Control cost incurred in foreign exchange.***

8.1.5. ***Any abnormal portion of the Quality Control cost.***

8.1.6 ***Penalties and damages excluded from the Quality Control cost***

8.2 ***Disclosures shall be made only where material, significant and quantifiable.***

8.3 ***Disclosures shall be made in the body of the Cost Statement or as a foot note or as a separate schedule.***

8.4 ***Any change in the cost accounting principles and methods applied for the measurement and assignment of the Quality Control cost during the period covered by the cost statement which has a material effect on the Quality Control cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.***

CAS – 22

COST ACCOUNTING STANDARD ON MANUFACTURING COST

[Revised 2017]

The following is the COST ACCOUNTING STANDARD – 22 (CAS - 22) issued by the Council of The Institute of Cost Accountants of India for determination of **"MANUFACTURING COST**". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material which has been set in normal type.

1. Introduction

1.1 This standard deals with the principles and methods of determining the **Manufacturing Cost of excisable goods.**

1.2 ***This standard deals with the principles and methods of classification, measurement and assignment for determination of the Manufacturing Cost of excisable goods and the presentation and disclosure in cost statements.***

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Manufacturing Cost of excisable goods.

3. Scope

This standard should be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Manufacturing Cost of excisable goods.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Abnormal and non-recurring cost: An unusual or atypical cost whose occurrence is usually irregular and unexpected and/or due to some abnormal situation of the production or operation.

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

Administrative overheads need to be analysed in relation to production/manufacturing activities and other activities. Administrative overheads in relation to production/manufacturing activities shall be included in the manufacturing cost.

Administrative overheads in relation to marketing, projects management, corporate office or any other expense not related to the manufacturing activity shall be excluded from manufacturing cost.

4.3 ***Captive Consumption: Captive Consumption means the consumption of goods manufactured by one division or unit and consumed by another division or unit of the same organization or related undertaking for manufacturing another product(s), as defined in section4(3) of the Central Excise Act, 1944.***

4.4 ***Defectives: End Product and/or intermediate product units that do not meet quality standards. This may include reworks or rejects.***

An intermediate product is a product that might require further processing before it is saleable to the ultimate consumer.

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

Rework includes repairs, reconditioning, retro-fitment and refurbishing.

4.4.2 ***Rejects: Defectives which cannot meet the quality standards even after putting in additional resources.***

Rejects may be disposed off as waste or sold for salvage value or recycled in the production process.

4.5 ***Depreciation: Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes. Depreciation does not include impairment loss.***

Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the estimated useful life of the asset.

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

Useful life of asset is either

(i) the period over which a depreciable asset is expected to be used by the enterprise; or

(ii) the number of production or similar units expected to be obtained from the use of the asset by the entity.

Depreciation that is charged in audited financial statement should be considered.

4.6 ***Direct Expenses: Expenses relating to manufacture of an excisable good, which can be identified to such excisable good other than direct material cost and direct employee cost.***

4.7 ***Employee Cost: The aggregate of all kinds of consideration paid, payable and provisions made for future payments for the services rendered by employees of an enterprise (including temporary, part time and contract employees). Consideration includes wages, salary, contractual payments and benefits, as applicable or any amount paid or payable on behalf of employee. This is also known as Labour Cost.***

4.7.1 Direct Employee Cost: The cost of employees which can be attributed to an excisable good in an economically feasible way.

4.7.2 Indirect Employee Cost: The cost of employees which cannot be directly attributed to a particular excisable good.

4.8 ***Interest and Finance charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.***

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded

as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

4.9 ***Manufacturing Cost: Manufacturing cost of an excisable good is the aggregate of costs of all resources used in the process of its manufacturing.***

Manufacturing cost includes cost of Materials (including process materials), Employee Cost, Cost of Utilities, Packing Cost, Direct Expenses, Repairs &Maintenance Cost, Pollution Control Cost, Quality Control Cost, Research & Development Cost, Cost of Inputs received free of cost or received at concessional value from the buyer of the excisable good, Depreciation and Amortisation (including amortisation cost of free tools, patterns ,dies, drawings, blue prints, technical maps, charts, engineering, development, art work, design work, plans, sketches, packaging material and the like necessary for production of excisable goods), Cost of Rework, reconditioning, retro-fitment, Manufacturing Overheads, other costs allocable to such activity, adjustment for stock of work-in-process and recoveries for sales of scrap and wastages and the like but does not include expenses of the above nature incurred for post manufacturing purposes.

Manufacturing Cost and Cost of Production are used interchangeably.

4.10 ***Manufacturing Overheads: Indirect costs involved in the manufacturing process***

The terms Manufacturing Overheads, Factory Overheads, Works Overheads and Production Overheads have the same meaning and are used interchangeably. Manufacturing overheads shall include administration cost relating to production, factory, works or manufacturing and depot.

Manufacturing Overheads shall be classified on the basis of behaviour as Variable Manufacturing Overheads and Fixed Manufacturing Overheads.

Variable Manufacturing Overheads comprise of expenses which vary in proportion to the change in volume of production. For example, cost of utilities etc.

Fixed Manufacturing overheads comprise of expenses which does not change with the change in volume of production. For example, salaries, rent, repairs & maintenance, etc.

4.11 ***Material Consumed: Material Consumed includes materials directly identified for production of excisable goods such as:***

(a) Indigenous materials

(b) Imported materials

(c) Bought out items

(d) Self-manufactured items

(e) Process materials and other items

(f) Materials received free of cost or at concessional value from the buyer

(g) Accessories, on which cenvat credit is admissible, and which are cleared along with the final product

(h) goods used for providing free warranty for excisable goods

Cost of material consumed consists of cost of material, duties and taxes, freight inwards, insurance and other expenditure directly attributable to procurement. Trade discount, rebates and other similar items are deducted for determining the cost of materials. Cenvat credit, credit for Countervailing

Customs Duty, Sales Tax set off, VAT, duty draw back and other similar duties subsequently recovered/recoverable by the entity are also deducted.

4.12 ***Normal Capacity is the production achieved or achievable on an average over a period or season under normal circumstances taking into account the loss of capacity resulting from planned maintenance.***

Capacity may be determined in terms of units of production or equivalent machine or man hours.

4.13 ***Packing Material Cost: The cost of material of any nature used for the purpose of packing of excisable good.***

4.14 ***Quality Control Cost: The quality control cost is the expenses incurred relating to quality control activities for adhering to quality standard. These expenses include salaries & wages relating to employees engaged in quality control activity and other related expenses.***

4.15 ***Repairs & Maintenance Cost: Cost of all activities which have the objective of maintaining or restoring an asset in or to a state in which it can perform its required function at intended capacity and efficiency.***

4.16 ***Research and Development Cost: The research and development cost incurred for development and improvement of the process or the excisable good.***

4.17 ***Royalty: Royalty is compensation/periodic payments for the use of asset (tangible and/or intangible) to the owner for use of his asset in the production/manufacture, selling and distribution by an entity.***

4.18 ***Scrap: Discarded material having some value in few cases and which is usually either disposed of without further treatment (other than reclamation and handling) or reintroduced into the production process.***

4.19 ***Technical Know-how Fee: Technical Know-how Fee is a lump sum or periodical amount payable to provider of Technical Know-how in the form of design, drawings, training of personnel, or practical knowledge, skills or experience.***

4.20 ***Waste and Spoilage:***

4.20.1 Waste: Material lost during production or storage due to various factors such as evaporation, chemical reaction, contamination, unrecoverable residue, shrinkage, etc., and discarded material which may or may not have any value.

4.20.2 Spoilage: Production that does not meet with dimensional or quality standards in such a way that it cannot be rectified economically and is sold for a disposal value. Net Spoilage is the difference between costs accumulated up to the point of rejection and the salvage value.

5. Principles of Measurement

5.1 ***Manufacturing cost for each excisable good shall be measured separately.***

5.2 ***Manufacturing cost of each excisable good shall be the aggregate of direct and indirect cost relating to manufacturing activity.***

5.3 ***Material cost shall be measured separately for each type of material, that is, for indigenous material, imported material, bought out components and process materials, self-manufactured items, accessories for each type of excisable good.***

Cost of Inputs received free of cost or at concessional value from the buyer of the excisable good shall be considered for determination of manufacturing cost.

5.4 ***The material cost of normal scrap/defectives which are rejects shall be included in the material cost of excisable goods manufactured. The material cost of actual scrap/ defectives, not exceeding the normal quantity shall be adjusted in the material cost of good production. Realized or realizable value of scrap or waste shall be deducted for determination of manufacturing cost. Material Cost of abnormal scrap/defectives should not be included in material cost but treated as loss after deducting the realisable value of such scrap / defectives.***

5.5 ***Employee Cost for each excisable good shall be measured separately.***

5.6 ***The cost of utilities consumed for manufacturing of excisable good shall be measured for each type of utility.***

5.7 ***Packing material cost used for each type of excisable good shall be measured separately.***

If excisable goods are transferred/dispatched duly packed, the cost of such packing shall include cost of all types of packing in which the excisable goods are removed from the place of removal.

5.8 ***The Direct Expenses for manufacturing of excisable goods shall be measured for each excisable good separately.***

5.9 ***Repairs and maintenance cost for manufacturing of excisable goods shall be measured for each excisable good separately.***

5.10 ***Depreciation and Amortisation cost for manufacturing of excisable goods shall be measured for each excisable good separately.***

5.11 ***Research & Development cost for manufacturing of excisable goods shall be measured for each excisable good separately.***

5.12 ***Cost incurred for manufacturing of excisable goods after split-off point shall be measured for each Joint/By-Product.***

In case the manufacturing process generates scrap or waste, realized or realizable value net of cost of disposal, of such scrap and waste shall be deducted from the cost of Joint Product.

5.13 ***Royalty and Technical Know-how Fee for manufacturing of excisable goods paid or incurred in lump-sum or which are in the nature of 'one-time' payment, shall be amortised on the basis of the estimated output or benefit to be derived from the related Technical Know how.***

Royalty paid on sales shall not form part of manufacturing cost of excisable good.

5.14 ***Quality Control cost incurred in-house for manufacturing of excisable goods shall be the aggregate of the cost of resources used in the Quality Control activities in relation to each excisable good. The cost of resources procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts, taxes and duties refundable or to be credited as input credit.***

5.15 ***Manufacturing Overheads for excisable goods representing procurement of resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts; taxes and duties refundable or to be credited as input credit.***

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

5.16 ***Any abnormal cost, where it is material and quantifiable, shall not form part of the manufacturing cost of excisable good.***

5.17 ***Interest and other Finance costs are not part of manufacturing cost of excisable good.***

5.18 ***Manufacturing cost of excisable good shall include cost of inputs received free of cost or at concessional value from the buyer of excisable good and amortisation cost of free tools, pattern, dies, drawings, blue prints, technical maps, charts, engineering, development, art work, design work, plans, sketches, and the like necessary for production of excisable good. It shall also include cost of rework, reconditioning, retro-fitment, Manufacturing Overheads and other costs allocable to such activity, adjustment for stock of work-in-process and recoveries from sales of scrap and wastages and the like necessary for production of excisable good.***

In case any input material, whether of direct or indirect nature, including packing material, is supplied free of cost or at concessional value by the buyer of the excisable good, the cost of such material shall be included in the manufacturing cost.

For example: Amortisation Cost of Moulds, Tools, Dies & Patterns and Cost of Packing Material etc. received free of cost or at concessional value from the buyer of excisable good shall be included in manufacturing cost.

5.19 ***Any Subsidy/Grant/Incentive or any such payment received/receivable, from other entity, other than the buyer with respect to any manufacturing cost of excisable good shall be deducted for ascertainment of the manufacturing cost of excisable good to which such amounts are related.***

5.20 ***The manufacturing cost of excisable good shall be determined based on the normal capacity or actual capacity utilization whichever is higher and unabsorbed cost, if any, shall be treated as abnormal cost.***

5.21 ***Fines, penalties, damages, demurrage and similar levies paid to statutory authorities or other third parties shall not form part of the manufacturing cost of excisable good.***

5.22 ***The forex component of imported material or other element of cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of manufacturing cost of excisable good.***

5.23 ***Credits/recoveries relating to the manufacturing cost, which are material and quantifiable, shall be deducted from the total manufacturing cost to arrive at the net manufacturing cost of excisable good.***

5.24 Work in process/progress stock shall be measured at cost computed for different stages of completion.

Stock of work-in-process/progress shall be valued at cost on the basis of stages of completion as per cost accounting principles. Opening and closing stock of work-in-process/progress shall be adjusted for computation of manufacturing cost of an excisable good.

6. Assignment of Cost

6.1 ***While assigning various elements of manufacturing cost of excisable goods, traceability to an excisable good in an economically feasible manner shall be the guiding principle. The cost which can be traced directly to each excisable good shall be directly assigned.***

6.2 ***Assignment of manufacturing cost of excisable goods, which are not directly traceable to the excisable good shall be based on either of the following two principles;***

6.2.1 Cause and Effect – Cause is the process or operation or activity and effect is the incurrence of cost.

6.2.2 Benefits received – to be apportioned to various cost objects in proportion to the benefits received by them.

6.3 *The variable manufacturing/production overheads shall be absorbed based on actual production.*

6.4 *The fixed manufacturing/production overheads and other similar item of fixed costs such as quality control cost, research and development costs and administrative overheads relating to manufacturing shall be absorbed in the manufacturing cost on the basis of the normal capacity or actual capacity utilization of the plant, whichever is higher.*

6.5 *In case a production process results in more than one product being produced simultaneously, treatment of joint products and by-products shall be as under:*

6.5.1 In case joint products are produced, joint costs are allocated between the products on a rational and consistent basis.

6.5.2 In case by-products are produced, the net realisable value of by-products is credited to the manufacturing cost of the main product.

6.6 *Miscellaneous Income relating to production/manufacture shall be adjusted in the determination of manufacturing cost.*

For example, income from sale of empty containers used for procurement of raw material shall be deducted in determination of manufacturing cost.

7. Presentation

7.1 Cost statement as per Appendix 1 to this standard or as near thereto shall present following information:

7.1.1 Actual capacity utilization in absolute terms and as a percentage of normal capacity.

7.1.2 Cost information relating to various elements of Cost shall be presented separately.

8. Disclosures

8.1 *Disclosure shall be made only where material, significant and quantifiable.*

8.2 *If there is any change in cost accounting principles and practices during the period under review which may materially affect the manufacturing cost of excisable good in terms of comparability with previous period(s), the same shall be disclosed.*

9. Effective date

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April 2015 for being applied for the preparation and certification of Cost Accounting Statements for excisable goods.

Appendix - I

Cost Statement showing Manufacturing Cost of (Name of excisable good) for the period:

	Name of the Manufacturer		
	Address of the Manufacturer		
	Excise Registration Number		
	Name of the unit		
	Address of the unit		
	Central Excise Tariff Heading		
A	**Quantitative Information**	**Unit**	**Quantity**
1	Normal/Installed Capacity		
2	Production		
3	Captive Consumption		
4	Production as %age of Normal/Installed Capacity		

B	**Cost Information**	**Unit**	**Quantity**	**Rate**	**Amount**	**Cost per Unit**
1	Materials (specify)					
	A					
	B					
	C					
	D					
	Total Materials Consumed					
2	Process Materials					
3	Utilities					
4	Direct Employee Cost					
5	Direct Expenses					
6	Consumable Stores and Spares					
7	Repairs and Maintenance Cost					
8	Quality Control Cost					
9	Research & Development Cost					
10	Technical Know-how Fee/Royalty, if any					
11	Depreciation/Amortization					

12	Other Manufacturing Overheads					
13	Total(1 to 12)					
14	Add/Less: Work-in-Progress Adjustments					
15	Less: Credit for Recoveries , if any					
16	Packing Cost					
17	Cost of Inputs Received Free or at concessional value from the buyer of the excisable good					
18	Manufacturing Cost (13 to 17)					

Date:

Seal & Signature of the
Company's Authorised Representative

I/We have verified above data on test check basis with reference to the books of account, cost accounting records and other records. Based on the information and explanations given to me/us, and on the basis of generally accepted cost accounting principles and practices and Cost Accounting Standards followed by the entity, I/we certify that the above cost data reflects true and fair view of the manufacturing cost of the above excisable good.

Date: Seal & Signature of Cost Accountant

Place: Membership No.: Firm Regn. No. :

Note: Separate Cost Statement(s) shall be prepared for each *excisable good*

CAS-23

COST ACCOUNTING STANDARD ON OVERBURDEN REMOVAL COST

(Revised 2017)

The following is the Cost Accounting Standard (CAS-23) on "**OVERBURDEN REMOVAL COST"** issued by the Council of the Institute of Cost Accountants of India. In this standard, the standard portions have been set in ***bold Italic*** type. These are to be read in context of the background material which has been set in normal type.

1. Introduction

The standard deals with the principles and methods of measurement and assignment of Overburden Removal Cost and the presentation and disclosure in cost statements.

2. Objective

The objective of this standard is to bring uniformity, consistency in the principles, methods of determining and assigning Overburden Removal Cost with reasonable accuracy.

3. Scope

The standard shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of Overburden Removal Cost including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified. Any term not defined in this Standard shall have the same meaning and expression as set out in the Glossary of Terms issued by the Council.

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 operations.

4.2 Administrative overheads: cost of all activities relating to general management and administration of an entity.

4.3 Amortization: Amortization is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

4.4 Cost Object: An activity, contract, cost centre, customer, process, product, project, service or any other object for which costs are ascertained.

Activity includes mining operations also.

4.5 Current Ratio: the ratio of overburden removed to mineral produced in a particular patch of mine during the year.

Quantity of mineral includes production and mineable mineral lying exposed.

Quantity of overburden removed is the net quantity after adjustment of opening and closing advance stripping quantities.

4.6 Depreciation: Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

4.7 Imputed Costs: Notional costs, not involving cash outlay, computed for any purpose.

4.8 Interest and Finance Charges: Interest and Financing Charges are interest and other costs incurred by an entity in connection with the financing arrangements.

Examples are:

1. Interest and commitment charges on bank borrowings, other short term and long term borrowings:
2. Financing Charges in respect of finance leases and other similar arrangements: and
3. Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs.

The terms Interest and financing charges, finance costs, and borrowing costs are used interchangeably.

4.9 Mines overheads: indirect costs involved in the mining process for rendering services.

This relates to the activities of both Mineral extraction and Overburden Removal.

4.10 Mining Plan: It is the plan expected to provide information required to measure the stripping activity with reasonable consistency.

4.11 Overheads: Overheads comprise of indirect materials, indirect employee costs and indirect expenses.

4.12 Overburden: It is the overlying materials generally having no commercial value.

4.13 Overburden Removal cost: is the cost incurred to remove the overlying material from the mine site.

4.14 Ratio Variance: It is the variance between current ratio and standard /average stripping ratio in terms of quantity of mineral produced during the period.

4.15 Repair 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.

4.16 Stripping Activity: It is the activity of overburden removal that benefits the identified component of an ore to be mined by the entity.

4.17 Stripping Ratio: Stripping ratio is ratio of excavation of overburden to ore.

Generally overburden is measured in cubic metres and ore in tonnes. Therefore, the Stripping ratio is equal to Volume of overburden (m3)/ Weight of ore (in tonnes).

4.18 Standard stripping ratio: this is the ratio between the total quantity of overburden to be removed (in cubic meters) and the total mineral to be extracted (in tonnes) during the Projected life of the project.

The term Standard stripping ratio and Average stripping ratio denote the same meaning and are used interchangeably.

The Ratio shall be reviewed periodically, at least every five years, to take into account changes in geological factors such as actual behavior of the soil and the Ore body. The ratio shall be reviewed immediately if the geological factors alter radically, for example due to earthquake.

The reported quantity of Overburden is considered in cost statement where the variance between the reported quantity and the measured quantity is within the permissible limits. Reported quantity is the quantity of overburden that is necessary corresponding to actual quantity of mineral raised.

For example, 3:1 stripping ratio means that mining one Ton of ore will require mining three cubic meters of waste rock (overburden).

4.19 Advance Stripping: Advance Stripping is the excess overburden removed in between the overburden bench and assumed angle of repose drawn from the starting of Mineral bench from the surface of Mineral than what is needed for extraction of Mineral.

5. Principles of Measurement

5.1. Overburden Removal Cost shall be the aggregate of direct and indirect cost relating to overburden removal activity.

5.2. Direct cost includes the cost of consumable stores, spares like machinery spares, explosives and detonators, manpower, equipment usage, utilities, payment made directly to contractors and other identifiable resources consumed in such activity.

5.3. Indirect cost includes the cost of resources common to various mining operation including overburden removal activity such as manpower,administrative overheads, loading and unloading equipment usage and other costs allocable to such activities.

5.4 The overburden removal cost attributable to a development phase of a mine area shall be capitalised as non-current asset when it is probable that future economic benefits to the area will flow to the entity and such cost can be identified and measured separately.

5.5 The overburden removal cost attributable to developed area of mine shall be charged to production of ore at the Standard stripping ratio.

The cost of advance stripping activity whose economic benefit is likely to flow to the entity during the subsequent period, shall be capitalised and amortised.

If the removal of ore is more than the Standard stripping ratio, then the cost of short removal overburden shall be charged to the cost of production either by creating the reserve or by adjusting the earlier capitalized overburden removal cost.

5.6 Overburden shall be measured by multiplying the number of trips undertaken by equipment for Overburden removal or by any electronic mode. Measurement at regular intervals may be carried out by volume/ physical verification to arrive at fair quantity of overburden removed. Final assessment will be made based on scientific methodology.

5.7 Current ratio is determined by dividing the actual overburden removed (net quantity after due adjustment for opening & closing advance stripping quantity) with the actual production of mineral including adjustment for mineable quantity of mineral lying exposed during the period.

5.8 Cost of overburden removal activity carried out by outsourcing shall be determined at agreed price as per contract price including duties and taxes and other expenditure directly attributable thereto. The cost shall also include the cost of resources provided to the contractor by the company.

5.9 Cost of overburden removal activity of each mine shall be computed and considered separately.

5.10 Subsidy/ grant/ incentive or amount of similar nature received/ receivable with respect to overburden removal activity if any shall be reduced for ascertainment of the cost of the overburden removal for a patch/ plot to which the amounts are related.

5.11 Any overburden removal cost resulting from some abnormal circumstances if material and quantifiable shall not form part of the overburden removal cost.

Examples are fire, cave-in, flooding and other similar events of abnormal circumstances.

5.12 Fine, penalties, damages and similar levies paid to statutory authorities or other third parties shall *not form part of the overburden removal cost.*

5.13 Interest & Finance charges incurred in connection with the overburden removal shall not form part of the overburden removal cost.

5.14 Any change in the cost accounting principles applied for the determination of the overburden removal 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 Direct cost of overburden removal shall be assigned to the overburden removal activity.

6.2 The cost for equipment shall be assigned in the ratio of machine hours actually engaged for mineral and overburden removal or any other appropriate method that apportions the cost in an equitable manner.

6.3 Administrative overheads and other indirect expenses shall be apportioned to mineral and overburden on the basis of ratio of actual mineral produced and overburden removed during the period or on the basis of actual machine hours engaged for mineral extraction, and overburden removal or any other appropriate basis.

7. Presentation

7.1. Overburden removal, absorption and cost details shall be presented separately for each mine.

8. Disclosures

8.1 The cost statements shall disclose the following:

(i) The basis of determining the overburden removal cost.

(ii) Where cost of removal is considered on the basis of standard ratio, any variation positive or negative from the current ratio.

(iii) Any subsidy grant/ incentive and any such payment reduced from the cost of overburden removal.

(iv) Credit/ recoveries relating to overburden removal.

(v) Any abnormal cost excluded from overburden removal cost.

(vi) Penalties and damages excluded from the overburden removal 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 overburden removal cost during the period covered by the cost statement which has a material effect on the overburden removal cost 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, 2017 for being applied for the preparation and certification of the General Purpose Cost Statements.

CAS - 24

COST ACCOUNTING STANDARD ON TREATMENT OF REVENUE IN COST STATEMENTS

(Revised 2017)

The following is the COST ACCOUNTING STANDARD on **"TREATMENT OF REVENUE IN COST STATEMENTS"** (CAS-24) issued by the Council of the Institute of Cost Accountants of India. In this Standard, the standard portions have been set in ***bold italic*** type. These are to be read in the context of the background material which has been set in normal type.

1. Introduction

This standard deals with the principles and methods of classification, measurement, treatment and assignment of revenue and its presentation and disclosure in cost statements.

2. Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods for treatment of revenue in cost statements with reasonable accuracy.

3. Scope

This standard shall be applied to cost statements which require classification, measurement, treatment, assignment, presentation and disclosure of revenue including those requiring attestation.

4. Definitions

The following terms are being used in this standard with the meaning specified. Any term not defined in this Standard shall have the same meaning and expression as set out in the Glossary of Terms issued by the Council.

4.1 By-product: Product with relatively low value produced incidentally in the manufacturing of the product or service.

4.2 Defectives: Materials, products or intermediate products that do not meet quality standards. This may include reworks or rejects.

4.3 Intermediate product: An intermediate product is a product that requires further processing before it is saleable.

4.4 Joint product: Products or services that are produced simultaneously, by the same process, identifiable at the end of the process and recognised as main products or services having sufficient value.

4.5 Net Sales Realization: is the revenue from operations net of discounts and indirect taxes.

4.6 Other Income: is the income that cannot be classified as revenue from operations.

Examples:

- Profit on sale of property, plant and equipment and investments;

- Interest from investments or deposits outside the business;
- Insurance claims received, not adjusted against an item of cost;
- Penalties or liquidated damages received, not adjusted against an item of cost;
- Fees received, not adjusted against an item of cost;
- Rent or lease from properties leased (unless the primary activity itself is leasing);
- Grants received;
- Royalties received (unless it is a part of major activity of the entity);
- Credits for previous years' adjustments;
- Dividend income on investments (other than in a financial enterprise);
- Gain on foreign currency transaction and translation (other than considered as finance cost);
- Excess provisions written back;
- Credits on account of revaluation of capital assets;
- All items of abnormal revenue such as recoveries from book debts written off in the previous period; and
- Prior period income.

4.7 Reporting Period: is the period for which the cost statements are prepared.

4.8 Revenue: The term Revenue will have the same meaning as assigned in the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules 2006 or in the Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules 2015, as applicable.

The terms Revenue and Sales Realisation denote the same meaning and are used interchangeably.

4.9 Revenue from operations: is the income arising in the course of the ordinary activities of an entity from the sale of goods or rendering of services.

Revenue from operations represents income arising from the sale of goods or rendering of services and includes other operating revenue, such as sale of scrap, government subsidies, or incentives received. Revenue from operations is generally recognised at the net value excluding indirect taxes. Sometime, revenue is presented at the gross value including excise duty and the excise duty is presented as deduction from such gross value of the revenue.

Other Operating Revenue is the incidental income arising in the course of ordinary activities of an entity but not arising from the sale of main goods or services, and it does not include Other Income.

Examples:

- Sale of By-products;

- Sale of manufacturing scrap;
- Export incentives received from Government; and
- Product related subsidies or grants received from Government.

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

4.11 Scrap: Discarded material having no or insignificant value and which is usually either disposed off without further treatment (other than reclamation and handling) or reintroduced into the process in place of raw material.

4.12 Spoilage: Production that does not meet the quality requirements or specifications and cannot be rectified economically.

4.13 Waste: Material lost during production or storage and discarded material which may or may not have any value.

Example of waste is hard waste and soft waste in textile industry.

5. Principles of Measurement

5.1 Revenue from sale of goods or services provided during a reporting period shall be measured based on the net sales realization.

5.2 Revenue from sale of joint products shall be measured separately for each main product or service sold.

5.3 Revenue from sale of goods or services shall be measured separately for each unit or location of an entity for each type of goods sold or service provided. It shall be sub-classified into revenue from exports, domestic sales, manufactured goods, operations, and trading activities.

5.4 Revenue from sale of goods or services shall be measured separately for sale of each type of by-products, defectives, second grade products, rejects, scrap, spoilage, or wastes.

5.5 If a by-product is further processed before sale, sales realisation of such by-product shall be net of further processing cost. Its net sales realisation shall be adjusted against the joint cost of production of relevant main products.

5.6 Net Sales realization of defectives, second-grade products, rejects, scrap, spoilage, and waste products shall be adjusted against the cost of production of related goods sold.

5.7 Revenue from sale of inputs, utilities, intermediate products, and shared or support services shall be adjusted against the cost of purchase or cost of production of the related input, utility, intermediate product and shared or support service.

5.8 Other income shall not be considered in determining profit or loss as per cost accounts.

5.9 Revenue generated from utilization of assets created under the CSR program shall not be considered in determining profit or loss as per cost accounts.

5.10 Product or service related subsidies, grants, or incentives, received or receivable on sale of goods or rendering of services shall be part of revenue from operations and shall be identified with each product sold or service rendered.

5.11 Any subsidy, grant, incentive or any such payment received or receivable to support the current operations of the entity other than those in the nature of capital grant and other than items referred in paragraph 5.10 above shall be treated as reduction in the related cost.

Reference:

- para 5.6 of CAS-3, Cost Accounting Standard on *Production and OperationOverheads*;
- para 5.1.9 of CAS-6, Cost Accounting Standard on *Material Cost*;
- para 5.8 of CAS-7, Cost Accounting Standard on *Employee Cost*;
- para 5.8 of CAS-8, Cost Accounting Standard on *Cost of Utilities*;
- para 5.1.8 of CAS-9, Cost Accounting Standard on *Packing Material Cost*;
- para 5.7 of CAS-10, Cost Accounting Standard on *Direct Expenses*;
- para 5.5 of CAS-11, Cost Accounting Standard on *Administrative Overheads*;
- para 5.13 of CAS-12, Cost Accounting Standard on *Repair and Maintenance Cost*;
- para 5.6 of CAS-13, Cost Accounting Standard on *Cost of Service Cost Centre*;
- para 5.13 of CAS-14, Cost Accounting Standard on *Pollution Control Cost*;
- para 5.5 of CAS-15, Cost Accounting Standard on *Selling and DistributionOverheads*;
- para 5.4 of CAS-17, Cost Accounting Standard on *Interest and Financing Charges*;
- para 5.2 of CAS-18, Cost Accounting Standard on *Research and Development Costs*;
- para 5.6 of CAS-19, Cost Accounting Standard on *Joint Costs*;
- para 5.3 of CAS-20, Cost Accounting Standard on *Royalty and Technical Know-howFee*;
- para 5.6 of CAS-21, Cost Accounting Standard on *Quality Control*; and
- para 5.19 of CAS-22, Cost Accounting Standard on *Manufacturing Cost*.

5.12 Any change in the cost accounting principles applied for the determination of revenue shall be made only if it is required by law or regulations or for compliance with the requirements of a cost accounting standard or the change would result in more appropriate preparation or presentation of cost statements of an entity.

6. Assignment of Revenue:

Revenue for each type of product or service shall be assigned directly to that product or service to the extent it is economically feasible.

Economic feasibility implies that it is practically feasible to assign the revenue to a particular product or service with reasonable cost and efforts. Reasonable cost and efforts are matters of judgment.

7. Presentation:

7.1 Net sales realization for each product or service shall be indicated separately for exports, domestic sales, manufactured goods, operations, and trading activities and matched against the cost of sales (net of duties) and margin of respective product or service.

7.2 The quantity of goods sold or services provided, where applicable, and selling price per unit shall be presented under each product or service.

8. Disclosures:

8.1 The cost statements shall disclose the following:

1. Revenue from sale of goods or services made to each related party with basis of determining the selling price;

2. Revenue from by-products and costs of further processing after split-off point, reduced from cost of relevant product;

3. Amount and nature of any subsidy, grant or incentive received or receivable and included in the revenue.

8.2 Any change in the cost accounting principles and methods applied for the measurement and assignment of revenue during the period covered by the cost statement which has a material effect on the revenue 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 statements or as a foot note or as a separate schedule.

9. Effective date:

This Cost Accounting Standard shall be effective from the period commencing on or after 1st April, 2017 for being applied for the preparation and certification of Cost Accounting Statement for goods sold and services provided.

Guidance Notes on Cost Accounting Standards

4.2

The Institute had issued guidance notes on the Cost Accounting standards, from time to time, making it more explicit to understand the standards and for better application of the same in the record keeping and audit procedures. Normally the guidance notes are greatly required in the respect of the standards dealing with specific elements of cost, they may also be issued in respect of specific purpose standards also .

The Guidance Notes deals with principles and methods as provided in the respective CAS and practical aspects in connection with the subject matter of that CAS, as applicable in the determination of material cost of a product or service etc. So far the Institute has issue 13 Guidance Notes on various issues.

Serial No.	Title
1.	Guidance Note on CAS-2 (Revised 2015) Capacity Determination
2.	Revised Guidance Note on Cost Accounting Standard on Cost of Production for Captive Consumption (CAS-4)
3.	Guidance Note on Cost Accounting Standard Material Cost (CAS-6)
4.	Guidance Note on Cost Accounting Standard on Employee Cost (CAS-7)
5.	Guidance Note on Cost Accounting Standard on Cost of Utilities (CAS-8).
6.	Guidance Note on Cost Accounting Standard on Packing Material Cost (CAS-9)
7.	Guidance Note on Cost Accounting Standard on Direct Expenses (CAS-10).
8.	Guidance Note on Cost Accounting Standard on Administrative Overheads (CAS-11).
9.	Guidance Note on Cost Accounting Standard on Repairs and Maintenance Cost (CAS-12).
10.	Guidance Note on Maintenance of Cost Accounting Records for Construction Industry Including Real Estate and Property Development Activity
11.	Guidance Note on Treatment of Costs Relating to Corporate Social Responsibility (CSR) Activities
12.	Guidance Note on Cost Accounting Standard on Cost of Service Cost Center (CAS-13)
13.	Guidance Note on Compilation Engagements by a Cost Accountant

These Guidance Notes explain in detail and clarifies on the various requirements of compliance of the relevant standards and will have the sections of introduction, scope, definitions and then the specific guidance on the treatment and disclosure aspects. *Students are advised, like in the case of standards, to thoroughly go through all the guidance notes on standards, issued by the Institute for better understanding of the standards and their compliance.*

The guidance notes on the standards dealing with specific elements of cost will normally have the following Chapters / sections, elaborating the contents of the respective CAS, in the same logical sequence, as in the standard:

1. Introduction
2. Definitions
3. Principles of Measurement
4. Assignment of Cost
5. Presentation
6. Disclosures and
7. Annexures, as the need may be.

Generally Accepted Cost Accounting Principles (GACAP)

4.3

The compilation of Generally Accepted Cost Accounting Principles (GACAP) by the Institute of Cost Accountants of India is a unique effort to record principles and practices in the discipline of Cost Accountancy in India.

The Expert Group constituted by the Ministry of Corporate Affairs acknowledged the existence of an un-codified set of generally accepted cost accounting principles in use in Indian industries and by the practicing cost accountants for attestation of Cost Statements. The Expert Group suggested that the principles be codified to provide a formal basis for the practice of Cost Accounting. The Expert Group also recommended review of alternate treatment of items in cost accounting thus eliminating needless diversities in practice leading to the development of cost accounting standards.

The Ministry of Corporate Affairs decided to implement the recommendations of the Expert Group and notified the Companies (Cost Records and Audit) Rules, 2014 on 30th June, 2014. These Rules introduced a common set of record rules for industries other than regulated industries specified in the Rules, in place of industry specific rules in vogue earlier. The Rules require every company to which the rules apply, including all units and branches thereof, to keep cost records in respect of each of its products and activities on regular basis. The cost records are to be maintained in accordance with the ***generally accepted cost accounting principles*** and ***cost accounting standards*** issued by the Institute of Cost Accountants of India to the extent these are found to be relevant and applicable. The variations, if any, are to be clearly indicated and explained.

GACAP, the Companies (Cost Records and Audit) Rules, 2014 require maintenance of cost records according to GACAP and Cost Accounting Standards gave the mandate for a compilation of GACAP.

Objectives

The objectives of this document are:

1. to codify the GACAP as applied in the Indian industry;
2. to narrow down diversities in cost accounting practices facilitating the process of development of cost accounting standards;
3. to provide a reference source to industry and practitioners in preparation and attestation of Cost Statements, where specific cost accounting standards are yet to be issued;
4. to provide a reference source to all the stakeholders in the understanding and interpreting the cost statement; and,
5. to provide a base for monitoring the evolution of new concepts and practices in cost accounting and to codify them as and when they become generally accepted.

Scope

The scope is to codify the cost accounting principles to be followed by business and other entities in India in preparing and presenting cost information – more particularly the General Purpose Cost Statements covered by Cost Audit. This document also encompasses the generally accepted cost accounting practices presently being followed by such entities.

Nature of Content and Format

1. This document titled Generally Accepted Cost Accounting Principles (GACAP) contains a summary of the Cost accounting principles currently followed by business entities in India in preparing and presenting cost information in the context of general purpose cost statements for statutory reporting and covered by Cost Audit.

2. It explicitly incorporates the principles already contained in the Cost Accounting Standards 1-24 issued by the Cost Accounting Standards Board (CASB) in India without necessarily repeating them.

3. In areas not covered by the standards, it reflects the cost accounting principles found in the Companies (Cost Records and Audit) Rules, 2014.

4. Where somewhat conflicting principles have been laid down by the Companies (Cost Records and Audit) Rules, 2014 in different industries, attempt has been made to harmonize the principles so as to evolve a generally acceptable framework. Where use of alternate principles are sanctioned by the Rules or where alternate principles are applied in practice in the absence of explicit guidance in Rules, the alternates have been mentioned with an indication of the preferred practice.

5. Because the Rules were framed at different points of time spread over many years, it is likely that the principles contained in the Rules and the practice based on them do not reflect current concepts. In such cases, the document reflects the current concepts.

6. It also reflects the Cost Accounting Principles contained in the Guidance Notes and other publications issued by Institute of Cost Accountants of India from time to time.

7. Cost Accounting principles which are gathering wide spread acceptance in Indian Companies for management reporting, even though not adopted for statutory cost reporting (for example, Activity Based Costing),are mentioned with suitable caveats regarding their lack of applicability for general purpose cost statements for statutory reporting, where applicable.

8. The document stipulates the main principles in **bold letters** followed by explanation in normal type.

Conceptual Frame Work

There is a need for a conceptual frame work that underlies the GACAP detailed in the succeeding sections. The conceptual frame work, as the name suggests, is a frame work and not a superset of cost accounting principles. It does not attempt to lay down a principle for any particular costing issue or to amplify the GACAP. The frame work helps to understand the GACAP that follow, in the appropriate perspective and guides in modifying them or developing new principles;

(a) **Focus on drivers of value**

Costing is necessary for an informed understanding of the organizational drivers of cost, revenue, profits and value. Costing has to fulfil this role both in a historical and in a forward looking context.

(b) **Cost for a purpose**

Over a long time it has been recognized that there is a cost concept relevant for a purpose. Thus external reporting requires historical and full absorption costing while performance evaluation requires attention directing and diagnostic information; planning and decision making requires analytical and predictive information. It is, therefore, not possible for the same set of cost data to fit all purposes, thereby resulting in a wide range of cost concepts from which preparers and users of cost information choose a concept relevant to the purpose.

(c) **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.

(d) **Materiality and cost effectiveness**

The selection of the methods of implementing the costing principles should have regard to the issues of materiality and cost effectiveness. Materiality of cost information is to be judged from the perspective of the user of that information. The degree of detail and accuracy required are governed by the perspective of materiality. From the preparers' viewpoint there is the need to balance the cost of maintaining a cost accounting system with corresponding benefits. This is the reason why in a number of places, while dealing with methods of implementing cost accounting principles, the expression "economically feasible way" has been used in this document.

Hence, for preparation and disclosure of cost information, one is required to judge the materiality aspect in conjunction with economic feasibility of maintaining such data and information. For example, maintenance of product/activity-wise cost details for each of the ancillary product or activity of an entity would neither be material nor economically feasible.

Any product or activity of an entity which is incidental to its main operations and does not constitute its main line of business and whose total turnover from the sale/supply of such product or activity does not exceed 2% of the total turnover of the entity or ₹20 crores, whichever is lower, should be treated as an ancillary product or activity.

(e) **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.

(f) **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.

Principles Applicable to Elements of Cost

The following section deal with GACAP applicable to individual elements of cost.

Before proceeding with element-wise principles, it is useful to summarise the principles applicable to all elements of cost.

1. When an element of cost is accounted at standard cost, variances due to normal reasons are treated as a part of the element-wise cost. Variances due to abnormal reasons will not form part of the cost.
2. Any Subsidy/Grant/Incentive and any such payment received/receivable with respect to the input cost is reduced from cost for ascertainment of the cost of the cost object to which such amount pertains.
3. Any abnormal cost where it is material and quantifiable will not form part of the cost.
4. Penalties, damages paid to statutory authorities or other third parties will not form part of the cost.
5. Costs reported under various elements of cost will not include imputed costs.
6. Finance costs incurred in connection with acquisition of resources such as materials, utilities and the like will not form part of the cost of such resources.
7. Any credits or recoveries from employees or suppliers or other parties towards costs incurred by the entity for a resource will be netted against such costs.
8. Except otherwise stated, the measurement of costs for cost accounting purposes will follow the same principles as set out in Generally Accepted Accounting Principles, applicable to the concerned entity.

Material Cost

1. Material Cost usually includes all costs required to bring the materials to the present condition and location.
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.
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.
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.
5. Where a material is acquired in exchange for other materials or services supplied, the cost of material acquired is taken as the cost of material supplied or services provided plus other applicable costs such as freight.
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.
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.
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.
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.

10. Self Manufactured Materials (and Self manufactured components and sub assemblies) are valued at cost including Direct Material Cost, Direct Employee Cost, Direct Expenses, Factory Overheads and share of Administrative Overheads relating to production. Share of other Administrative Overheads, Finance Cost and Marketing Overheads are excluded.

11. The material cost of normal scrap/defectives, which are rejects, is included in the material cost of goods manufactured. This cost not exceeding the normal is adjusted in the material cost of good production. Material cost of abnormal scrap/defectives should not be included in the material cost, but treated as loss after giving credit to the realizable value of such scrap/defectives.

12. Issues of materials are valued using appropriate assumptions on cost flow.

    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.

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.

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.

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.

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.

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.

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.

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.

3. Remuneration payable to Managerial Personnel including Executive Directors on the Board and other officers of a corporate body under a statute is considered as part of the Employee Cost of the year under reference whether the whole or part of the remuneration is computed as a percentage of profits.

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

5. Separation costs related to voluntary retirement, retrenchment, termination etc. should be amortized over the period benefiting from such costs.

6. Amount payable to employees during the lay off period or for the strike period or during suspension, is not included in cost.

7. Cost of employee share options is treated part of employee cost provided the same is not a notional cost and involves an actual cash outlay.
8. Gratuity, pension and other superannuation benefits, measured using actuarial valuation method or any other methods, are part of Employee Cost.
9. Amortized separation costs related to voluntary retirement, retrenchment, and termination etc. for the period is treated as indirect cost and assigned to the cost objects. Unamortized amount relating to discontinued operations should not be treated as employee cost.
10. Recruitment costs, Training costs and other such costs is treated as overheads and dealt with accordingly.
11. Overtime premium and idle time cost should be assigned directly to a cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime or idle time.
12. Where the employee service is directly traceable to a Cost object, such cost is assigned on the basis of time consumed.
13. When employee costs are not directly traceable to a Cost object, they are assigned on a suitable basis like estimates of time based on time study.

Direct Expenses

1. The identification of Direct Expenses is based on traceability in an economically feasible manner.
2. Similarly if an item of the expense does not meet the test of materiality, it can be treated as part of overheads.
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.
4. Other Direct Expenses other than those referred above are determined on the basis of amount incurred in connection therewith.
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.
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.

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.
2. The cost of generated utilities includes direct materials, direct labour, direct expenses and factory overheads.
3. Cost of Utilities generated for the purpose of inter unit transfers is arrived as Cost of self generated utilities with Distribution cost added.
4. Cost of Utilities generated for Intercompany transfer is arrived as Cost of self generated utilities plus Distribution cost plus share of administrative overheads.
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.

6. The Cost of Utilities includes Cost of distribution of such utilities.
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.
8. Cost of stand by utility includes the committed costs of maintaining such utility.
9. While assigning cost of utilities, traceability to a cost object in an economically feasible manner is the guiding principle.
10. The most appropriate basis for distribution of cost of a utility to the departments consuming services is to be derived from usage parameters.

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.
2. Cost of in-house Repairs and Maintenance activity will include cost of materials, consumable stores, spares, manpower, equipment usage, utilities and other resources used in the activity.
3. Cost of Repairs and Maintenance activity carried out by outside contractors inside the entity will include the charges payable to the contractor apart from the above in-house cost.
4. Cost of Repairs and Maintenance activity carried out by contractors at his premises is determined at invoice or agreed price including duties and taxes and other expenditure directly attributable net of discounts (other than cash discount), taxes and duties refundable or to be credited. It will also include the cost of other resources provided to the contractors.
5. Each type of Repairs and Maintenance is treated as a distinct activity, if material and identifiable.
6. The cost is measured for each major asset category separately.
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, when Repairs and Maintenance is considered as a separate cost centre, the cost of which is apportioned to user centres.
8. Where a high value spare is replaced, and the replaced spare is reconditioned and such spare is expected to result in future economic benefits, it is taken into stock. Such a spare is valued at an amount that measures its service potential in relation to a new spare, the amount of which will not exceed the cost of reconditioning the spare. The difference between the total of the cost of the new spare and the reconditioning cost and the value of the reconditioned spare should be treated as Repairs and Maintenance cost.
9. Cost of major overhaul is amortized on a rational basis.
10. Repairs and Maintenance cost is traced to a cost object to the extent economically feasible.
11. Where the Repairs and Maintenance cost is not directly traceable, it is assigned based on either of the principles of Cause and Effect or Benefits Received.

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.

3. The terms Production Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

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.

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.

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).

8. It is not a good practice to allocate overheads to Cost Centres/ Cost Objects on the basis of "what the traffic will bear" – that is by size of the user.

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

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 assignment	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.

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.

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.

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.

18. Charging overheads on the basis of "benefits received" by the various users is preferred. This requires some measure of "receipt of benefit" to be developed.

19. Sometimes capacity in a service department is created in anticipation of demand for services. It is appropriate to allocate such capacity costs on the basis of "capacity to serve" rather than actual usage of services.

    Ultimately all overheads must be charged to products of services. Hence the total production overheads of Production Cost Centres are applied to products passing through them using a suitable absorption base.

20. Before the final step of absorption, production overheads of production cost centres have to be segregated between fixed overheads and variable overheads. The fixed overheads are absorbed by products based on normal capacity or actual capacity utilization whichever is higher. Variable overheads are absorbed by products based on actual capacity utilization. This treatment is in line with Accounting Standard 2 as well.

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.

22. Under-absorbed fixed overheads are charged off to Costing Profit & Loss Account and shown as an item of Reconciliation with financial accounts.

Depreciation

1. Depreciation, though part of overheads, generally appears as a separate line item in the cost statements instead of being grouped under overheads. This is because of its size in the technology driven business of today and its unique characteristic of being non-cash cost.

2. Amortization of intangible assets tends to be grouped with depreciation because intangible assets themselves are grouped with Fixed Assets in the presentation under Schedule III of the Companies Act 2013.

3. The measurement of depreciation in Cost accounts tends to mirror the practices in financial accounts.

4. However the treatment of depreciation in Cost Accounts must address the following issues:

    - Depreciation not calculated on period of use basis.

    - Depreciation an idle assets

- 100% of depreciation on certain class of assets
- Write-off of small value assets
- Depreciation on fully depreciated assets
- Depreciation on revalued assets

5. Sometimes depreciation in books is not calculated on period of use, for example 50% of annual depreciation is taken for an asset put into use for a day in financial accounts keeping in mind Income Tax provisions. **Cost accounts will always use the depreciation computed on period of use basis and take the balance to Costing P & L or reconciliation with financial accounts.**

6. Even where 100% of the depreciation is allowed in the first year for income tax purposes, companies are required to use regular rates of depreciation for cost accounting purposes. Even where an entity uses 100% depreciation rates in financial books of accounts, **depreciation based on estimated life is used for costing purposes with the difference taken to costing Profit & Loss or Reconciliation with Financial Accounts.**

7. **Where small value items are written off fully at the time of purchase in financial accounts, the same is generally adopted for cost accounts.**

8. **In the case of old plants, there is the special case for fully depreciated assets which however continue in regular service. Some entities continue to provide a notional depreciation on such assets for decision making purposes.**

9. Depreciation on the amount by which the asset is written up on Revaluation is charged to Revaluation Reserve in financial books. **Some entities compute the depreciation on the revalued figure for costing purposes to reflect the true cost of depreciation.**

10. **It goes without saying that the cumulative depreciation charged in the Cost Accounts against any individual item of fixed asset will not exceed the original cost of the asset.**

11. The assignment of depreciation to various cost centres should not pose a problem so long as detailed Fixed Asset records are maintained by the Company. However there are some common items of fixed assets between cost centres e.g. yard piping carrying products from one process to another, common storage tanks and the like. **Depreciation on common assets are apportioned to individual cost centre on some suitable basis e.g. yard piping is assigned to the cost centre receiving the material.**

Administrative Overheads

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

   The principles of measurement of Material Cost, Employee Cost, Utilities, Repairs & Maintenance and Depreciation found in the respective standards will apply if included in administrative overheads.

2. **In case of leased assets, if it is an operating lease – the entire rentals will be treated as a part of administrative overheads, while in case of a financial lease – the finance cost portion will be segregated and treated as a part of finance cost**.

3. **The cost of software (developed in house, purchased, licensed or customized), including up-gradation should be amortized over its useful life.**

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. 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**.

   The cost of shared services is best assigned to user activities on the basis of actual usage, infrastructure costs on the basis of readiness to serve and general management costs on a rational basis. For e.g.: Number of employees, turnover, investment size etc.

5. Since most administrative costs are fixed in nature, it is preferable to change them to users on "readiness to serve" basis such as installed capacity, budgeted sales etc. rather than actual production or actual sales. Even the drivers mentioned in (9) above can be on the basis of expected driver qualities rather than actual.

Selling and Distribution Overheads

1. Selling costs can be recorded in a manner which will facilitate customer / product profitability analysis, as appropriate. Thus selling costs can be identified to markets, distribution channels, territories, salesman etc., before being assigned to customer / product as applicable.

2. The acceptable bases for apportionment of common selling costs to customers / products are:

   a. Weight

   b. Units / equivalent units

   c. Value of goods

   d. Any other appropriate and equitable basis

3. The acceptable bases for assigning common transport costs to products are:

   a. Weight

   b. Volume of goods

   c. Tonne km

   d. Units / equivalent units

   e. Value of goods

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

Interest and Finance Charges

1. Interest and Finance Charges have come to be included in cost of sales though not in cost of production. Such costs are also assigned to products before arriving at margins by product.

2. For the purpose of assignment, Interest charges are grouped under

- interest on long term funds
- interest on working capital funds

3. The former is assigned to product lines based on fixed capital investment (including fixed assets and mould and dies) in such product lines. A portion of the interest is also charged to outside investments, if they exist, and excluded from cost of sales. For this purpose, it is usual to develop an average cost of long term funds and apply it to fixed capital investment in each product line.

4. It is not the accepted practice to charge imputed interest on owners' funds in cost accounting.

Sales

1. Cost of sales statements lead right up to margin and hence sales also have to be handled in Cost Accounting.

2. **Since costing is always by product, cost accounting requires product wise analysis of sales.** This is usually produced by other modules of the enterprise system.

3. What is critical is the value of sales produced by such analysis. Often sales analysis produce invoiced value of sales. **What is required for cost accounting is net value of sales net of trade discounts, returns, allowances, volume discounts, special discounts based on market conditions etc.**

4. Many of these deductions from sales are transacted through credit notes which also must be processed through the sales analysis to arrive at product wise break up.

5. **Some of these deductions from sales may be available only in total and hence may have to be allocated to products on a suitable basis, say, sales value.**

6. It is not unusual for businesses to focus on net realization from sales ex-factory gate. This means that freight (both primary and secondary), transit insurance, loading and unloading charges, handling charges and the like are deducted from net sales as arrived at in 3 above to arrive at net sales realization ex-factory gate. This also entails freight and other transport costs not being shown under the head Distribution costs. So long as these costs are shown separately as deductions from net sales value, the practice is acceptable.

7. Companies (Cost Records and Audit) Rules, 2014 require gross sales to be shown in addition to net sales in cost statement. This requires that excise duty, sales tax (VAT) etc is added to net sales to arrive at gross sales by product. However, in view of application of GST, w.e.f. 1/7/2017, the Gross sales becomes Net Sales.

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. Cost elements, which are material for a product or activity, must be disclosed separately.
11. Cost details of all ancillary products or activities may be maintained under a miscellaneous group and disclosed appropriately.
12. Changes in the costing principles and methods applied must be disclosed with the effect.

Conclusion

This document contains a discussion of the generally accepted cost accounting principles in the context of today and the times gone by. It must be understood that cost accounting principles and methods of applying them are in a constant flux influenced by fresh thinking by experts, regulatory influences, parallel developments in financial accounting standards and the like. Professional accountants will be well advised to use this document as a guide and not as a set of rules.

llustration 1.

Burnet Ltd., a manufacturing unit, provides the following extracts from its records for the year ended March 31, 2022:

The Company's specifications capacity for a machine per hour	1,500 units
No. of shifts (each shift of 8 hours) per day	3 shifts
Paid Holidays in a year (365 days):	
(i) Sunday	52 days
(ii) Other holidays	12 days
Annual maintenance is done within these holidays	—
Preventive weekly maintenance for the machine is carried on during Sundays	
Normal idle capacity due to lunchtime, shift changes etc. per shift	1 hour
Production based on sales expectancy in past 5 years (units in lakh):	75.70
	87.42
	65.38
	77.97
	76.08
Actual Production for the year (units in lakh)	81.50

You are required to calculate:

(i) Installed Capacity

(ii) Practical Capacity

(iii) Actual Capacity (%)

(iv) Normal Capacity

(v) Idle Capacity (%)

(vi) Abnormal Capacity

Keeping in view of the relevant Cost Accounting Standard (CAS-2).

Solution:

Calculation of different capacities

Burnett Ltd

(i) Installed Capacity: days in year × working hours per day × unit per hour

$365 \times 8 \times 3 \times 1500 = 131.40$ lakh units

(ii) Practical capacity: days available × available hour per shift × shifts × units per hour

$(365\text{-}52\text{-}12) \times (8\text{-}1) \times 3 \times 1500 = 94.815$ lakh units

(iii) Actual capacity Utilization: Current production / Installed capacity

(81.50 / 131.40) × 100 = 62.02%

(iv) Normal capacity: (75.70+87.42+65.38+77.97+76.08) / 5 = 76.51 lakh units

(v) Idle Capacity: Installed capacity – Actual capacity

(131.40-81.50) = 49.90 / 131.40 = 0.3798 = 37.98%

(vi) Abnormal Idle capacity: (94.815 – 81.50) = 13.315 lakh units

Illustration 2.

The following information pertains to REACON CEMENT LTD., a manufacturing cement company for the year that ended as follows:

The year ended March 31	2021-22	2020-21
Rated Capacity per Hr (in MT)	80	80
Break down (Hrs)	2,177	1,015
Planned Maintenance (Hrs)	247	422
Power restrictions (Hrs)	1,237	1,481
Shortfall (there are no orders) (Hrs)	792	677
Want of wagons (Hrs)	495	635
Total stoppage (Hrs)	4,948	4,230
Total running (Hrs)	3,888	4,582
Total available Hours	8,836	8,812
Production during the year (in MT)	2,48,844	3,29,928
Hourly Rate of Production (in MT)	64	72
Capacity Utilization (%)	62.21	82.48
Annual Installed Capacity (in MT)	4,00,000	4,00,000

Based on information stated above, you as a Cost Auditor are required to offer your comments on:

(i) The performance of the company

(ii) Your suggestion for improvement.

Solution:

Reacon Cement Ltd.

Performance analysis

(i)

(a) Rated capacity = 80 MT/Hr : Rated capacity achieved in 2020-21 = (72/80) × 100 = 90%

Rated capacity achieved in 2021-22 = (64 /80) × 100 = 80%. The capacity achievement as % of rated capacity has declined from 90% to 80% in 2021-22.

Further the Capacity Utilization has gone down to 62.21% in 2021-22 from 82.48% of previous year; a reduction of 20.27%.

(b) From the data available the following observations are noted:-

1. Breakdown hours have gone up from 1,015 hours to 2,177 hrs, an increase by 114.48%
2. Planned Maintenance hrs has reduced from 422 hrs to 247 hrs i.e. by 41.47%
3. Shortfall hrs due to lack of orders has increased from 677 hrs to 792 hrs i.e. by 16.99%
4. The total stoppage hrs. has increased from 4,230 hrs to 4,948 hrs i.e. by 16.97%
5. The total running hrs has come down from 4,582 hrs to 3,888 hrs i.e. by 15.15%
6. The production has come down from 3,29,928 MT to 2,48,844 MT i.e. by 24.58% From the above findings, it can be pointed out that the under utilization of capacity to the extent of little over 20% can be attributed mainly to:-
   - Increased total stoppage hours of 4,948 of 2021-22 as against that of 4,230 hrs in 2020-21 and
   - The net increase of 718 hrs (4,948-4,230) is again due to increase of break down by 1,162 hrs (2,177-1,015) in the year 2021-22

(ii) **Suggestion:**

Therefore, the Company should look into the aspect of proper maintenance, securing sufficient orders to avoid lost time. Better utilization of capacity can be also be achieved by improving availability of wagons. The company may also carry out a cost-benefit analysis to have captive source of power.

Illustration 3.

The following data have been available of Sunflag Dolon Limited:

	2019 - 20	2020 - 21	2021 – 22
Installed Capacity—Ton	250	250	250
Production—Ton	240	230	125
Cost Per Ton (₹)	1,000	1,077	1,660

The poor capacity utilisation in 2021-22 was due to abnormal power-cut. The escalation in costs were 5% in 2020-21 and 7% in 2021-22 based on 2019-20

(i) Calculate the abnormal cost due to power cut.

(ii) How would you treat these abnormal cost?

Solution:

	2019-20	2020-21	2021-22
Installed Capacity – Ton	250	250	250
Production – Ton	240	230	125
% of Capacity Utilisation	96	92	50
Cost per Unit (₹/Ton)	1,000	1,077	1,660
Escalation factor	100	105	107
Cost at base year price	1,000	$\left(1077\times\frac{100}{105}\right)$ i.e. 1,026	$\left(1660\times\frac{100}{107}\right)$ i.e. 1,551
Total cost of production (₹)	2,40,000	2,35,980	1,93,875
Variable Cost/Ton (₹)	402	402	401
Fixed Cost/Ton	598	624	1,150
Fixed Cost @ 100% utilisation (₹)	574		

Hence, increase in Fixed Cost/Ton due to poor capacity utilization in 2021-22

= (1,150 – 574) = ₹ 576

(i) Total abnormal cost due to power cut = 576 × 125 = ₹ 72,000

(ii) The abnormal cost must be excluded from computation of cost and has to be shown under Para 7 of the Cost Audit Report as "Abnormal Non-Recurring Cost".

(iii) The 50% under utilisation of capacity being due to power-cut only, the Company should consider possibility of captive generation, if the power-cut is likely to persist. Accordingly, the investment needed, potential savings, etc. must be computed to determine the viability of such a decision.

Working Notes:

	2020-21	2021-22
Difference in Total Cost	[2,40,000 – 2,35,980] = 4,020	[2,35,980 – 1,93,875] = 42,105
Difference in production	10	105
Hence, Variable Cost	**402**	**401**

Illustration 4.

GLORY LTD., a manufacturing company provides the following extracts from its Cost Accounting Records for the year ended March 31, 2022:

The total capacity for 5 Machines per hour as per the company's specification.	2500 Units
No. of shifts (each shift of 8 hours) per day	3
Paid holidays in a year (365 days):	
(i) Weekly holidays	52
(ii) Other holidays	10
Annual maintenance is done within these holidays (i.e. 10)	

Preventive maintenance for the machines is carried on during weekly off day.	
Normal idle capacity due to lunchtime, shift changes etc. per shift	0.5 hour
Production based on sales expectancy in past 3 years (units in lakh):	154.50
	159.54
	166.66
Actual production for the year ended March 31, 2022:	158.80

You are required to calculate:

(1) Installed Capacity

(2) Practical Capacity

(3) Actual Capacity (%)

(4) Normal Capacity

(5) Idle Capacity (%)

(6) Abnormal Capacity — Keeping in view of the relevant Cost Accounting Standard (CAS-2).

Solution:

GLORY LTD.

CALCULATION OF DIFFERENT CAPACITIES FOR THE COMPANY

(1)	Installed Capacity : 365 × 8 × 3 × 2500 = 21900000 i.e. 219 lakh units
(2)	Practical capacity: (365 – 52 – 10) × (8 – 0.5) × 3 × 2500 = 17043750 i.e. 170.4375 lakh units
(3)	Actual capacity (given) = 158.80 lakhs units
	Actual capacity utilization: (158.80/219) × 100 = 72.51%
(4)	Normal Capacity: (154.50 + 159.54 + 166.66)/3 = 160.23 lakh units
(5)	Idle capacity: (219 – 158.80) = 60.20 lakh unit i.e. (60.20/219) = 27.49%
(6)	Abnormal Idle capacity: (170.4375 – 158.80) = 11.6375 lakh units i.e. (11.6375/170.4375) = 6.83%.

Illustration 5.

A plant operates 3 shifts of 8 hours each for all days except Sundays and 8 holidays.

Preventive maintenance is taken care in Sundays and annual maintenance in 8 hoildays.

Normal idle time for food, shift change and other work for the workers is 1 hour per shift.

Installed Capacity of the machine = 1200 units per hour.

Production during last 5 years & Current year are 69.4, 72.6, 71.4, 70.5, 70.8, 69.9 lakh units

Determine according to CAS 2, Installed capacity, Actual capacity, Idle capacity, Abnormal idle capacity.

Solution:

(i) Installed capacity = days in year × working hours per day × unit per hour

= 365 × 8 × 3 × 1200 unit = 105.12 lakh units

(ii) Available capacity = days available × available hour per shift × shifts × units per hour

= (365 – 52 – 8) × (8 – 1) × 3 × 1200 = 76.86 lakh units

(iii) Normal capacity = 69.4 + 72.6 + 71.4 + 70.5 + 70.8 / 5 = 70.94 Lakhs units

(iv) Actual capacity = Current production / Installed capacity = 69.9 / 105.12 = 66.50 %

(v) Idle capacity = Installed capacity – Actual capacity = 105.12 – 69.90 = (35.22/105.12) × 100 = 33.50%

(vi) Abnormal Idle capacity = Normal capacity – Actual capacity

= 76.86 – 69.9 = 6.96 lakh units

Illustration 6.

The following particulars pertaining to production of yarn are extracted from the records of Balarampur Textiles Ltd. for the year ended March 31, 2022:

Particulars	₹ '000
Direct Material Cost per unit	2,560
Direct Wages & Salaries	1,540
Direct Expenses	450
Indirect Materials	533
Factory Overheads	897
Administrative Overheads (40% relating to Production activities)	1,250
Quality Control Cost	565
Research and Development Cost	600
Interest on Working Capital	350
Sale of Scrap Realised	460

You are to determine the cost of production for the purpose of captive consumption in terms of the Rule 30 of the Central Goods & Services Tax Rules 2017 and as per the CAS-4 (Revised) and the Assessable Value for the purpose of paying GST on applicable transactions.

Solution:

According to the Rule 30 of the Central Goods & Services Tax Rules 2017, the Assessable Value of goods used for captive consumption is 110% of cost of production of such goods. The manner of determination of cost of production for captive consumption is laid down in CAS-4.

Particulars	**₹ in '000**
Direct Material	2,560
Direct Wages and Salaries	1,540
Direct Expenses	450
Indirect Materials	533
Factory Overheads	897
Administrative Overheads (40% on ₹1,250)	500
Quality Control Cost	565
R& D Cost	600
Total cost	**7,645**
Less: Realisation of scrap	460
Cost of production as per CAS-4	7,185

Note :

1. The cost of Working Capital Interest is not chargeable to Cost of Production
2. Assessable value as per Rule 30 of CGST Rules, 2017 is ₹ 79,03,500 (110 % × 71,85,000)

Illustration 7.

ABUNA ELECTRONICS LTD. is engaged in the manufacture of LED TV sets having its factories at Patna and Gujarat. The company manufactures picture tube at Patna which is consumed to produce LED TV sets at Gujarat factory. The following information pertaining to captively consumed picture tubes are extracted from the records of the company for the half year ended March 31, 2022.

(₹ in Thousand)

Direct material	950
Direct wages and salaries	357
Direct expenses	80
Indirect materials	70
Factory overheads	320
Administrative overheads (20% relating to production activities)	640
Quality control cost	100
Research and development cost	125
Selling and distribution expenses	225
Sale of scrap realized	130
Profit margin	15%

You are required to determine:

(i) The cost of production for purpose of captive consumption in terms of Rule 30 of the Central Goods & Services Tax Rules 2017 and as per CAS-4 (Revised), and

(ii) Assessable Value for the purpose of paying GST on applicable transactions.

Solution:

ABUNA ELECTRONIC LTD.

Computation of Cost of Production (As per CAS-4)

Amount in ₹ thousand

Direct materials	950
Direct wages and salaries	357
Direct expenses	80
Factory overheads (320+70)	390
Quality control cost	100
Research and development cost	125
Administrative overheads (to the extent relates to Production activities)	128
Less: Sale of scrap realized	(130)
Cost of production	**2,000**
Add: 10% as per Rule 30 of CGST Rules, 2017 (10% of ₹ 2,000)	200
Assessable Value as per Rule 30 of CGST Rules, 2017	**2,200**

Illustration 8.

Purchase of Materials ₹ 3,00,000 (inclusive of GST of ₹ 15,715); Free on Board ₹12,000; Import Duty paid ₹15,000; Freight inward ₹ 20,000; Insurance paid for import by sea ₹ 10,000; Rebates allowed ₹ 4,000; Cash discount ₹3,000; Subsidy received from the Government for importation of these materials ₹ 20,000. Compute the landed cost of material (i.e. value of receipt of material).

Solution:

Computation of Material Cost Sheet

	Particulars	Amount (₹)
	Purchase price of Material	3,00,000
Add:	Free on Board	12,000
Add:	Import Duties of purchasing the material	15,000
Add:	Freight Inward during the procurement of material	20,000
Add:	Insurance paid	10,000
	Total	**3,57,000**
Less:	Rebates	4,000
Less:	GST Input Tax Credit	15,715
Less:	Subsidy received from the Government for importation of materials	20,000
	Value of Receipt of Material	**3,17,285**

Note:

(i) Cash discount is not allowed, as it is a financial item.

(ii) Subsidy received, rebates and GST Input Tax Credit are to be deducted for the purpose of computing the material cost.

Illustration 9.

Purchase of Materials $ 50,000 [Forward contract rate $ = ₹64.40 but $ = ₹64.60 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; Payment made to the foreign vendor after a month, on that date the rate of exchange was $ = ₹65.20. Compute the landed cost of material.

Solution:

Computation of Landed Cost of Material

	Particulars	**Amount (₹)**
	Purchase price of Material [50,000 × 64.60]	32,30,000
Add	Import duties of purchasing the material	5,65,000
Add	Freight Inward during the procurement of material	1,62,000
Add	Insurance paid	48,000
	Value of Receipt of Material	**40,05,000**

(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 $ = ₹64.40, 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 $ = ₹64.60.

Illustration 10.

Opening stock of raw materials (5,000 units) ₹ 1,80,000; Purchase of Raw Materials (17,500 units) ₹ 7,00,000; Closing Stock of Raw Materials 3,500 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 of materials due to shrinkage in transit 1% of materials purchased; Abnormal Loss due to absorption of moisture before receipt of materials 100 units. Calculate the value of Closing Stock (Average Cost Method).

Solution:

Computation of value of closing stock of raw materials [Average Cost Method]

	Particulars	**Quantity (Units)**	**Amount (₹)**
	Opening Stock of Raw Materials	5,000	1,80,000
Add	Purchase of raw materials	17,500	7,00,000
Add	Freight inwards		85,000
			9,65,000

Less	Abnormal Loss of raw materials (due to absorption of moisture before receipt of materials) = [(7,00,000 + 85,000) × 100]/17,500	(100)	(4,486)
Less	Normal loss of materials due to shrinkage in transit [1% of 17,500 units]	(175)	-----
Add	Cost of self-manufactured packing materials for purchased raw materials only (60,000 – 8,000)		52,000
	Cost of raw materials	**22,225**	**10,12,514**
Less:	Value of Closing Stock $= \left(\frac{\text{Total Cost}}{\text{Total units} - \text{Units of Normal Loss}}\right) \times \text{Closing Stock units}$ $= \left(\frac{10,12,514}{5,000 + 17,500 - 175}\right) \times 3,500$	(3,500)	(1,58,737)
	Cost of Raw Materials Consumed	**18,725**	**8,53,777**

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 arose 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.

Illustration 11.

A Steel Company which produces Iron Casting Pipes and rod iron is covered under the Cost Audit according to the Companies (Cost Records and Audit) Rules 2014. From the expenditure data relating to 2021-22, determine the employees cost according to CAS -7.

₹ in Lakh

(i)	Salary, wages and other allowances	750
(ii)	Bonus	100
(iii)	Contribution to Providend Fund	90
(iv)	Wages to contractors employees	100
(v)	Employees welfare	40
(vi)	Abnormal cost due to strike	80
(vii)	VRS payment for closure of Rod Iron section of the plant	62
(viii)	Arear Salary (2020-21)	210
(ix)	Compensation paid against the past periods against Court order	67

Solution:

The following items will not be included according to CAS-7:

(i) VRS paid for closure of an unit

(ii) Abnormal cost charges to Profit and Loss A/C

(iii) Area salary not related to the current year

(iv) Compensation paid against past periods

(v) Wages paid to contractor employees.

[As per explanation(1) of CAS-7 under para-4.7: Contract employees include employees directly engaged by the employer on contract basis but does not include employees of any contractor engaged in the organisation.]

Thus, employees cost :

		₹ lakh
(i)	Salary and wages	750
(ii)	Contribution to PF	90
(iii)	Employees welfare	40
(iv)	Bonus	100
	Total	980

Illustration 12.

A manufacturing firm has up its own power plant to cater its need in manufacturing process.

Its one month data is given below :

Number of units produced = 100 lakh units of which 5% is used by generating unit.

Material and utility used :

(i) Coal 300 MT @ ₹ 30,000 per MT

(ii) Oil 5 MT @ ₹ 1,60,000 MT

(iii) Cost of Water extraction and treatment : 6 lakh litres @ ₹ 3 per litre

(iv) Steam boiler cost ₹ 55 lakh with residual value 5 lakhs after life of 10 years.

(v) Cost of Generating Plant is ₹ 90 lakhs with no residual value. Depreciation is charged on straight line method @ 10%

(vi) Generating Plant : 100 skilled workers@ ₹ 30,000 & 150 helpers @ ₹ 20,000 pm.

(vii) Boiler plant : 60 semi-skilled workers @ ₹ 25,000 & 100 helpers @ ₹ 20,000 pm

(viii) Repair & Maintenance of generating plant & Boiler is ₹ 5.0 lakhs

(ix) Share of Administrative charges ₹ 20 lakh

(x) Realization from Sale of ash disposed is ₹ 1.5 lakh

Prepare a cost sheet for Electricity Generating Cost and calculate cost per unit.

Solution:

	Calculation	**₹ Lakh**
Material cost		
Coal	300 × 30,000	90.00
Oil	5 × 1,60,000	8.00
Water	6 × 3	18.00
Total Material Cost		116.00
Wages for Generator Plant	(100 × 30,000) + (150 × 20,000)	60.00
Wages for Boiler plant	(60 × 25,000) + (100 × 20,000)	35.00
Depreciation - Generating Plant	90 × 0.10	9.00
Depreciation- boiler plant	(55-5) /10	5.00
Repair & Maintenance of generating plant & boiler		5.00
Administraive Exp		20.00
Total Cost		250.00

As generating unit consumes 5%, effective unit produced for manufacturing = 95 lakh

Cost per unit = ₹ 250/95 = ₹ 2.63

Illustration 13.

During the Energy Audit of Reliable Engineering Ltd., the following figures relating to usage of power were placed before the Auditor:

	2021-22	2020-21	2019-20
Total Power consumed (kWh)	2642720	2744360	2393250
Rate per kWh (₹)	6.29	5.42	4.90
Total Production (in million kg.)	422.16	416.36	376.08

Compute the necessary productivity measures and (i) Price Variance and (ii) Volume Variance of power usage during these years.

Solution:

The power usage of Reliable Engineering Ltd. is given below along with the productivity measures and Price Variance and Volume Variance.

	2021-22	**2020-21**	**2019-20**
1. Power consumed (kWh)	26,42,720	27,44,360	23,93,250
2. Production (in million kg.)	422.16	416.36	376.08
3. Rate per kWh (₹)	6.29	5.42	4.90
4. Power Cost (₹) [1 × 3]	16,622,709	14,874,431	11,726,925
5. Power Cost/'000 kg. (₹) (W.N.-2)	39.375	35.725	31.182
6. Price Variance (₹) (W.N.-1)	22,99,166	14,27,067	
7. Volume Variance (₹) (W.N.-1)	2,28,375	14,39,003	

Workings:

(1)

		2021-22	2020-21
Price Variance	: 26,42,720 × (6.29 – 5.42)	22,99,166	
	: 27,44,360 × (5.42 – 4.90)		14,27,067
Volume Variance	: [₹39.375 × (422.16 – 416.36) ×1,000 kg.]	2,28,375	
	: [₹35.725 × (416.36 – 376.08) × 1,000 kg.]		14,39,003

(2)

1 Million kg = 10,00,000 kg

422.16 Million kg. = 42,21,60,000 kg

Hence, for 1000 kg. = 4,22,160

For 2021-22, Power Cost/ '000 kg

$$= \frac{₹\,1,66,22,709}{4,22,160} = ₹\ 39.375 \text{ and so on}$$

Illustration 14.

TROMA LTD., a manufacturing unit, produces two products PB and PS. The following information is extracted from the Books of the Company for the year ended March 31, 2022:

Particulars	Product PB	Product PS
Units Produced (Qty.)	2,10,000	1,68,000
Units sold (Qty.)	1,68,000	1,36,500
Machine hours utilized	1,26,000	84,000
Design charges (₹)	1,57,500	1,89,000
Software development charges (₹)	2,62,500	3,78,000

Royalty paid on sales ₹6,09,000 [@ ₹ 2 per unit sold for both the products].

(i) Royalty paid on units produced ₹3,78,000 [@ ₹1 per unit produced for both the products].

(ii) Hire charges of equipment used in the manufacturing process of product PB only ₹53,000.

Note: No adjustments are to be made related to units held i.e. Closing Stock.

You are required to compute the Direct Expenses—keeping in view of Cost Accounting Standard (CAS-10).

Solution:

TROMA LTD.

Computation of Direct Expenses (As per CAS-10)

Amount in ₹

Particulars	Product PB	Product PS
Royalty paid on sale	3,36,000	2,73,000
Add: Royalty paid on units produced	2,10,000	1,68,000
Add: Hire charges of equipment used in the manufacturing process of product-PB only	53,000	—
Add: Design charges	1,57,500	1,89,000
Add: Software development charges related to production	2,62,500	3,78,000
Direct expenses (total)	**10,19,000**	**10,08,000**

Illustration 15.

As per the CAS-12, how should high value spare, when replaced by a new spare and reconditioned, be treated?

Solution:

As per CAS-12 on Repairs and Maintenance Cost, high value Spare, when replaced by a new spare and reconditioned, should be recognised as property, plant and equipment when they meet the definition of property, plant and equipment and depreciated accordingly. Otherwise, such items are to be classified as inventory and recognised in cost as and when they are consumed.

Example: A Company purchased equipment for ₹10 crore and the insurance spare was ₹ 1 crore. If the company is covered under Ind AS, such spare is capitalized as Property, Plant and equipment. After use for five years, the equipment broke down and a part was replaced with the aforesaid insurance spare. After 5 years, the depreciated value of equipment is ₹5 crore. As property, plant and equipment are depreciated when they are available for use, accordingly the depreciated value of new spare is ₹50 lakh. The old spare was reconditioned and the cost of reconditioning is ₹10 lakh. As per the estimated life of the old spare for future economic benefits, the current market value of the reconditioned old spare has been estimated at ₹25 lakh. The amount to be treated in repairs and maintenance is ₹ 35 lakh as follows:

		(₹ in Crores)
A. Equipment Cost		10.00
B. Cost of New Spare		1.00
Total Cost		**11.00**
Depreciation for 5 years		5.50

Depreciated value of equipment and spare [₹ 5 + 0.50]		5.50
Reconditioning cost of old spare	0.10	
Depreciated value of old spare	0.50	
Book value reconditioned spare		**0.60**
Current market value of reconditioned spare to be restated in Books of Account		0.25
Amount to be treated in Repairs and Maintenance		**0.35**

Illustration 16.

Standard Material requirement to produce 1000 units of product X is 1200 units of material at a standard price of ₹60 per unit. The Standard allows for reject of 25% of input. It is estimated that one third of rejects can be reworked at an additional cost of ₹ 20 per unit. Scrap units can be sold at ₹ 5 per unit.

During a particular period, units produced were 19500 with 24000 units of materials at standard cost of ₹ 60 per unit, 7000 units were rejected out of which 2500 units were reworked at a cost of ₹ 51,000. The balance units were sold as scrap for ₹ 5 per unit.

Calculate Material Quality Variance and Scrap Variance.

Solution:

Quality control cost is the cost of resources used for quality control procedures.

Standard Material Cost :

Units	Particulars	Amount
Material 1200 units	Standard Cost (₹)	72,000
Rejection 300 units		
Reworked Unit =100	Rework cost (₹)	2,000
Scrap of 200 units	Sale value of scrap (₹)	-1,000
		₹ 73,000
Unit Produced 1000 (1200 - 200)	Standard Cost per unit	₹ 73.00

Actual Material Cost :

Units	Particulars	Amount
Material 24000 units	Actual Cost (₹)	14,40,000
Rejection 7000 units		
Reworked Unit = 2500	Rework cost (₹)	51,000
Scrap of 4500 units	Sale value of scrap (₹)	-22,500
		₹ 14,68,500
Unit Produced 19500 (24,000 - 4,500)	Actual Cost per unit	₹ 75.31

Material Quality Variance = Actual Material Cost – Actual Quantity × Std Rate

= ₹ 14,68,500 – (19500 × 73) = 14,68,500 – 14,23,500 = ₹ 45,000 (A)

Material Usage Variance = Actual Quantity × Standard Rate – Standard Quanity × Std Rate

= Standard Rate (Actual Quantity – Standard Quantity) = 60 × [24,000 –(19,500 × 6/5)]

= 60 × (24,000 – 23,400) = 60 × 600 = ₹ 36,000 (A)

For Scrap Variance

Actual scrap = ₹ 22,500

Scrap value as per standard = 19,500 × (1/5) × 5 = ₹ 19,500

Scrap Variance = ₹ 3,000 (F)

$$\text{Material cost/unit} = \frac{₹\ 72,000}{1200} = ₹\ 60\ /\text{unit}$$

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. CAS-17 deals with ________ .
   (a) Royalty and Technical Knowhow fee
   (b) Material Cost
   (c) Research & Development Cost
   (d) Interest & Financing charges

2. CAS 21 deals with _________ .
   (a) Cost of service cost centre
   (b) Quality Control
   (c) Capacity determination
   (d) Cost classification.

3. The foreign exchange component of imported material is converted at the rate on _________ .
   (a) Date of Payment
   (b) Date of Delivery
   (c) Date of Transaction
   (d) Date of Use

4. Which of the following is not forming part of Cost of transportation?
   (a) Cost of transport
   (b) Transit insurance
   (c) Demurrage Charge
   (d) Local Octroi charges

5. Idle capacity is the difference between ________ .
   (a) Installed capacity and Actual Capacity Utilisation
   (b) Installed capacity and Normal Capacity
   (c) Abnormal Idle capacity and Normal Capacity
   (d) Installed capacity and Normal Capacity

6. Remuneration of the Non-Executive Directors is treated as__________ .
   (a) Employee Costs
   (b) Administrative Overheads
   (c) Non-Cost Item
   (d) Selling & Distribution Overhead

7. Which of the following is not part of the Employee Cost as per CAS-7?
   (a) Leave with Pay
   (b) Medical benefits to the Employees and dependents
   (c) Compensation for Lay off period
   (d) Cost of Employees' stock option

State True or False

1. As per CAS-7, any Cost incurred by company for providing ESOP to it's employee is not forming part of Employee Cost.
2. Remuneration paid by the company to its Executive Directors and Non-Executive Directors on the Board will be considered as part of the Employee Cost.
3. Fines paid by company to the State Pollution Control Boar for violation environmental guideline is a part of the Pollution Control cost as per CAS-14.
4. The Companies (cost records and audit) Amendment Rules, 2019, issued vide notification No. GSR 752E dt. 15.10.2019 is effective from 15.10.2019.
5. Cost Accounting Standards are issued by Ministry of Corporate Affairs.

Fill in the blanks

1. Cost of repairs and maintenance measured as per principles and methods defined under CAS __________.
2. The cost incurred to remove the overlying material from the mine site is measured as per CAS _________.
3. CAS – 1 Classification of cost is effective from _________.
4. Employee cost, which cannot be directly attributed to a particular cost object is called _________.
5. Interest on Working capital is part of _________ Cost.

Short Essay Type Questions

1. What is cost centre and what are the types of cost centre?
2. Write note on Secondary Packing Material and its treatment as per CAS-9?

Answer:

Multiple Choice Questions

1.	(d) Interest & Financing charges.
2.	(b) Quality Control
3.	(c) Date of Transaction
4.	(c) Demurrage Charge
5.	(a) Installed capacity and Actual Capacity Utilisation
6.	(b) Administrative Overheads
7.	(c) Compensation for Lay off period

State True or False

1.	False- As per CAS-7, any Cost incurred by company for providing ESOP to it's employee is forming part of Employee Cost.
2.	False -Remuneration paid to Executive Directors is a part of Employee cost whereas remuneration to non-executive directors shall part of Administrative Overheads.
3.	False -As per CAS -14, Fines, penalties and similar levies paid to statutory authorities shall not form part of the Pollution Control cost.
4.	False - The Companies (Cost Records and Audit) Amendment Rules, 2019, issued vide notification No. GSR 752E dt. 15.10.2019 is effective from 01.04.2018.
5.	False - Cost Accounting Standards are issued by Institute of Cost Accountants of India with the prior approval from Ministry of Corporate Affairs.

Fill in the Blanks

1.	CAS-12
2.	CAS-23
3.	01.04.2015
4.	Indirect Employee Cost
5.	Finance

B. Practical Questions

Multiple Choice Questions

1. The material purchase value arrived at ₹ 1,65,800.00 after adjustment of freight ₹12,400.00, taxes ₹ 17,200.00, trade discount received ₹ 3,600.00, Detention Charges ₹ 4,400.00, Subsidy received ₹15,200.00 and Cash Discount received ₹ 5,400. Find the value of Material Cost as per CAS-6.

   (a) ₹ 1,81,100.00

   (b) ₹ 1,60,400.00

   (c) ₹ 1,66,800.00

   (d) ₹ 1,72,200.00

2. M/s. Tech Pro Ltd. has incurred the following expenses: software services charges relating to production ₹42,000.00, Royalty on production ₹56,000.00, Job Charges ₹20,000.00 and Special Design Charges ₹14,500.00. VRS cost ₹19,500.00 Find the Direct Expenses as per CAS-10 is ₹________.

   (a) 1,52,000.00

   (b) 98,000.00

   (c) 1,32,500.00

   (d) 1,29,800.00

⦿ Unsolved Case

The below details are extracted from the Trial balance of M/s Infinity steel Ltd as on 31/3/2022:

(₹ in Lakhs)

Particulars	Dr.	Cr.
Sales - Steel Material	-	11,656.00
Income from investments	-	12.00
Sale of Scrap	-	57.00
Sundry Creditors Written off	-	4.00
Purchases of raw materials	8,400.00	-
Closing stock of raw materials	-	420.00
Power & Fuel Consumed	360.00	-
Water Charges	30.00	
Employees Cost	420.00	-
Legal Consultancy Fee	6.50	
Audit Fee	3.20	
Annual Fire Safety Inspection Fee of Corporate office	2.50	
Polution Control Fee	4.00	
Repair & Maitenance - Cooling Plant	12.00	
Repairs & Maintanance of factory building	11.00	-
Lease Rent (Finance)	22.50	
Rent Paid	22.00	
Depreciation	40.00	-
Interest & Financial charges	62.00	
Marketing & Publicity	15.50	-
Paking Material Expenses	26.50	
Bad bebt written off	3.00	-
Donation	5.50	-

During the course of audit, the following issues were found:

1. The production during the year is 48,500 MT.
2. Opening stock of raw materials is ₹ 6,80,00,000.00.

3. Sale of Scrap includes Sale of Iron ore fines (waste RM) ₹ 40,00,000.00, Sale of discarded steel structure recovered from building demolition ₹ 5,00,000.00 and balance ₹ 12,00,000.00 are damaged hording scrap due to cyclone.

4. Water charges paid to govt. for raising water from river. 20% water raised is used in residential colony and rest is used in cooling plant.

5. The Repairs & maintainance of factory building expenses consists a bill or ₹ 1,20,000 that belongs to previous year. Against this insurance claim lodged last year received during the year ₹ 1,00,000.

6. The employee cost comprise of different departments i.e. at Plant, administrative & selling department in the ratio of 70:20:10 respectively.

7. A sum of ₹ 2,20,000 incurred for special Covid-19 vaccination drive for employees which is included in employee cost.

8. 20% of employees at plant are contractual basis who are engaged by the company.

9. Rent paid includes 20% for building at Factory site, 30% for Guest House at marketing location and Balance paid as Godown rent.

10. 70% of Fixed Asset of the company is engaged in production process.

11. 40% of Packing Material expenses incurred for safeguard the product while the remaining packing cost incurred for transport convience.

Calculate the Cost of Manufacturing of Steel Material as per CAS-22.

Cost Auditing and Assurance Standards 5

This Module includes:

Cost Auditing and Assurance Standards

SLOB Mapped against the Module

To develop detail understanding of Cost Auditing Standards to ensure appropriate evaluation of cost records maintained. (CMLO 4a, b)

Module Learning Objectives:

This module discusses the Cost Auditing Standards. Cost Auditing Standards are designed to achieve uniformity and consistency in the cost auditing principles and to establish regulations and also to follow the disclosed practices consistently and to comply with promulgated Cost Auditing Standards. After studying this module, the students will be able to –

- Get an overview about the Cost Auditing and Assurance Standards

Introduction

5

The Companies (Cost Records and Audit) Rules, 2014 [as amended from time to time] were notified by the Ministry of Corporate Affairs, Government of India in exercise of the powers conferred by section 148 of the Companies Act, 2013.

Sub-section (3) of section 148 prescribes that the auditor conducting the cost audit shall comply with the *cost auditing standards.* This proviso to be read with the following explanation:

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

While formulating the Standards, the Cost Audit & Assurance Standards Board [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 of the Cost Accountants of India. The Standards issued by the CAASB are aligned, to the extent possible, with other recognised Standards issued in India and prevailing International Practices. If a particular standard or any part thereof is inconsistent with a law, the provisions of the said law shall prevail.

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 the Preface to CAASB which is available on the Institute website and also given in Volume-II of this Guide. Any limitation on the applicability of a Standard is made clear in the Standard itself.

Cost Auditing Standards – Overview 5.1

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 under the authority of IFAC have issued series of International Standards on Auditing (ISAs). These Standards have been widely acknowledged and adopted [with or without any modifications] by all professional Institutes across the world. As a founder member of IFAC, the Institute could have also adopted these Standards. However, as these Standards are primarily focussed on the financial audit; hence there was need to modify their content to the extent required.

It is a well-known fact that prima facie, the function of "Audit" per se do not differ in any audit assignment except for its 'scope' and the 'target clientele'. Broadly, the role & responsibility of an auditor, be it financial audit or cost audit, remains same. For all practical purposes and under provision of law, cost auditor has same rights, duties, and obligations as applicable to the financial auditor. Hence, even though the cost accounting differs from financial accounting, but the audit practice thereof does not differ. Therefore, Standards on Cost Auditing [SCAs] issued by the Institute are, in-principle, based on the International Standards on Auditing [ISAs] with suitable modifications in framework and content wherever found necessary.

Government of India, Ministry of Corporate Affairs, vide their letter no. 52/33/CAB/2013 dated 10th September, 2015 has, under section 148(3) of the Companies Act, 2013, granted Central Government's approval to the following Cost Auditing Standards:

1. Cost Auditing Standard-101 on Planning an audit of Cost Statements;
2. Cost Auditing Standard-102 on Cost Audit Documentation;
3. Cost Auditing Standard-103 on Overall objectives of the independent cost auditor and the conduct of an Audit in accordance with Cost Auditing Standards;
4. Cost Auditing Standard-104 on Knowledge of business, its processes and the business environment.

COST AUDITING STANDARDS

Cost Auditing Standard on Planning an Audit of Cost Statements - 101

The following is the **Cost Auditing Standard (Cost Auditing Standard- 101)** on "**Planning an Audit of Cost Statements**". In this Standard, the standard portions have been set in ***bold italic*** type. This Standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

Planning an audit of cost statements, records and other related documents is considered necessary to ensure achievement of audit objectives with available resources and securing coordination with the auditee on audit work.

2. Objective

The objective of this Standard is to guide the members in planning for the audit of cost statements so that it is performed in an efficient and effective manner. Audit planning shall also include establishing the overall audit strategy and audit plan for the conduct of the audit.

3. Scope

This Standard deals with the auditors' responsibility to plan an audit of cost statements, records and other related documents. The auditor shall prepare and document the overall audit strategy and audit plan.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 ***Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.***

4.2 ***Audit Partner: Audit partner means the partner in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the audit and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.***

4.3 ***Audit Plan: A record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.***

4.4 ***Audit Risk: Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.***

(a) ***The risk of material misstatement has two components viz. Inherent Risk and Control risk.***

(1) ***Inherent risk: the susceptibility of an assertion about the measurement, assignment or disclosure of cost to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.***

(2) ***Control risk: the risk that a misstatement that could occur in an assertion about the***

measurement, assignment or disclosure of cost and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal, operational and management control.

(b) ***Detection risk: the risk that the procedures followed by the cost auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.***

4.5 ***Audit Team: Audit team means all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.***

4.6 ***Auditee: Auditee means a company or any other entity for which cost audit is being carried out.***

4.7 ***Cost Audit: Cost audit is an independent examination of cost statements, cost records and other related information of an entity including a non-profit entity, when such an examination is conducted with a view to expressing an opinion thereon.***

4.8 ***Cost Auditor: "Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under 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.***

4.9 ***Firm: Firm means a sole practitioner, partnership including LLP (Limited Liability Partnership) or any other entity of professional cost accountants as may be permitted by law and constituted under The Cost and Works Accountants Act & Regulations.***

4.10 ***Initial Audit: Initial audit means an audit where:-***

(a) ***The entity is subject to audit for the first time, as per the applicable laws, or***

(b) ***The audit of the entity for the prior period was conducted by a different audit firm.***

4.11 ***Misstatement: A difference between the amounts, classification, presentation or disclosure of a reported cost statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable cost reporting framework. Misstatements can arise from error or fraud.***

Where the cost auditor expresses an opinion on whether the cost statements give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the cost auditor's judgment, are necessary for the cost statements to be presented fairly, in all material respects, or to give a true and fair view.

4.12 ***Overall Audit Strategy: Overall Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.***

4.13 ***Risk Assessment: The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the overall cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof.***

5. Requirements

5.1 Prior to entering the planning phase, the Cost Auditor shall ensure that:

(a) the appointment as cost auditor is proper, he has received the letter of appointment and legal formalities regarding his appointment have been complied with;

(b) the ethical requirements as per the regulations continue to be satisfied; (Refer 6.3)

(c) an understanding of the terms of reference including the units to be covered, products/services to be covered, scope of coverage where the regulations leave it to be agreed between the auditor and the auditee.

5.2 The audit partner and other key members of an audit team shall be involved in planning the audit, including planning and participating in the discussion among audit team members. (Refer 6.4)

5.3 The Cost Auditor shall formulate an Overall audit strategy that sets the scope, timing and direction of the audit.

The overall audit strategy guides the development of the audit plan.

5.4 In formulating the Overall audit strategy, the Cost Auditor shall consider all relevant factors. (Refer 6.5)

These relevant factors include:

(a) results of preliminary activities as specified in 5.1 above

(b) knowledge from previous audits and other engagements with the auditee

(c) knowledge of business

(d) nature and scope of the audit

(e) statutory deadlines and reporting format

(f) relevant factors determining the direction of the audit efforts

(g) nature, timing and extent of resources required for the audit.

5.5 The Cost Auditor shall develop an audit plan.

The audit plan will include the nature, extent and timing of risk assessment, audit procedures and other activities (Refer 6.5, 6.6)

5.6 The Cost Auditor shall plan the nature, extent and timing of the direction and supervision of audit team members and the review of their work.(Refer 6.7)

5.7 The Cost Auditor shall update the Overall audit strategy and the audit plan as required during the course of audit. (Refer 6.8)

5.8 The Cost Auditor shall document the overall audit strategy, the audit plan and any significant changes made therein during the audit engagements and the reasons for the changes.

5.9 In the initial audit, the Cost Auditor shall perform procedures regarding the acceptance of the client relationship and the specific audit.

In case where the audit of the entity for the prior period was conducted by a different audit firm, the auditor shall communicate with the previous auditor. (Refer 6.9)

6. Application Guidance

6.1 The nature and extent of planning activities will vary according to the:

(a) size and complexity of the entity's activities, the number of products to be covered, the processes and operations involved.

(a) the audit team members' previous experience with the entity and the industry.

(b) changes in circumstances that occur during the audit.

6.2 Planning is not a discrete phase of an audit, but rather a continuous and iterative process. Planning includes scheduling which involves determining the priority of audit procedures and their inter dependence. For example, the risk assessment procedures are planned early in the audit process.

6.3 Prior to the performance of other significant activities for the current year's audit, the auditor shall ensure that {Refer 5.1 (b)} :

(a) After the Cost Auditor has accepted the appointment for an entity, there are no changes in his position in relation to the entity that impede his arm's length relationship with the entity. Such as, acceptance of an assignment relating to designing and implementation of cost accounting system for the entity.

(b) Subsequent to his acceptance of the assignment, no issues about management integrity has cropped up that may affect the auditor's willingness to continue the engagement.

6.4 The involvement of the audit partner and other key members of the audit team in planning the audit draws on their experience and insights, thereby enhancing the effectiveness and efficiency of the planning process. (Refer 5.2)

6.5 Matters that are relevant in formulating the overall audit strategy and drawing up the audit plan include, in addition to those mentioned earlier, the following (Refer 5.4, 5.5):

(a) The cost reporting framework generally prescribed, under the Companies Act and Rules prescribed thereunder, as well as under any other law as applicable, on the basis of which the cost information to be audited has been prepared, including need for reconciliation with financial reporting framework.

(b) Industry regulators' requirement as to how costs will be handled.

(c) Unique features of an industry that influence audit requirements such as definition of product in the newspaper industry.

(d) Reliance that can be placed on the work of financial auditors, other cost auditors appointed by the entity and internal auditors. such as their attendance in annual stocktaking

(e) State of IT (Information Technology) implementation, whether the entity is using an ERP (Enterprise Resource Planning) system or internally developed systems and the reliance that can be placed on them.

(f) Statutory timelines for cost reporting, which can be modified by the management for early completion.

(g) Timelines for Board/ audit committee meetings, which can set the time limits for completion of audit work.

(h) Resources required and available in terms of manpower, equipment and others and the assignment of these to specific parts of the work.

6.6 The audit plan is more detailed than the overall audit strategy as it includes the nature, timing and extent of audit procedures to be performed by audit team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. (Refer 5.5)

6.7 The nature, extent and timing of the direction and supervision of audit team members and review of their work vary depending on, among others, the size and complexity of the entities activities, risk assessment results and the capabilities and competence of the individual team members performing the audit work. (Refer 5.6)

6.8 As a result of unexpected events, changes in conditions or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan. (Refer 5.7)

6.9 Additional Consideration in Initial Audit Engagements (Refer 5.9): The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For the initial audit, additional matters the auditor may consider in formulating the overall audit strategy and audit plan include the following.

(a) The planning activities may expand to cover consultations with the previous auditor, review of previous year's audit working papers, if not prohibited by other Law or regulation, and previous year's transactions having an impact on current year's cost.

(b) Any major issues (including the application of cost accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as cost auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.

(c) The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (such as Inventory).

(d) Other procedures required by the firm's system of quality control for initial cost audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

6.10 In audits of small entities where the entire audit may be conducted by a small audit team comprising the audit partner working with say one team member, formulating the audit strategy and drawing up the audit plan need not be elaborate. Nonetheless it is necessary to have regard to the matters mentioned under Requirements.

7. Effective Date

This Standard is effective for audits on or after September 11, 2015.

Cost Auditing Standard on Cost Audit Documentation – 102

The following is the **Cost Auditing Standard (Cost Auditing Standard-102)** on "**Cost Audit Documentation**". In this Standard, the standard portions have been set in ***bold italic*** type. This Standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

The purpose of this Standard is to provide guidance to the members in preparation of Audit Documentation in the context of the audit of cost statements, records and other related documents.

Nature and Purpose of Cost Audit Documentation

Cost Audit documentation that meets the requirement of this Cost Auditing Standard and the specific documentation requirements of other relevant Cost Auditing Standards provides:

(a) Evidence of the cost auditor's basis for a conclusion about the achievement of the overall objectives of the cost auditor; and

(b) Evidence that the cost audit was planned and performed in accordance with Cost Auditing Standards and applicable legal and regulatory requirements.

Cost Audit documentation serves a number of additional purposes, including the following:

(a) Assisting the audit team to plan and perform the cost audit.

(b) Assisting members of the audit team responsible for supervision to direct and supervise the cost audit work, and to discharge their review responsibilities.

(c) Enabling the audit team to be accountable for its work.

(d) Retaining a record of matters of continuing significance to future cost audits.

(e) Enabling the conduct of quality control reviews in accordance with the Guidance Manual for Audit Quality issued by Quality Review Board (QRB).

(f) Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

2. Objective

The objective of this Standard is to guide the members to prepare documentation that provides:

(a) A sufficient and appropriate record of the basis for the Cost Auditor's Report; and

(b) Evidence that the audit was planned and performed in accordance with Cost Auditing Standards and applicable legal & regulatory requirements.

3. Scope

This Standard deals with the cost auditor's responsibility to prepare audit documentation for the audit of cost statements, records and other related documents. The specific documentation requirements of other Cost Auditing Standard's do not limit the application of this Cost Auditing Standard. Laws or regulations may establish additional documentation requirements.

4. Definitions

The following terms are being used in this Standard with the meaning specified.

4.1 Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

4.2 Audit documentation: Audit Documentation means the records, in physical or electronic form, including working papers prepared by and for, or obtained and retained by the Cost auditor, in connection with the performance of the audit.

4.3 Audit file: Audit file means one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific Assignment or audit.

4.4 Audit Partner: Audit partner means the partner in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the audit and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

4.5 Audit Team: Audit team means all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

4.6 Audit working papers: Audit working papers are the documents which record all audit evidence obtained during audit. Such documents are used to support the audit work done in order to provide assurance that the audit was performed in accordance with the relevant Cost Auditing Standards.

4.7 Cost Auditor: "Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act, 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under subsection (1) of section 6 and who is deemed to be in practice under sub-section (2) of section 2 of that Act and includes a firm of cost accountants.

4.8 Firm: Firm means a sole practitioner, partnership including LLP (Limited Liability Partnership or any other entity of professional cost accountants as may be permitted by law and constituted under The Cost and Works Accountants Act & Regulations.

5. Requirements

5.1 The cost auditor as part of the audit documentation shall record audit procedures performed, relevant audit evidence obtained, and conclusions reached. (Refer 6.1)

5.2 The Cost Auditor shall prepare audit documentation that is sufficient to enable another competent person, having no previous connection with the said audit, including person undertaking peer review to understand:

- *(a) Conformance of audit procedures performed with legal and regulatory requirements;*
- *(b) Conformance to Cost Auditing Standards. (Refer 6.6)*
- *(c) The results of audit procedures performed*
- *(d) The audit evidence obtained*
- *(e) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.(Refer 6.7 & 6.8)*

5.3 The Cost Auditor shall record the discussions of significant matters with client personnel and outsiders. (Refer 6.9).

5.4 The Cost Auditor shall record any departure from the standard requirement in a Cost Auditing Standard. (Refer 6.11)

5.5 In documenting the nature, timing and extent of audit procedures performed, the Cost Auditor shall record the characteristics of the specific items or matters tested, the persons responsible for performing and reviewing such procedures with relevant dates and extent of review. (Refer 6.12)

5.6 The Cost Auditor shall prepare audit documentation on a timely basis. (Refer 6.14)

5.7 If, in exceptional circumstances, Cost Auditor performs any new or additional audit procedures or draws new conclusions, after the date of Cost Audit Report, then he shall document such circumstances and details of such procedures performed. (Refer 6.15)

5.8 The cost auditor shall assemble the audit documentation in an audit file. (Refer 6.16)

6. Application Guidance

6.1. The Cost Audit documentation will usually contain:

(a) Checklists

Example: Checklist of compliance with:-(1) The Rules, regarding maintenance of Cost Records, as prescribed under the Companies Act,

(2) The Cost Accounting Standards (CAS) as prescribed by the Institute

(3) The Generally Accepted Cost Accounting Principles (GACAP) as prescribed by the Institute

(b) Audit programs

Example: Audit Program for Material Cost, Employee Cost and others

(c) Analysis

Cost Audit relies more on analytical review than on substantive testing to establish true and fair view.

Example: Calorific value of different fuels used and average Cost per unit of calorific value and Specific Heat Consumption.

(d) Audit Query List

Contains a log of audit queries raised and their resolution

(e) *Abstracts of significant contracts relating to costs and revenues*

Example: Supply of materials indicating price, quality terms, O & M contracts, Terms of supply of contract labour and others

(f) Letters of confirmation

Example: Stock of materials with subcontractors.

(g) Letter of Representation from Management Correspondence (including e-mail) concerning significant matters.

Example: Correspondence regarding terms of supply of goods and services.

(h) Abstract or copies of the entity's records

6.2. Audit documentation may be in paper form or electronic form. Where it is in electronic form, special care may be required to protect against accidental deletion, or tampering.

6.3. The content and form of audit documentation will depend on a number of factors such as:

(a) the size and complexity of the operations of the auditee,

(b) the extent of computerization of cost records,

(c) the assessed risks of material misstatement of cost,

(d) the cost audit methodology and tools used. For example whether automated queries were used to get audit evidence from cost records.

(e) the nature of the audit procedure to be performed.

6.4. In particular, it is necessary to document the basis for a conclusion, not readily determinable from other documentation. For example: consumption of materials by a product from technical norms, normal price for a related party contract from Cost Auditor's own sources of data of the industry.

6.5. Audit documentation must be sufficient and appropriate, and oral explanations by the Cost Auditor cannot substitute for such documentation.

6.6. Audit documentation must contain evidence of conformance to requirements of Cost Auditing Standards in respect of this Standard and other standards {Refer 5.2(b)}:

Typical of such evidence are:

(a) an adequately documented audit plan

(b) the signed appointment letter from the auditee

(c) Minutes of discussion with client personnel, with names of members of audit team present, particularly of the audit partner when he is present

(d) Minutes of audit team discussions, with names of members of audit team present, particularly of the audit partner when he is present.

6.7. Matters that give rise to significant risks of a material misstatement are significant matters. Those that causes a revision of the Cost Auditor's previous assessment of the risks of material misstatement is also a significant matter. The Cost Auditor may have reached a certain conclusion regarding the misstatement of the Material Cost in a Cost statement based on the availability of a well documented Bill of Materials but his assessment of risk may undergo a change if he finds that there is considerable use of substitute and alternate materials in the actual production process. Matters that cause the Cost Auditor significant difficulty in applying necessary audit procedures are also significant, as for example heaps of bulk material in irregular shapes which make volumetric measurement of stock in a physical stock taking unreliable. {Refer 5.2(e)}

6.8. Determining what are significant matters in an audit to warrant their inclusion in the documentation must be objectively done. The conclusions reached and the application of professional judgment in respect of these also needs to be documented. For example the determination of the normal capacity for applying overheads is a significant matter in Cost Audit and requires not mere calculations but considerable judgment. These should be adequately documented. {Refer 5.2(e)}

6.9. Records of discussions include Minutes of discussion of significant matters with management, those charged with governance and others. It also includes Discussion with third parties seeking information or confirmation. (Refer 5.3)

6.10. The Cost Audit Documentation in respect of smaller entities may be less detailed than what is indicated but must include at the minimum the following:

(a) A description of the entity, the products produced, services provided and other activities

(b) An organization Chart showing the responsibility centres and the person responsible

(c) A description, preferably a flow chart of the manufacturing process

(d) Internal controls over material cost, labour cost and expenses

(e) The risks of material misstatement assessed, for example, in respect of scrap recovery and disposal

(f) Tests of materiality used

(g) The overall audit strategy and audit plan

(h) Significant matters noted during the audit, and conclusions reached

6.11. If, in exceptional circumstances, the Cost Auditor finds it necessary to perform alternative audit procedures different from a corresponding requirement in a Cost Auditing Standards, the Cost Auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. (Refer 5.4)

6.12. It is necessary in a Cost Audit to identify the specific matters or items tested. In connection with a Cost Audit these may include Purchase Orders for supply of key raw materials, Goods Receipt Notes for materials, Issue notes for materials, bills of contractors for supply of contract labour among others. Where the Cost Auditor resorts to test checking, the basis used for selection, for example issues of spares above a certain value, and the documents selected. (Refer 5.5)

6.13. Names of the team member preparing specific audit documents and details of their review by the Cost Auditor are a necessary part of the Audit Documentation.

6.14. Preparing the audit Documentation on timely basis helps to enhance the quality of audit. Documentation prepared after the audit work has been performed is likely to be less accurate than the documentation prepared during execution. (Refer 5.6)

6.15. Facts which become known to the Cost Auditor after the date of the audit report but which if known earlier would have caused the cost statements to be changed or the Cost Audit Report to be modified should be added to the Cost Audit Documentation. The resulting changes to the audit documentation must also be reviewed as the original documentation. (Refer 5.8)

6.16. The Cost Audit Documentation must be assembled as the audit goes on and the final assembly required of audited documentation must be limited. Assembly the final audit file should be completed within a reasonable time after the completion of the audit. After the assembly of the final audit file has completed, the auditor should not delete or discard audit documentation of any nature before the end of its retention period. (Refer 5.9)

6.17. The audit documentation is the property of the Cost Auditor. Unless otherwise specified by law or regulation, he may at his discretion, make portions of, or extracts from audit documentation available to clients

6.18. The Cost Audit Documentation should be retained for at least ten years from the date of the Cost Audit Report.

7. Effective Date

This Standard is effective for audits on or after September 11, 2015.

Cost Auditing Standard Overall Objectives of the Independent Cost Auditor and the Conduct of an Audit in Accordance with Cost Auditing Standards - 103

The following is the **Cost Auditing Standard** (Cost Auditing Standard - 103) on **"Overall Objectives of the Independent Cost Auditor and the Conduct of an Audit in Accordance with Cost Auditing Standards".** In this Standard, the standard portions have been set in ***bold italic*** type. This Standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

This Standard on Auditing deals with the overall objectives of the independent cost auditor, the nature and scope of a Cost audit the independent auditor's overall responsibilities when conducting an audit of cost statements in accordance with Cost Auditing Standards. It also explains the requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the Cost Auditing Standards.

The independent Cost Auditor is referred to as "Cost auditor" hereafter.

2. Objectives

The objective of this Standard is to lay down the overall objectives of the Cost Auditor and ensuring* the Conduct of *the Audit of Cost Statements in accordance with the Cost Auditing Standards.

The Cost auditor's overall objectives are:

2.1. to obtain reasonable assurance about whether the cost statements as a whole are free from material misstatement, whether due to fraud or error, and to enable the auditor to express an opinion whether the Cost Statements are prepared, in all material respects, in accordance with the applicable Cost reporting framework, Cost Accounting Standards (CAS) and Generally Accepted Cost Accounting Principles (GACAP) as issued by the Institute, and give a true and fair view of the Cost of a product, activity or service. In the case of a Cost Audit under the Companies Act and Rules prescribed thereunder, the objective is to express an opinion on whether the Cost Statements subject to audit represent a true and fair view of the cost of production, cost of sales and margin of products covered by the Cost Audit.

2.2. to report on the cost statements in the form required by law or by the Cost Auditing Standards in accordance with the auditor's findings.

Where reasonable assurance cannot be obtained, the cost auditor should qualify the opinion and in extreme cases disclaim an opinion.

The Cost Auditors objective may extend to making observations and suggestions where required by applicable regulations.

3. Scope

The scope of this standard is to establish overall objectives of the cost auditor while conducting an audit of cost statements, in accordance with the cost auditing standards.

It also describes management responsibility for the preparation and presentation of the Cost Statement, to identify the Cost Reporting framework and to lay down Cost Accounting policies.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1. Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

4.2. Audit Partner: Audit partner means the partner in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the audit and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

4.3. Audit Risk: Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.

(a) The risk of material misstatement has two components viz. Inherent Risk and Control risk.

(1) Inherent risk: the susceptibility of an assertion about the measurement, assignment or disclosure of cost to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(2) Control risk: the risk that a misstatement that could occur in an assertion about the measurement, assignment or disclosure of cost and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal, operational and management control.

(b) Detection risk: the risk that the procedures followed by the cost auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

4.4. Audit Team: Audit team means all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

4.5. Auditee: Auditee means a company or any other entity for which cost audit is being carried out.

4.6. Auditor: Auditor is used to refer to the person or persons conducting the audit, usually the audit partner or other members of the audit team, or, as applicable the firm. Auditor includes Cost Auditor

4.7. Cost Audit: Cost audit is an independent examination of cost statements, cost records and other related information of an entity including a non-profit entity, when such an examination is conducted with a view to expressing an opinion thereon.

4.8. Cost Auditor: "Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under subsection (1) of section 6 and who is deemed to be in practice under subsection (2) of section 2 of that Act and includes a firm of cost accountants.

4.9. Firm: Firm means a sole practitioner, partnership including LLP (Limited Liability Partnership) or any other entity of professional cost accountants as may be permitted by law and constituted under The Cost and Works Accountants Act & Regulations.

4.10. Management: The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance.

4.11. Misstatement: A difference between the amounts, classification, presentation or disclosure of a reported cost statement item and the amount, classification, presentation, or disclosure that is required for the item *to be in accordance with the applicable cost reporting framework. Misstatements can arise from error or fraud.*

Where the cost auditor expresses an opinion on whether the cost statements give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the cost auditor's judgment, are necessary for the cost statements to be presented fairly, in all material respects, or to give a true and fair view.

4.12. Non-compliance: Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations governing Cost Accounting, Cost Records and Cost Audit. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

4.13. ***Overall Audit Strategy: Overall Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.***

4.14. Professional Judgment: The application of relevant training, knowledge and experience, within the context provided by cost auditing standards, cost accounting standards and ethical requirements, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

4.15. Criticism: An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatements due to error or fraud, and a critical assessment of audit evidence.

4.16. ***Risk Assessment: The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the overall cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof.***

4.17. Those charged with governance: The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

5. Requirements

5.1. The cost auditor shall comply with the relevant ethical requirements including those pertaining to independence in respect of cost audit engagements. (refer 6.1)

5.2. While conducting an audit, the cost auditor shall comply with each of the Cost Auditing Standards relevant to the audit. A Cost Auditing Standard is relevant to the audit when the Cost Auditing Standard is in effect and the circumstances addressed by the Cost Auditing Standard exist. (refer 6.2)

5.3. The cost auditor shall have an understanding of the entire text of the Cost Auditing Standard, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

5.4. The cost auditor shall not represent compliance with the cost auditing standards in the cost auditor's report unless the auditor has complied fully with all of the Cost Auditing Standards relevant to the audit.

5.5. ***In exceptional circumstances, the cost auditor may judge it necessary to depart from a relevant requirement in a Cost Auditing Standard. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement.{Refer 6.2(c)}***

5.6. ***The cost auditor shall plan and perform an audit with an attitude of ticism recognizing that circumstances may exist that cause the Cost Statements to be materially misstated. (refer 6.3)***

5.7. ***The auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (refer 6.4)***

5.8. ***The cost auditor shall exercise professional judgment in planning and performing the audit.***

5.9. ***The cost auditor shall determine whether the Cost Reporting Framework followed by management in preparing cost statements is in line with the Companies Act and the Rules prescribed thereunder. (refer 6.5)***

5.10. ***The cost auditor shall not be required to perform audit procedures regarding the entity's compliance with laws and regulations governing cost audit in the absence of identified or suspected non-compliance. (refer 6.6)***

5.11. ***If an objective in a relevant Cost Auditing Standard cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the Cost Auditing Standards, to modify the auditor's opinion.***

6. Application Guidance:

6.1 **Audit and Ethics:** The cost auditor should comply with relevant ethical requirements as per Code of Ethics issued by the Institute of Cost Accountants of India. This code establishes fundamental principles of professional ethics relevant to the auditor while conducting an audit and provides a conceptual framework for applying these principles. The fundamental principles with which the auditor is required to comply are Independence, Integrity, Objectivity, Professional competence and due care, Confidentiality and Professional conduct. In case of an audit engagement, it is in the public interest that the auditor should be independent of the entity subject to the audit. The cost auditor's independence from the entity safeguards the cost auditor's ability to form an opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity to be objective and to maintain an attitude of ticism. (Refer 5.1)

For Example: The provision of services for maintenance of cost records, design and implementation of Cost Systems and internal audit are considered to erode the independence.

6.2 **Conduct of audit:** (Refer 5.2)

(a) The Cost Auditing Standards provide the standards for the cost auditor's work in fulfilling the overall objectives of the cost auditor. The Cost Auditing Standards deal with general responsibilities of the cost auditor, as well as cost auditor's further considerations relevant to the application of those responsibilities to specific topics.

(b) In performing an audit, the cost auditor may be required to comply with legal or regulatory requirements in addition to Cost Auditing Standards. In such cases in addition to complying with each of the Cost Auditing Standard relevant to the cost audit, it may be necessary for the cost auditor to perform additional audit procedures in order to comply with the legislative and regulatory requirements. The Cost Auditing Standards do not override law or regulations that govern audit process.

The form of the cost auditor's opinion will depend upon the applicable cost reporting framework and any applicable laws or regulations such as Companies Act and Rules prescribed thereunder.

(c) The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Refer 5.5)

6.3 Professional Skepticism: An attitude of ticism 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 ticism is necessary throughout the cost audit process for the auditor to reduce the risk of overlooking unusual circumstances, of over generalizing when drawing conclusions from cost audit observations, and of using faulty assumptions in determining the nature, timing and extent of the cost audit procedures and evaluating the results thereof. When making inquiries and performing other cost audit procedures, the cost auditor should not be satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the cost auditor's opinion. (Refer 5.6)

(a) A cost auditor conducting an audit in accordance with Cost Auditing Standards obtains reasonable assurance that the Cost Statements taken as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the Cost Statements taken as a whole. Reasonable assurance relates to the whole audit process.

A cost auditor cannot obtain absolute assurance because there are inherent limitations in an audit that affect the cost auditor's ability to detect material misstatements. These limitations result from factors such as the following:

(1) The use of sample testing.

(2) The inherent limitations of internal control (for example, the possibility of management override or collusion).

(3) The fact that most audit evidence is persuasive rather than conclusive.

Also, the work undertaken by the cost auditor to form an audit opinion is permeated by judgment, in particular regarding:

(1) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and

(2) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the Cost Statements.

(b) Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions. (For example, transactions between related parties). In these cases certain Cost Auditing Standard identify specified audit procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:

(1) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or

(2) Any indication that a material misstatement has occurred.

Accordingly, because of the factors described above, an audit is not a guarantee that the Cost Statements are free from material misstatement, because absolute assurance is not attainable. Further, an audit opinion does not assure the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

Professional skepticism is the state of mind which is ready for the situation that grabs out the errors or questions the financial events and other events while conducting an assurance engagement. It's basically a skill just like the professional judgement which makes the auditor alert for any particular situation. The exercise of professional skepticism is fundamental to the successful performance of auditors, audit firms, and the audit profession as a whole in discharging their responsibilities to the stakeholders of business entity and the society at large.

Professional Skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information and explanations obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

The auditor should also apply professional skepticism when forming the auditor's opinion, by considering the overall sufficiency of evidences and explanations provided by management to support the audit opinion, and by evaluating whether the financial statements overall are a fair presentation of underlying transactions and events and the financial state of affairs of the company. The challenge for audit firms is to identify, develop and retain people with the necessary skills to undertake audits with a sceptical mind-set. It also involves nurturing the conditions that allow professional skepticism to flourish, which in turn helps professionals to discharge her/his duties and responsibilities.

The three elements of professional skepticism —auditor attributes, auditor mindset, and auditor actions permeate the entire audit process and are integral to audit quality. These elements of professional skepticism interact dynamically as auditors respond to conditions and pressures that change or arise during the audit.

The purpose of an audit is to provide investors, lenders and other stakeholders with an opinion that management prepared financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. It will impair the value of audit without professional skepticism. So it's in one's best interests to understand what professional skepticism means and how to apply it throughout the attestation process.

Professional skepticism also plays a critical role in an auditor's consideration of fraud. Where the risk of fraud is high, an auditor might modify planned audit procedures to gather more reliable evidence in support of financial statement assertions. For example, an auditor might obtain confirmation from an independent third party, engage a specialist or examine documentation from independent sources to corroborate management representations. If required, tools and techniques of forensic audit may also be applied.

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalizing when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

6.4 Audit Risk and Materiality: Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and industry, the regulatory environment in which they operate, and their size and complexity, they face a variety of business risks. Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the Cost Statements. The auditor is ultimately concerned only with risks that may affect the cost statements. (Refer 5.7)

(a) The cost auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the Cost Statements give a true and fair view or in accordance with the applicable cost reporting framework. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is inappropriate. The risk that the cost auditor expresses an inappropriate audit opinion when the Cost Statements are materially misstated is known as "audit risk."The cost auditor reduces audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

(b) Audit risk is a function of the risk of material misstatement in the cost statements (or simply, the "risk of material misstatement") (i.e., the risk that the Cost Statements are materially misstated prior to audit) and the risk that the auditor will not detect such misstatement ("detection risk"). The cost auditor performs audit procedures to assess the risk of material misstatement and seeks to limit detection risk by performing further audit procedures based on that assessment. The audit process involves the exercise of professional judgment in designing the audit approach, through focusing on what can go wrong (i.e., what are the potential misstatements that may arise) at the assertion level and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence.

(c) The cost auditor is concerned with material misstatements, and is not responsible for the detection of misstatements that are not material to the Cost Statements taken as a whole. The cost auditor considers whether the effect of identified uncorrected misstatements, both individually and in the aggregate, is material to the Cost Statements taken as a whole. Materiality and audit risk are related.

In order to design audit procedures to determine whether there are misstatements that are material to the cost statements taken as a whole, the cost auditor considers the risk of material misstatement at two levels:

(1) the overall cost statement level and

(2) In relation to cost heads, items of cost and disclosures and the related assertions.

(d) The cost auditor considers the risk of material misstatement at the overall cost statement level, which refers to risks of material misstatement that relate pervasively to the Cost Statements as a whole and potentially affect many assertions. Risks of this nature often relate to the entity's control environment (although these risks may also relate to other factors, such as declining economic conditions), and are not necessarily risks identifiable with specific assertions at the cost heads, items of cost or disclosure level. Rather, this overall risk represents circumstances that increase the risk that there could be material misstatements in any number of different assertions, for example, through management override of internal control. Such risks may be especially relevant to the cost auditor's consideration of the risk of material misstatement arising from fraud. The auditor's response to the assessed risk of material misstatement at the overall cost statement level includes consideration of the knowledge, skill, and ability of personnel assigned significant engagement responsibilities, including whether to involve experts; the appropriate levels of supervision;

(e) The cost auditor also considers the risk of material misstatement at the cost heads, items of cost and disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level. The cost auditor seeks to obtain sufficient appropriate audit evidence at the cost heads, items of cost, and disclosure level in such a way that enables the auditor, at the completion of the audit, to express opinion on the Cost Statements taken as a whole at an acceptably low level of cost audit risk. Auditors use various approaches to accomplish that objective. The discussion in the following paragraphs provides an explanation of the components of audit risk.

(f) The risk of material misstatement at the assertion level consists of two components as follows:

(1) "Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related cost heads, items of cost and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cost heads consisting of amounts derived from cost estimates that are subject to significant measurement uncertainty pose greater risks than do cost heads consisting of relatively routine, factual data.

External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a cause changes to a manufacturing process rendering the existing classification of variable and fixed costs inappropriate and cause product contribution to be misstated. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of cost heads, items of cost, or disclosures may influence the inherent risk related to a specific assertion. These latter factors include, for example, external market constraints may cause normal capacity as an unreliable basis for determining unit costs.

(2) "Control risk" is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's Cost Statements. Some control risk will always exist because of the inherent limitations of internal control.

Inherent risk and control risk are the entity's risks; they exist independently of the audit of the Cost Statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. When the auditor's assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the auditor performs tests of controls to support the risk assessment. The Cost Auditing Standard do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risk of material misstatement." Although the Cost Auditing Standard ordinarily describe a combined assessment of the risk of material misstatement, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

(g) "Detection risk" is the risk that the cost auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements.

Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor usually does not examine all of cost heads, items of cost, or disclosure and because of other factors. Such other factors include the possibility that a cost auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed through adequate planning, proper assignment of personnel to the audit team, the application of ticism, and supervision and review of the audit work performed.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level.

For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.

6.5 **Responsibility for the Cost Statements**: The cost auditor is responsible for forming and expressing an opinion on the Cost Statements. (Refer 5.9)

The term "Cost Statements" refers to a structured representation of the cost information, which ordinarily includes accompanying notes, derived from cost accounting records and intended to communicate an entity's use of economic resources and the output obtained in accordance with a Cost reporting framework. The term can refer to for example, a cost statement, reconciliation with financial accounts and related explanatory notes.

(a) The requirements of the Cost reporting framework determine the form and content of the Cost Statements and what constitutes a complete set of Cost Statements. For certain Cost reporting frameworks, a single cost statement as such and the related explanatory notes constitute a complete set of Cost Statements. For example: a Cost Statement under Cost Accounting Standard 4.

(b) The Cost auditor is not responsible for preparing and presenting the cost statements in accordance with the applicable Cost reporting framework including inter-alia:

(1) Designing, implementing and maintaining internal control relevant to the preparation and presentation of Cost Statements that are free from material misstatement, whether due to fraud or error;

(2) Selecting and applying appropriate Cost accounting policies; and

(3) Making cost estimates that are reasonable in the circumstances.

6.6 **Non-compliance:** The cost auditor shall request management to provide written representation that all known instances of non-compliance or suspected non - compliance with laws and regulations governing Cost Accounting, Cost Records and Cost Audit have been disclosed to the cost auditor. The representations provide necessary audit evidence about management knowledge of identified or suspected non-compliance with laws and regulations whose effects may have a material effect on the cost statement however, written representation do not provide sufficient audit evidence on their own, and accordingly do not affect the nature and extent of other audit evidence that is to be obtained by the cost auditor. (Refer 5.10)

7. Effective Date

This Standard is effective for audits on or after September 11, 2015.

Cost Auditing Standard on Knowledge of Business, its Processes and the Business Environment - 104

The following is the ***Cost Auditing Standard*** **(Cost Auditing Standard - 104)** on "**Knowledge of Business, its Processes and the Business Environment**". In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

In performing an audit of cost statement, records and other related documents, the cost auditor should have the knowledge of the client's business to enable him to understand the processes and express his opinion on the cost statements.

The cost auditor's level of knowledge for a cost audit engagement should include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates.

2. Objective

The objective of this standard is to enable the cost auditor to have knowledge of the client's business which is sufficient to identify and understand the events, transactions and practices that, in the cost auditor's judgment may have a significant effect on the examination of cost statements or on the preparation of the cost audit report.

3. Scope

This standard deals with obtaining the knowledge of the client's business, its processes and business environment as it is important for the cost auditor and members of the audit team working on an audit engagement.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

4.2 Audit Plan: A record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risk.

4.3 Audit Risk: Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.

(a) The risk of material misstatement has two components viz. Inherent Risk and Control risk.

(1) Inherent risk: the susceptibility of an assertion about the measurement, assignment or disclosure of cost to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(2) Control risk: the risk that a misstatement that could occur in an assertion about the measurement, assignment or disclosure of cost and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal, operational and management control.

(b) Detection risk: the risk that the procedures followed by the cost auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

4.4 Auditee: Auditee means a company or any other entity for which cost audit is being carried out.

4.5 Cost Auditor: "Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act, 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under 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.

4.6 Overall Audit Strategy: Overall Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

4.7 Risk Assessment: The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the overall cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof.

5. Requirements

5.1 The Cost Auditor shall have adequate level of understanding of the knowledge of Business, its Processes and the Business Environment to develop a reasonable assurance in order to express an opinion on the cost statements on which he is expressing an opinion.(refer 6.1)

5.2 The Entity and Its Environment: The cost auditor should obtain an understanding of the following:

(a) The nature of the entity, (including its operations covering Business processes, major inputs, Joint & By-Products and Wastages and major outputs etc) and the entity's ownership and governance structure.

(b) Relevant industry, regulatory, and other external factors including the applicable cost and financial reporting framework.(refer 6.2)

(c) The entity's selection and application of cost accounting policies.(refer 6.3)

(d) The measurement and review of the entity's performance. (refer 6.4)

5.3 The Entity's Internal Control: The cost auditor shall obtain an understanding of internal controls relevant to the audit. (refer 6.5)

(a) Control Environment: The cost auditor shall evaluate whether management has created and maintained a culture of honesty and ethical behaviour.

(b) The entity's risk assessment process: The cost auditor shall obtain an understanding of whether the entity has a process for: (refer 6.6, 6.7, 6.8)

(1) Identifying business risks relevant to cost reporting objectives;

(2) Assessing the likelihood of their occurrence;

(3) Estimating the significance of the risks; and

(4) Deciding about actions to address those risks.

(c) Cost Information System/ Management Information System: The cost auditor shall obtain an understanding of the Information System including Management Information System, relevant to cost reporting, including the following areas: (refer 6.9)

(1) The classes of transactions and their analysis, that are significant to the cost statements;

(2) The procedures, by which those transactions and their analysis are initiated, recorded, processed, and reported in the management information systems and cost statements;

(3) The related cost accounting records, supporting information that are used to initiate, record, process and report transactions; and

(4) The reporting process used to prepare the entity's cost statements, including significant estimates and disclosures.

(d) Control Activities: The auditor shall obtain an understanding of the control activities, relevant to the audit.(refer 6.10)

(e) Monitoring of controls:

(1) The auditor shall obtain an understanding of the major activities, that the entity uses to monitor internal control over reporting.(refer 6.11)

(2) The cost auditor shall evaluate the adequacy of the internal audit function in relation to cost records. (refer 6.12)

5.4 IT (Information Technology) Environment and Control: The cost auditor shall evaluate and assess: (refer 6.13)

(1) IT Architecture, Systems and programmes in use in the entity;

(2) Controls on access to data;

(3) Controls on changes to data in master files, systems or programmes; and

(4) Integrity of information and security of the data

5.5 Identifying and Assessing the Risks of Material Misstatement: The cost auditor shall identify and assess the risks of material misstatement at the cost statement level; and at the assertion level including items of cost, cost heads and disclosures thereof.

For this purpose, the cost auditor shall: (refer 6.14, 6.15, 6.16)

(1) Identify risks including relevant controls that relate to the risk of material misstatements or a risk of fraud;

(2) Assess whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;

(3) Assess whether the risk involves significant transactions with related parties;

(4) Assess the degree of subjectivity in the measurement of information related to the risk.

(5) Assess whether there arises a need for revising the assessment of risk based on additional audit evidence obtained.

5.6 Documentation: The auditor shall document:

(a) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 5.1 & 5.2 above and of each of the internal control components specified in paragraphs 5.3 above; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;

(b) The identified and assessed risks of material misstatement at the cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof as required by paragraph 5.5 above; and

(c) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 5.5 above.

6. Application Guidance

6.1 Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous and dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the cost auditor plans the audit and exercises professional judgment throughout the audit, for example, when: (Refer 5.2)

(a) Assessing risks of material misstatement of the cost statements;

(b) Considering the appropriateness of the selection and application of cost accounting policies, and the adequacy of cost statement disclosures;

(c) Identifying areas where special audit consideration may be necessary, for example, abnormal losses, lower yields, higher wastages, higher utilities consumption, related party transactions etc.

(d) Developing Models for use in performing analytical procedures;

(e) Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and

(f) Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

6.2 Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments etc. Examples of matters the cost auditor may consider include: {Refer 5.2(b)}

(a) The market and competition

(b) Cyclical or seasonal activity

(c) Changes in product technology

(d) Business risk (for example, high technology, high fashion, ease of entry for competition)

(e) Declining or expanding operations

(f) Adverse conditions (for example, declining demand, excess capacity, serious price competition)

(g) Key ratios and operating statistics

(h) Specific cost accounting practices and problems

(i) Specific or unique practices (for example, relating to labour contracts, financing methods, accounting methods).

(j) Energy supply sources and cost

(k) Environmental requirements and problems

6.3 An understanding of the entity's selection and application of cost accounting policies may encompass matters such as: {Refer 5.2(c)}

(a) The methods the entity uses to account for significant and unusual transactions (abnormal events).

(b) The effect of significant cost accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

(c) Changes in the entity's cost accounting policies.

(d) Cost reporting framework, and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

6.4 Management will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the cost or financial statements. Accordingly, an understanding of the entity's performance measures assists the cost auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the cost auditor may consider, include: {Refer 5.2(d)}

(a) Key performance indicators and key ratios (financial and non-financial).

(b) Key trends and operating statistics.

(c) Period-on-period financial performance analyses.

(d) Budgets, forecasts, variance analyses, segment information and divisional, departmental or other unit level performance reports.

(e) Employee performance measures and incentive compensation policies.

(f) Comparisons of an entity's performance with that of competitors.

6.5 While understanding controls that are relevant to the audit, cost auditor should evaluate the design of those controls and determine whether they have been implemented properly, by performing procedures in addition to discussions with the entity's personnel.(Refer 5.3)

6.6 If the entity has established risk assessment process, the cost auditor should obtain an understanding of it, and the results thereof. If the cost auditor identifies risks of material misstatement that management failed to identify, the cost auditor should evaluate whether there was an underlying risk of a kind that the cost auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the cost auditor should obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process. {Refer 5.3(b)}

6.7 As part of the risk assessment, the cost auditor should determine whether any of the risks identified are, in the cost auditor's judgment, a significant risk. In exercising this judgment, the cost auditor should exclude the effects of identified controls related to the risk. {Refer 5.3(b)}

6.8 An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the cost statements. However, the cost auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement. {Refer 5.3(b)}

6.9 The cost auditor should understand the related cost accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred primarily to the accounting system and subsequently to cost accounting statement. {Refer 5.3(c)}

6.10 The cost auditor should obtain an understanding of control activities relevant to cost/ management information system in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions and disclosure in the cost statements or to every assertion relevant to them. {Refer 5.3(d)}

6.11 The cost auditor should obtain an understanding of the major activities that the entity uses to monitor internal control relevant to cost reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. {Refer 5.3(e)(1)}

6.12 If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the cost auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the cost statement and assertion levels. If based on responses to the cost auditor's inquiries, it appears that there are findings that may be relevant to the entity's audit; the cost auditor may consider it appropriate to read related reports of the internal audit function. {Refer 5.3(e)(2)}

6.13 The cost auditor should assess the following with regard to IT environment and controls. (Refer 5.4)

(a) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

(b) Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.

(c) The possibility of IT personnel gaining access to privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(d) Unauthorized changes to data in master files.

(e) Unauthorized changes to systems or programs.

(f) Failure to make necessary changes to systems or programs.

(g) Inappropriate manual interventions.

(h) Potential loss of data or inability to access data as required.

6.14 Risks at the cost statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the cost statements and may require an overall response by the auditor. (Refer 5.5)

6.15 Risks of material misstatement at the cost statement level refer to risks that relate pervasively to the cost statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Cost statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud. (Refer 5.5)

6.16 The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion. (Refer 5.5)

7. Effective Date

This Standard is effective for audits on or after September 11, 2015.

Exercise

A. Theoretical Questions

State True or False

1. Cost Auditing Standards are issued by Central Government in consultation with the Institute of Cost Accountants of India, constituted under the Cost and Works Accountants Act, 1959.
2. The Cost Accounting Standards Board [CASB] of the Institute of the Cost Accountants of India formulates the Cost Auditing Standards.
3. The International Auditing and Assurance Standards Board (IAASB) is established under the authority of International Federation of Accountants (IFAC) and The Institute of Cost Accountants of India is a founder member of IFAC.
4. An Engineering expert has been engaged by the cost auditor in connection with the audit of an entity. He will also be considered as a part of the Audit Team.
5. Audit working papers provide assurance that the audit has been performed in accordance with the relevant Cost Accounting Standards and GACAP.
6. Cost auditing standards are advisory in nature.

Fill in the Blanks

1. Cost Auditing Standard 104 on Knowledge of business, its processes and the business environment was issued on _______ and is effective from _______ .
2. The Cost Auditing Standard 102 relates to _______ .
3. A company or any other entity for which cost audit is being carried out is called _______.
4. It is the responsibility of _______ for the preparation and presentation of Cost Statements,
5. Cost Auditing standards are issued in terms of section _______ of Companies Act, 2013.

Short Essay Type Questions

1. Explain the meaning of:
   a. Initial Audit
   b. Misstatement
   c. Audit documentation
2. Write briefly as to how do you assess that the appointment of the cost auditor is proper.
3. What are the factors which a new cost auditor is to consider while formulating the overall strategy of cost audit of a company?
4. What do you understand by audit risk? Explain in brief.

Answer:

State True or False

1.	False - Cost auditing standards are issued by the Institute of Cost Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government.
2.	False - The Cost Audit & Assurance Standards Board [CAASB] of the Institute of the Cost Accountants of India formulates the Cost auditing standards.
3.	True
4.	True
5.	False - Audit working papers provide assurance that the audit has been performed in accordance with the relevant Cost Auding Standards.
6.	False - Cost auditing standards are mandatory in nature.

Fill in the Blanks

1.	10th September, 2015, 11th September, 2015
2.	Cost Audit Documentation
3.	Auditee
4.	Company Management
5.	Section 148 (3)

Cost Audit Programme 6

This Module includes:

Cost Audit Programme

SLOB Mapped against the Module

To develop detail understanding on preparation of Cost Audit Programme. (CMLO 4b)

Module Learning Objectives:

This module enumerates the important factors which are considered in planning the Audit Assignment and also discusses about the overall checklist of the Cost Audit Programme to audit the various cost elements. After studying this module, the students will be able to –

- Learn about the Cost Audit Programme
- Understand the Factors in Planning Cost Audit Assignment

Introduction 6.1

A cost accountant in practice should observe certain principles in planning and performing the cost audit in hand. The work should be planned with professional care recognising that circumstances may exist to cause the cost statements to be materially misstated. Therefore, the audit assignment should be so programmed to provide reasonable assurance that the cost information provided is free of material misstatements.

Factors in Planning Cost Audit Assignment

6.2

In planning the audit assignment certain important factors are taken into consideration viz.

(a) Requirement of audit personnel for the assignment

(b) Documentation of the audit procedures and of evidences

(c) Quality control exercised over performance of the assignment etc.

We describe each one of these factors in planning the audit programme for the students to understand them, in the following paragraphs.

Audit personnel for the assignment

Experience and training of audit personnel engaged for the assignment should be considered particularly keeping in view the relevant industry. Prior practical experience of the industry helps in carrying out the study of the system and procedures in vogue. For this purpose, two pronged approaches may be adopted by the cost auditors. First, a study of the industry and the second, study of the Annual Reports of the auditee company for the past at least 5 years.

The cost audit team to whom the assignment is to be delegated need appropriate direction and supervision. It is therefore, essential that they accomplish the following tasks:

(i) Physical inspection of the activities and the area where they are performed;

(ii) Knowledge of the key personnel responsible for the activities and for the maintenance of cost records;

(iii) Physical inspection of the cost accounting records and other records relating to activities;

(iv) Study of the statements of budgets, plans and strategies relating to activities;

(v) Study of the Cost Accounting system used and the basis according to relevant CAS.

The audit personnel should be asked to collect the documentary evidences for the above tasks and file in the relevant cost audit file for future reference.

Documentation of the audit procedures and of evidences

The cost auditor should document all matters which are important in providing evidence to support the opinion given in the report. Documentation means the working papers prepared by and for, or obtained and retained by the cost auditor in connection with the performance of the audit or compliance function. Working papers record the evidence resulting from the work performed, to support the cost auditors' opinion. It is important to remember that the documents may include issues beyond accounting data as other information such as production schedule, quantitative and statistical data etc. may be required for preparation of performance analysis.

The daily worksheets should include all queries raised, with it was discussed and how, and if they were satisfied. Use of standardised working papers such as, checklists, confirmation forms, standard letters etc. may improve the efficiency with which such working papers are prepared and reviewed. Schedules, statements, analyses and other documents prepared by the entity may be utilised and treated a part of the working papers, only after being satisfied that the materials have been properly prepared with due care.

Working paper management improves the productivity of the audit assignment undertaken. The essentiality is that of quick retrieval of information from the files of working papers. Working paper file contains details relating to the financial year under reference. This file should be properly indexed and divided into convenient sections.

The cost auditor and his team should adopt appropriate procedures for maintaining the confidentiality and safe custody of the working papers and for retaining them for a period sufficient to meet the needs of the practice and in accordance with legal and professional requirements of retention of records.

Quality control over performance of the assignment

Supervision and control involves direction, review and monitoring of the audit assignment in hand. The personnel carrying out these responsibilities generally perform the following functions during the course of audit.

(a) Monitoring the progress of the preparation / maintenance of cost accounting records;

(b) Reviewing that the audit assistants do have necessary skill and competence to understand the system and procedure to carry out the assigned tasks as per the overall plan;

(c) Being aware of the cost accounting and auditing questions raised during carrying out of the assignment and assessing their significance and modifying the plan and programme, as considered necessary; and

(d) Removing the differences of professional judgement between the personnel and deciding the level which is appropriate for reference purpose.

Cost Audit Programme 6.3

Checklist to Audit various Cost Elements

Before discussing the overall checklist of the cost audit programme, it is prudent to go through the checklists to audit various cost elements as mentioned below:

1. Audit of production - Product wise
2. Audit of raw material cost
3. Audit of key raw materials inventory status
4. Audit of electricity cost
5. Audit of cost of electricity generated by DG set
6. Audit of demineralised water cost
7. Audit of steam cost
8. Audit of stores and spares cost
9. Audit of repairs and maintenance cost
10. Audit of employee cost
11. Audit of insurance cost
12. Audit of depreciation cost
13. Audit of administrative overhead cost
14. Audit of selling and distribution overhead cost
15. Audit of packing material cost
16. Audit of sales value

6.3.1 Audit of Production - Product Wise

Following checklist should be considered to audit production - product wise:

- Ensure that there is proper inventory balancing for each of the finished product, for example, Opening Stock + Production = External Sales + Internal Transfers + Closing Stock
- Ensure that closing stock of previous year is correctly considered as opening stock of current year

- Check the capacity utilisation of previous 5 years - product wise
- For any abnormal under utilisation of production capacity the auditor should seek the reasons from the management and what steps management has proposed to undertake to overcome under utilisation of capacity. Under utilisation of capacity should merit attention and focus where either product is profitable or the product has substantial positive contribution
- Check whether there is any circumstance where there is addition to capacity for any product during the year but actual production achieved is either equal to or less than that of previous year. Reasons for the same should be sought from the management
- The cost auditor should ask for MIS Reports as shown in Table 1 & 2.

Table 1

Inventory Balancing of Each of Finished Product

Products	Unit	Opening Stock	Production	External Sales	Internal Transfers	Closing Stock
1	MT					
2	-do-					
3	-do-					
4	-do-					
5	-do-					

Table 2

Product wise Capacity Utilisation of Previous 5 Years

Products	Capacity Utilisation	F.Y. 2017-18	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
1	%					
2	-do-					
3	-do-					
4	-do-					
5	-do-					

6.3.2 Audit of Raw Material Cost

Following checklist should be kept in view to audit raw material cost during cost audit:

- Ensure that proper quantitative inventory balancing is carried out for all the raw materials, for example, Opening Stock + Purchases – Consumption = Closing Stock (Refer Table 3).
- Work out Input / Output Ratios for key raw materials for previous 3 to 5 years. (Refer Table 5). Least of these 3 to 5 years Input / Output Ratio can be considered as Benchmark Input / Output Ratio. Consumption of current year should be compared against this Benchmark Ratio. There should be proper justification for any significant increase.

- In case of chemical based industries, some chemicals tend to evaporate during their storage. Being normal loss, it should be shown as consumption for that product. In case of multiple products, this normal loss need to be appropriated among products based on consumption quantity.
- In some cases it may happen that residue of some particular raw material is not reusable but has to be sold out in the market, say for example, raw material X is used in Product A & Product B. It may be the case that residue of Product A is saleable but that of Product B is not saleable. In such case, sale value of residue of raw material X will be reduced from raw material consumption of X for Product A only. Other case may be that residue of both the Products A & B is saleable. In such case, sale value of residue of raw material X will be reduced from raw material consumption of X for Product A as well as Product B.
- If R & D Department has carried out some process improvement for reducing the consumption of some key raw material then it needs to be checked how much raw material consumption has reduced.
- For charging raw material cost to product/products, both FIFO & Weighted Average rates can be applied. A company can follow any method but it needs to be ensured that it is applied consistently.
- Usually, a company prepares expense control chart where raw material is shown by different cost centres like production cost centres and utilities cost centres like filtered water, DM water, boiler, cooling water etc. The total of all these cost centres should agree with total raw material consumption as per Trial Balance.
- If some raw material is produced in-house, then the company would have created separate cost centre for that raw material. So its valuation should be done as per costs which are booked against this cost centre.
- Sometimes it may happen that both imported & local raw materials are used in various products. In such case it is prudent to show consumption of both imported & local raw materials in the same proportion in all the products to avoid distortion of that particular raw material cost in various products.
- Similarly, it may happen that both local & self manufactured raw materials are used in various products. In this case also it is better to show consumption of both local & self manufactured raw materials in the same proportion in all the products to avoid distortion of that particular raw material cost in various products.
- Distillation loss of a manufactured product can be explained by citing the example, say, a company is making product A which can either be sold as product A or which can be converted into product B and can be sold as product B. Now, sometimes product A is required to be distilled either (i) before selling it as product A or (ii) before its conversion into product B. In case of (i) above, it will form part of cost of production of product A and in case of (ii) above, it will form part of cost of production of B.
- Sometimes a company may keep rented storage tank at port to store the material which is subsequently brought to the company premises. This rent will form part of cost of material.
- Usage above standard may be due to unproductive plant or equipment being used in manufacture. Check and ensure that correct equipment is being used.
- Explore the possibility to tie up the entire requirement of A category raw materials with proven manufacture at a fixed rate. This will result in no risk factor for any increase in cost of that raw material during the period of contract.
- R & D department can carry many innovations for utilizing alternative cheaper materials without compromising on quality of output.

- Demurrage or detention charges or any penalty levied should not form part of landed cost of raw material.
- Examine if all the specifications and features of the product, some of which are causes for this extra spoilage, are really necessary and if insisted upon then they are paid for by the customer.
- Ensure that at the end of the year all raw materials dispatched by suppliers through the public or private carriers where ownership of goods has been passed on to the company are shown either in transit or as receipts.
- Check that the opening balance is correct after adjustment of results of physical stock verification. Similarly closing balances should be checked to ensure that adjustments on stock verification have been carried out.
- Check up whether all the receipts have been correctly valued after taking into account freight and other incidental charges.
- Statement of over-usage of raw materials should be prepared regularly and it should be given to concerned departmental head for necessary action.
- R & D department should suggest how to reduce/eliminate wastages.
- Check the trend of rates of key raw materials for previous 4 years (Refer Table 4).

Table 3

Balancing of Key Materials in MT

Particulars	Opening Stock	Purchases	Total Available	Consumption	Transfer to other plant	Closing Stock
Raw Material 1						
Raw Material 2						
Raw Material 3						
Raw Material 4						
Raw Material 5						

Table 4

Rates of Key Raw Materials for Previous 4 Years

Particulars	Unit	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
Raw Material 1	₹/MT				
Raw Material 2	-do-				
Raw Material 3	-do-				
Raw Material 4	-do-				
Raw Material 5	-do-				

Table 5

Consumption of Key Raw Materials per MT of Finished Products

Particulars	Finished Products	Unit	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
Raw Material 1	Finished Products 1	MT / MT				
Raw Material 2	Finished Products 2	-do-				
Raw Material 3	Finished Products 3	-do-				
Raw Material 4	Finished Products 4	-do-				
Raw Material 5	Finished Products 5	-do-				

6.3.3 Audit of Key Raw Materials Inventory Status

Following list of control points should be kept in view for audit of key raw materials representing significant inventory value.

List of control points:

- Obtain information about current stock position
- Assess how the stock position is keeping pace with consumption pattern
- Check whether unnecessary increase in the volume of inventory results in more and more cost locked up in inventory (Refer Table 6)

Table 6

List of Key Raw Materials Inventory Dominating Total Inventory Value of Raw Materials

Key Finished Products	Average Monthly Consumption Previous Year (MT)	Average Monthly Consumption Current Year (MT)	Closing Stock of the Month (MT)	Closing Stock as Months' Cover
Raw Material 1				
Raw Material 2				
Raw Material 3				
Raw Material 4				
Raw Material 5				

6.3.4 Audit of Electricity Cost

Following checklist should be kept in view to audit electricity cost during cost audit:

- Focus on A Category cost centres (Refer Table 7)
- Any increase in consumption without any corresponding increase in output requires explanation from the management as it is a matter of concern (Refer Table 7 & 8)

- Check the trend of electricity cost for previous 5 years (Refer Table 9, 10, & 11)
- Check whether proper meters are installed
- Check whether meters are regularly calibrated
- Monthly report showing cost centre wise allocation of electricity as submitted by electrical department should be the basis for ascertainment of cost centre wise/product wise electricity cost (Refer Table 7 & 12)
- A company may have more than one source of electricity. Therefore, check and verify the effect of different sources of electricity on overall cost of electricity
- Check that optimum electricity is procured from the cheaper source (Refer Table 13)

Table 7

Trend of Consumption of Electricity for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres	KWH					
1	-do-					
2	-do-					
3	-do-					
Total 1	-do-					
Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					
Others						
Stores	-do-					
Warehouse	-do-					
Office	-do-					
Total 3	-do-					
Total 1 + 2 + 3	-do-					

Table 8

Consumption of Electricity per MT of Finished Products for 5 years

(For A Category & B Category Products)

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	KWH/MT					
2	-do-					
3	-do-					
4	-do-					
5	-do-					

Table 9

Trend of Cost of Electricity for Previous 5 Years

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Cost of electricity	₹/KWH					

Table 10

Cost of Electricity (₹/MT) for Key Products for 5 Years

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹/MT					
2	-do-					
3	-do-					
4	-do-					
5	-do-					

Table 11

Total Electricity Cost for the Company for Previous 5 Years

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Electricity Cost	₹ Lakhs					

Table 12

Consumption of Electricity – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	KWH					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
Total	-do-					

Table 13

Procurement of Electricity & its Average Cost – Source wise

Source	F.Y 2019 - 20			F.Y. 2020 - 21			F.Y. 2021 - 22		
	KWH	₹ Lakhs	₹ / KWH	KWH	₹ Lakhs	₹/ KWH	KWH	₹ Lakhs	₹/ KWH
1									
2									
3									
4									
5									
Total									

6.3.5 Audit of Cost of Electricity Generated by DG Set

Following checklist should be remembered to audit the cost of electricity generated by DG set:

- Monthly report of Diesel Generating Set prepared by officer in-charge of DG set should be the basis for ascertainment of cost of electricity generated
- Ensure that monthly report contains the following information:
  - (a) No of hours DG set is operated
  - (b) Quantity of high speed diesel used
  - (c) Total units generated

- Proper meters should be in place to quantify the total units generated and units allocated to various cost centres
- Meters should be regularly calibrated
- There should be proper system to quantify quantity of diesel used
- Ratio of units (KWH) generated to diesel used should be studied for previous 5 years
- Ensure that allocation of units to various cost centres are in line with the output of respective cost centres
- Ensure that employee cost is properly booked and it pertains to only those employees who are really employed for DG set and actually working for DG set
- Ensure that cost of consumable stores and repairs is properly allocated and it pertains to cost actually incurred for DG set
- Ensure the correctness of depreciation and insurance booked against DG set
- Ensure that proper cost centre is allocated to DG set
- Generally, CMA Department prepares expense control chart which lists out all the expenses incurred for DG set and its allocation to various cost centres. The cost auditor should also go through this expense control chart
- Cost auditor should ask for MIS reports as shown in Table 14, 15 & 16

Table 14

Trend of Cost of Electricity Generated for Previous 5 Years

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Cost of Electricity Generated	₹ / KWH					

Table 15

Trend of Cost of Electricity per MT of Product 1 for Previous 5 Years

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Cost of Electricity per MT of product 1	₹ / MT					

Table 16

Trend of Consumption of Electricity for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres	KWH					
1	-do-					
2	-do-					
3	-do-					
Total 1	-do-					
Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					
Others						
Stores	-do-					
Warehouse	-do-					
Office	-do-					
Total 3	-do-					
Total 1 + 2 + 3	-do-					

6.3.6 Audit of Demineralised Water Cost

Following checklist should be kept in view to audit demineralised water cost during cost audit:

- Proper cost centre should be allocated to DM water plant
- Monthly report prepared for demineralised water plant should form the basis for ascertainment of cost of demineralised water plant
- Ensure that monthly report so prepared contains the following data
  - (a) Quantity of filtered water used
  - (b) Quantity of chemicals used

(c) Electricity units used (KWH)

(d) Quantity of demineralised water generated

(e) Quantity of demineralised water allocated to production cost centres, boiler etc

- There should be proper system in place to quantify quantity of demineralised water generated and quantity allocated to various cost centres
- It is recommended to have proper meters which should be regularly calibrated
- Ensure that quantity of DM water allocated to production cost centres and boiler are in line with output of respective cost centres
- Ensure that employee cost allocated pertains only to those employees who are looking after DM water plant
- Ensure that cost of consumables and repairs allocated to demineralised water plant actually pertains to DM water plant only. It should be ensured that expenses pertaining to other cost centres are not booked against DM water cost centre
- Ensure correctness of depreciation and insurance
- Cost of electricity should be as per work sheet prepared by CMA department
- Cost of chemicals consumed should be as per priced stores ledger
- Generally, company prepares expense control chart which shows compilation of element wise cost of DM water and its allocation to various cost centres. The cost auditor should collect and go through this expense control chart
- Ensure that cost sheet of DM water shows correct applicable cost of filtered water
- Cost auditor should ask for the MIS report as shown in Table 17, 18 & 19

Table 17

Cost of Demineralised Water for Previous 5 Years

Year	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Cost	₹ / KLT					

Table 18

Cost of Demineralised Water per MT of Product 1 for Previous 5 Years

Year	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Product 1	₹ / MT					

Table 19

Cost of Consumption of DM Water for Previous 5 Years – Centre wise

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres	MT					
Boiler						

6.3.7 Audit of Steam Cost

Following checklist should be considered to audit steam cost during cost audit:

- Generally boiler house prepares monthly report which becomes the basis for ascertainment of cost of steam. Ensure that monthly report for boiler contains the following information:
  - (a) Running hours of boiler
  - (b) Quantity of steam generated (MT)
  - (c) DM water consumption (KL)
  - (d) Electricity consumption (Kwh)
  - (e) Fuel consumption
  - (f) Furnace oil, LSHS, Light Diesel oil, coal, Lignite etc.
  - (g) Steam consumption in boiler auxiliary
  - (h) Line losses
  - (i) Steam consumed by manufacturing plants, labs etc
- The cost auditor should check the following ratios for previous 5 years:
  - (a) Cost of steam generated for previous 5 years (Refer Table 20)
  - (b) Quantity of steam generated per unit of fuel used (Refer Table 21)
  - (c) Quantity of steam consumption in boiler auxiliary to total steam generated
  - (d) Quantity of line losses to total steam generated
  - (e) Quantity of steam per MT of finished product (Refer Table 22)
  - (f) Cost of steam per MT of finished product for previous 5 years (Refer Table 23)
- Focus on A category cost centres (Refer Table 24)
- Proper steam meters should be in place to quantify steam generation and its allocation to various cost centres
- Steam meters should be regularly calibrated
- Line losses may be due to leakages in pipe lines. So all pipe lines should be properly insulated
- Ensure that employees cost is correctly worked out and cost of only those employees is considered who are really employed for boiler house
- Ensure that cost of consumable stores and repairs is properly booked against boiler

- Ensure that depreciation and insurance are correctly worked out
- Cost auditor should go through steam cost of previous 5 years
- Generally CMA department prepares expense control chart which lists out all expenses for boiler and its allocation to various cost centre. The auditor can study this expense control chart

Table 20

Cost of Steam Generated for Previous 5 Years

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Cost of Steam Generated	₹ / MT					

Table 21

Input / Output Ratio at Steam Generation Stage for Previous 5 Years

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Coal	MT					
Steam	-do-					
Input /Output Ratio	MT / MT					

Table 22

Consumption of Steam per MT of Finished Product for Previous 5 Years

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Steam	MT					
Product 1	-do-					
Steam per MT of Product 1	MT / MT					

Table 23

Cost of Steam per MT of Product 1 for Previous 5 Years

Particulars	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Product 1	₹ / MT					

Table 24

Consumption of Steam (in MT) for Previous 5 years – Cost Centre wise

Sr. No.	Production Cost Centres	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	1					
2	2					
3	3					
4	4					
5	5					
	TOTAL					

6.3.8 Audit of Stores and Spares Cost

Following checklist should be kept in view to audit cost of stores & spares during cost audit:

- The cost auditor should obtain information as shown in Table 25 from either CMA department/Finance department or through prevailing ERP system in the company. It provides at a glance year wise, cost centre wise expenses on stores & spares. If there is any substantial increase in expenditure with respect to any particular cost centre/cost centres then reasons for the same should be discussed with the head of that cost centre(s) so that appropriate action can be taken to prevent such recurrences. Through this table, cost auditor will come to know A category of cost centres which will account for 70% to 75 % of total stores & spares expenses incurred. It is always advisable to focus on these A category cost centres to monitor, control and reduce expenses on stores & spares. This is because even a small step taken by the management with respect to these A category of cost centres will result in far greater advantage to the management regarding cost control and cost reduction with respect to stores & spares
- Similarly, cost auditor should obtain information as shown in Table 26 from either CMA department/Finance department or through prevailing ERP system in the company. It provides at a glance year wise, product wise expenses on stores & spares. If there is any substantial increase in expenditure with respect to any particular product then reasons for the same should be discussed with the head of concerned cost centre(s) so that appropriate action can be taken to prevent such recurrences
- The cost auditor can pick up few major items of stores & spares and ensure that they have been booked against correct cost centres
- The cost auditor should ask for information as shown in Table 27. The higher per MT expenses can be due to lower capacity utilization which he needs to highlight to the management
- The cost auditor should also go through expense control chart which shows plant wise expenses duly tied up with Trial Balance

Table 25

Expenses Incurred on Stores & Spares for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres						
1	₹ Lakhs					
2	-do-					
3	-do-					
Total 1	-do-					
Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					
Others						
Stores	-do-					
Warehouse	-do-					
Office	-do-					
Total 3	-do-					
Total 1+2+3	-do-					

Table 26

Cost of Stores & Spares for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ Lakhs					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

Table 27

Cost of Stores & Spares (₹/MT) for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ / MT					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

6.3.9 Audit of Repairs and Maintenance Cost

Following checklist should be taken into account to audit cost of repairs & maintenance during cost audit:

- The cost auditor should obtain information as shown in Table 28 from either CMA department/Finance department or through prevailing ERP system in the company. It provides at a glance year wise, cost centre wise expenses on repairs & maintenance. If there is any substantial increase in expenditure with respect to any particular cost centre / cost centres then reasons for the same should be discussed with the head of that cost centre(s) so that appropriate action can be taken to prevent such recurrences. Through this table, the cost auditor will come to know A category of cost centres which will account 70% to 75% of total expenses on repairs & maintenance incurred. It is always advisable to focus on these A category cost centres to monitor, control and reduce expenses on repairs & maintenance. A little step taken by the management with respect to these A category of cost centres will result in far greater advantage to the management regarding cost control and cost reduction with respect to repairs and maintenance.
- Similarly, the cost auditor should obtain information as shown in Table 29 from either CMA department/ Finance department or through prevailing ERP system in the company. It provides at a glance year wise, product wise expenses on repairs & maintenance. If there is any substantial increase in expenditure with respect to any particular product then reasons for the same should be discussed with the head of concerned cost centre(s) so that appropriate action can be taken to prevent such recurrences.
- The cost auditor can pick up few major items of repairs & maintenance and ensure that they have been booked against correct cost centres.
- The cost auditor should ask for information as shown in Table 30. Higher per MT expenses can be due to lower capacity utilisation which he needs to highlight to the management.
- The cost auditor should also go through expense control chart which gives plant wise expenses duly tied up with Trial Balance.

Table 28

Expenses Incurred on Repairs & Maintenance for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres						
1	₹ Lakhs					
2	-do-					
3	-do-					
Total 1	-do-					
Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					
Others						
Stores	-do-					
Warehouse	-do-					
Office	-do-					
Total 3	-do-					
Total 1 + 2 + 3	-do-					

Table 29

Cost of Repairs & Maintenance (₹/Lakhs) for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ Lakhs					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

Table 30

Cost of Repairs & Maintenance (₹ / MT) for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ / MT					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

6.3.10 Audit of Employee Cost

Following checklist should be kept in view to audit employee cost during cost audit:

- The cost auditor should verify the following information:
  - (a) Employee cost for previous 5 years – cost centre wise
  - (b) Number of employees for previous 5 years - cost centre wise
  - (c) Employee cost per employee for previous 5 years - cost centre wise (Refer Table 31, 32 & 33)
- The cost auditor should also verify the following information:
  - (a) Employee cost for previous 5 years – product wise
  - (b) Number of employees for previous 5 years – Product wise
  - (c) Employee cost per employee for previous 5 years – product wise (Refer Table 34, 35 & 36)
- The cost auditor should also verify product wise employee cost per MT of production for previous 5 years (Refer Table 37)
- Increase in per MT employee cost may be due to lower capacity utilisation of the product. This needs to be properly brought out to the management
- The cost auditor should verify that cost centre wise list of employees is regularly updated in employee payroll so that cost centre wise employee cost gives correct reflection of employee cost
- Generally, employees are transferred from one cost centre to another cost centre. The cost auditor should ensure that pay roll of employees reflect all such transfers correctly and timely
- Increase in number of employees for particular cost centres or product should be looked into. The reasons and justification should be obtained from the management

Table 31

Employee Cost for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres						
1	₹ Lakhs					
2	-do-					
3	-do-					
Total 1	-do-					
Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					
Others						
Stores	-do-					
Ware House	-do-					
Office	-do-					
Total 3	-do-					
Total 1 + 2 + 3	-do-					

Table 32

Number of Employees for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres						
1	No.					
2	-do-					
3	-do-					
Total 1	-do-					

Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					
Others						
Stores	-do-					
Warehouse	-do-					
Office	-do-					
Total 3	-do-					
Total 1 + 2 + 3	-do-					

Table 33

Employees Cost per Employee for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres						
1	₹ Lakhs / No.					
2	-do-					
3	-do-					
Total 1	-do-					
Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					

Others						
Stores	-do-					
Warehouse	-do-					
Office	-do-					
Total 3	-do-					
Total 1 + 2 + 3	-do-					

Table 34

Employee Cost for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ Lakhs					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

Table 35

Number of Employees for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	No.					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

Table 36

Employee Cost per Employee for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ Lakhs / No.					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

Table 37

Employee Cost for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ / MT					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

6.3.11 Audit of Insurance Cost

The insurance premium paid by company may cover various kinds of insurances. Insurance of Plant & Machinery, buildings and equipments, furniture & fixtures usually covers risks of general loss and fire. Following checklist should be kept in view to audit cost of insurance during cost audit:

- The cost auditor should obtain information as shown in Table 38 from either CMA department/Finance department or through prevailing ERP system in the company. It provides at a glance year wise, cost centre wise expenses on insurance. Through this table, a cost auditor will come to know A category of cost centre(s) which will account for 70% to 75% of total insurance expenses incurred.
- Similarly, the cost auditor should obtain information as shown in Table 39 from either CMA department/ Finance department or through prevailing ERP system in the company. It provides at a glance year wise, product wise expenses on insurance. If there is any substantial increase in expenditure with respect to any particular product then reasons for the same should be discussed with the insurance department. It may be due to allocation of insurance expenses to wrong plant / wrong cost centre. The cost auditor can pick few major items and ensure that they have been booked against correct cost centres.
- The Cost auditor should ask for information as shown in Table 40. Higher per MT expenses may be due to lower capacity utilisation which he needs to highlight to the management.

Table 38

Expenses Incurred on Insurance for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres						
1	₹ Lakhs					
2	-do-					
3	-do-					
Total 1	-do-					
Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					
Others						
Stores	-do-					
Warehouse	-do-					
Office	-do-					
Total 3	-do-					
Total 1 + 2 + 3	-do-					

Table 39

Cost of Insurance (₹/Lakhs) for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ Lakhs					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

Table 40

Cost of Insurance (₹/MT) for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ / MT					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

6.3.12 Audit of Depreciation Cost

Depreciation is defined as the diminution in the value of a fixed asset due to use and/or lapse of time. A fixed asset such as a plant & machinery has a life span during which it renders service and on the expiry of which, the asset has either no value or has only a small value as scrap. During the period of the life of the asset, its value is thus gradually reduced till it reaches nil or a very small figure. This reduction in value is called depreciation.

Following checklist should be considered to audit cost of depreciation during cost audit:

- The cost auditor should obtain information as shown in Table 41 from either CMA department/Finance department or through prevailing ERP system in the company. It provides at a glance year wise, cost centre wise expenses on depreciation. Through this information, a cost auditor will come to know A category of cost centres which will account for 70% to 75% of total depreciation charged in books of accounts.
- Similarly, the cost auditor should obtain information as shown in Table 42 from either CMA department/ Finance department or through prevailing ERP system in the company. It provides at a glance year wise, product wise depreciation. If there is any substantial increase in depreciation expenditure with respect to any particular product then reasons for the same should be discussed with the central accounts section which maintains fixed asset register. It may be due to capitalisation of additions in wrong plant/wrong cost centre. The cost auditor can pick up few major items and ensure that they have been booked against correct cost centres.
- The cost auditor should ask for information as shown in Table 43. Higher per MT expenses can be due to lower capacity utilisation which he needs to highlight to the management.

Table 41

Expenses Incurred on Depreciation (₹/Lakhs) for Previous 5 Years – Cost Centre wise

Cost Centres	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
Production Cost Centres						
1	₹ Lakhs					
2	-do-					
3	-do-					
Total 1	-do-					

Utility Cost Centres						
Filtered Water	-do-					
DM Water	-do-					
Steam	-do-					
Air Compressor	-do-					
Nitrogen	-do-					
Cooling Water	-do-					
Chilled Water	-do-					
Total 2	-do-					
Others						
Stores	-do-					
Warehouse	-do-					
Office	-do-					
Total 3	-do-					
Total 1 + 2 + 3	-do-					

Table 42

Cost of Depreciation (₹/Lakhs) for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ Lakhs					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

Table 43

Cost of Depreciation (₹/MT) for Previous 5 Years – Product wise

Products	Unit	F.Y. 2017 - 18	F.Y. 2018 - 19	F.Y. 2019 - 20	F.Y. 2020 - 21	F.Y. 2021 - 22
1	₹ / MT					
2	-do-					
3	-do-					
4	-do-					
5	-do-					
TOTAL	-do-					

6.3.13 Audit of Administrative Overhead Cost

A company is required to incur certain fixed expenses in order to run its business of manufacturing and selling its products. A cost auditor should ask for the following information:

(a) Trend of administrative expenses (₹/Lacs) – year wise (Refer Table 44)

(b) Administrative expenses (₹/MT) – year wise product wise (Refer Table 45)

Table 44

Trend of Administrative Expenses (₹/Lakhs) for Company/for Plant 1 – Year wise for Previous 4 Years

Particulars	2018-19 (₹ Lakhs)	%	2019-20 (₹ Lakhs)	%	2020-21 (₹ Lakhs)	%	2021-22 (₹ Lakhs)	%
(a) Stationery for computers								
(b) Stationery for other office use								
(c) Travelling – domestic								
(d) Travelling - abroad								
(e) Bus expenses								
(f) Uniform								
(g) Security								
(h) Legal and professional fees								
(i) Seminar								
(j) Telephone expenses								
(k) Book and periodicals								
(l) Audit fees – financial audit								
(m) Audit fees – cost audit								
(n) Donations								
(o) Penalties								
TOTAL								

Table 45

Administrative Expenses (₹/MT) for Previous 4 Years – Product wise

Products	Unit	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
1	₹/MT				
2	-do-				
3	-do-				
4	-do-				
5	-do-				

- The above Tables (44 & 45) provide at a glance year wise trend of administrative overhead cost and year wise product wise trend of per MT administrative expenses.
- The auditor should see that basis of allocation/apportionment to different plants/products is consistent over a period of time.
- For any abnormal increase in any expenses, the cost auditor should ask for cost centre wise break up of all these years to enable him to analyse and discuss with the management.
- He should see that donations and penalties are not charged to products but shown as items of reconciliation.
- If there is any substantial increase/decrease in per MT administrative expenses as compared to any of 4 years, he should seek the reasons for the same.
- The auditor should see whether any annual rate contract with concerned suppliers are entered into for a given period or for a given quantity to control expenses with respect to stationery for computer and stationery for other office use.
- If there is any substantial increase either in domestic travel or foreign travel, it may be due to certain business conditions which might have necessitated either domestic travel or foreign travel. If required, the cost auditor should ask for cost centre wise analysis.
- Incidence of legal and professional fees depends upon circumstances of that particular year. For any substantial increase, he should obtain reasons for the same. It should be ensured that the cost of litigation is not more than the benefit.

6.3.14 Audit of Selling and Distribution Overhead Cost

The main function of a manufacturing concern is to produce and sell the product(s) manufactured. Similarly, the function of a non manufacturing concern like a wholesale trade or retail business is to purchase and sell goods and merchandise. In both cases, we find that selling (and incidentally, distribution also) is a common function and thus, selling & distribution costs are incurred by all concerns, both manufacturing and non manufacturing. As most of the items of selling & distribution expenses are not identifiable with products, they are in the nature of indirect costs. The necessity for proper accounting of selling & distribution costs arises from the following:

1) Determination of the costs of sales of products and the extent of profitability of each. [Costs are not complete and profits cannot be worked out unless selling & distribution cost are included]
2) Control of selling & distribution costs
3) Price fixation

- A cost auditor should ask for the following information:
  - (a) Trend of selling & distribution expenses (₹/Lakhs) – year wise (Refer Table 46)
  - (b) Selling & distribution expenses (per/MT) – year wise product wise (Refer Table 47)

Table 46

Trend of Selling & Distribution Expenses (₹/Lakhs) for Company/for Plant –Year wise

Particulars	2018-19 (₹ Lakhs)	%	2019-20 (₹ Lakhs)	%	2020-21 (₹ Lakhs)	%	2021-22 (₹ Lakhs)	%
(a) Stationery for computers								
(b) Travelling – domestic								
(c) Travelling - abroad								
(d) Commission								
(e) Discount								
(f) Advertising								
(g) Legal cost for debt realisation								
(h) Seminar								
(i) Telephone expenses								
(j) Book and periodicals								
(k) Vehicle hire charges								
TOTAL								

Table 47

Selling & Distribution Expenses (₹/MT) for Previous 4 Years – Product wise

Products	Unit	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
1	₹/MT				
2	-do-				
3	-do-				
4	-do-				
5	-do-				

- The above information (Table 46 & 47) provide at a glance year wise trend of selling & distribution overhead cost and year wise product wise trend of per MT selling & distribution expenses.
- He should see that basis of allocation/apportionment to different plants/products is reasonable and consistent over a period of time.
- For any abnormal increase in any expenses, the cost auditor should ask for reasons to enable him to analyse and discuss with the management.
- If there is any substantial increase either in domestic travel or foreign travel, it may be due to expansion of domestic market and or export market or launch of some new product. Therefore, the cost auditor should discuss with marketing department to analyse the reasons.

- Incidence of legal and professional fees depends upon circumstances of that particular year. For any substantial increase, he should obtain reasons for the same.

6.3.15 Audit of Packing Material Cost

Following checklist should be kept in view to audit packing material cost during cost audit:

- Efforts should be made to negotiate the rate of high value consumption packing materials.
- Steps should be taken to reduce handling losses, wastages, etc.
- At times, finished product is sold both in loose form and in packed form. In such cases, cost of packed material will have packing material cost which should be recovered in sales invoice. So, few sales invoices can be checked to ensure that for packed material, packing cost is recovered through sales invoices.
- Ensure that proper quantitative inventory balancing is carried out for all the packing materials i.e. opening stock + purchases – consumption = closing stock (Refer Table 48).
- For charging packing material cost to product/products, both FIFO and weighted average rates can be applied. A company can follow any method but it needs to be ensured that it is applied consistently.
- Usually, a company prepares expense control chart where packing is shown for different production cost centres and total of all these cost centres will agree with total packing material consumption as per Trial Balance.
- If some packing material is produced in-house then the company would have created separate cost centre for that packing material. So its valuation should be done as per costs which are booked against this cost centre.
- Explore the possibility to tie up the entire requirement of A category packing materials with proven manufacture at a fixed rate. This will result in no risk factor for any increase in the cost of packing material during the period of contract.
- Demurrage or detention charges or any penalty levied should not form part of landed cost of packing material.
- Ensure that at the end of the year all packing materials despatched by suppliers through the public or private carriers where ownership of goods has passed on to the company are shown either in transit or as receipts.
- Check that the opening balance is correct after adjustment of results of physical stock verification. Similarly, closing balances should be checked to ensure that adjustments on stock verification have been carried out.
- Check up whether all the receipts have been correctly valued after taking into account freight and other incidental charges.
- Check the trend of rates of key packing materials for previous 5 years (Refer Table 49).
- Check the trend of consumption of key packing materials (per/MT) of finished products year wise for 5 years (Refer Table 50).

Table 48

Balancing of Key Packing Materials

Particulars	Opening Stock	Purchases	Total Available	Consumption	Transfer to other plant	Closing Stock
Packing Material 1						
Packing Material 2						
Packing Material 3						
Packing Material 4						
Packing Material 5						

Table 49

Rates of Key Packing Materials for Previous 5 Years

Particulars	Unit	F.Y. 2017-18	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
Packing Material 1	₹/Unit					
Packing Material 2	-do-					
Packing Material 3	-do-					
Packing Material 4	-do-					
Packing Material 5	-do-					

Table 50

Consumption of Key Packing Materials per MT of Finished Products for Previous 5 Years

Particulars	Finished Products	Unit	F.Y. 2017-18	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
Packing Material 1	Finished Products 1	₹/MT					
Packing Material 2	Finished Products 2	-do-					
Packing Material 3	Finished Products 3	-do-					
Packing Material 4	Finished Products 4	-do-					
Packing Material 5	Finished Products 5	-do-					

6.3.16 Audit of Sales Value

Following checklist should be kept in view to audit sales of products:

- More focus should be on products of A category and B category in terms of sales value (Refer Table 51).
- Check whether efforts have been made to increase sales realisation to absorb any increase in variable cost so that contribution of product or net margin is maintained (Refer Table 54).
- Check whether efforts have been made to procure more orders for product/products having higher contribution (Refer Table 51 & 54).

- Check whether company has diverted resource allocation from high volume/low contribution products to high contribution products (Refer Table 51, 52 & 54).
- Check whether there is any expansion of production capacity for product/products enjoying higher contribution (Refer Table 54 & 56).
- Check that there is a proper balance between the opening stock, production, sales and closing stock in order to ensure no unnecessary locking up of working capital in terms of closing stock (Refer Table 55).
- Check that any increase in production capacity has resulted in increase in sales quantity without affecting corresponding sales realisation (Refer Table 52, 53, 54 & 56)

Table 51

Product wise Sales Value & % Share in Total Sales Value for Previous 5 Years

	F.Y. 2017-18		F.Y. 2018-19		F.Y. 2019-20		F.Y. 2020-21		F.Y. 2021-22	
Products	**₹ Crore**	**%**	**₹ Crore**	**%**	**₹ Crore**	**%**	**₹ Crore**	**%**	**₹ Crore**	**%**
1										
2										
3										
4										
5										
TOTAL										

Table 52

Product wise Sales Quantity (in MT) for Previous 5 Years

Products	F.Y. 2017-18	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
1					
2					
3					
4					
5					

Table 53

Product wise Sales Realisation (₹/ MT) for Previous 5 Years

Products	F.Y. 2017-18	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
1					
2					
3					
4					
5					

Table 54

Product wise Sales Realisation & Variable Cost of Key Products (In ₹/MT)

	F.Y. 2018-19		F.Y. 2019-20		F.Y. 2020-21		F.Y. 2021-22	
Products	Sales Realisation	Variable Cost	Sales Realisation	Variable Cost	Sales Realisation	Variable Cost	Sales Realisation	Variable Cost
1								
2								
3								
4								
5								

Table 55

Inventory Balancing of Each of Finished Product

Products	Unit	Opening Stock	Production	External Sales	Internal Transfers	Closing Stock
1						
2						
3						
4						
5						

Table 56

Product wise Capacity Utilisation for Previous 5 Years

Products	Capacity Utilisation	F.Y. 2017-18	F.Y. 2018-19	F.Y. 2019-20	F.Y. 2020-21	F.Y. 2021-22
1	(%)					
2	-do-					
3	-do-					
4	-do-					
5	-do-					

Overall Checklist of the Cost Audit Programme

An overall checklist of the programme is drawn up for reader's guidance:

SI. No.	Planning Phases	Action to be taken	Comments
1.	**Familiarisation with the company:**		
(a)	Nature of business and industry	Acquire the previous years' Annual Reports and Accounts (at least 5 years)	The specific business objectives shall also be checked and notes kept in respect thereof, as contained in the Memorandum of Association.
(b)	Objectives of the company, e.g., maximisation of profits, cost reduction, quality improvement, customised production etc. Strategies of the company like market expansion, market diversification including mergers/ acquisitions, research including innovation, product diversification including product mix etc.	Keep notes	
(c)	Ownership, e.g. public or private, domestically controlled or MNC, major shareholders, management position of shareholders	Identify and keep notes on legal forms.	
(d)	Corporate structure, subsidiaries and affiliates ownership percentage and dates of acquisition	Keep notes	
2.	**Company records:** Memorandum and Articles of Association, foreign technical collaboration & agreement, other agreement deeds or contracts including that of inter- company transactions, secretarial records and registers.	Obtain copies. Keep notes	Only material information need to be obtained/notes kept in respect of that contained in the secretariat records and registers, since these contain much detailed information relating to different statutory matters.
3.	**Familiarisation with the Organisation of the Company:**		
(a)	Head of Finance/ Accounts/Costing	Keep notes	
(b)	Other Directors & Key Managerial Personnel		
(c)	Delegation of Financial and Administrative Authorities; Organisation control systems in existence including MIS, and cost control processes		

4.	**Familiarity with organisation profile:** Main or Central or Head Office Administration Offices other functional managements, e.g. Purchase, Sales, Production, Finance, etc. Background of Key personnel	Obtain detailed organisation chart showing functional relationships.	
5. *(a)* *(b)* *(c)* *(d)*	**Familiarity with the company policies:** Capitalisation: Debit/Credit lines- Short-term Seasonal capital requirements, Short-term obligations, Long-term obligations, especially capital arrangements in the last five years and their life cycle profiles. Products or Services: Main Product lines, By-product lines production sites Inter-company transactions policies Other important policies	Keep notes and Identify Obtain a chart Keep notes Identify	
6.	**Sales policy and sales management:** Pricing Policies – Home and export sales, Export Policy – Exporting countries, Export/Import Control Order –effect, Product image – place in national economy, Own country sales policy, Distribution policy, Credit and collection policy.	Keep notes and Identify	
7.	**Production planning and control:** Manufacturing process, factory layout, Product details, Production plans, scheduling etc. Plant capacities and other facilities.	Obtain the process flowcharts, planning scheduled, and charts for licensed and installed capacities.	
8.	**Accounting systems:** Financial accounting, Cost accounting, Integrated accounts, Internal control set-up, Stores accounting, Trial balance, details of Manual and/ or ERP base Accounting systems	Obtain the proce-dures manual, if any.	
9.	**Management information systems:** ♦ Budgets ♦ Standard costing	Obtain an outline of the schemes adopted, if any	
10.	**Internal audit system and Internal control:** Systems/Internal Audit Programmes, Internal Audit Manual	Obtain Internal Auditor's Manual and reports on areas covered.	

11.	**Cost records, statements and reports:**		
(a)	Cost accounting records and other related records	Obtain them from the cost department.	
(b)	Cost Statements and related Statements & documents		
(c)	Cost Accounts Manual		
(d)	Previous cost auditor's reports (if any)		

An Illustrative check-list of information to be obtained

A. One Time Information:

1. Organisation chart
2. Process of manufacture with Flow Chart
3. Blueprint of production area with machine locations
4. List of cost centres – production and utilities/services
5. Machine details of individual cost centres, Capacity of each machine/cost centre
6. Cost centre-wise/machine-wise deployment of workers
7. Product details – different types and products manufactured/produced
8. Details of any product manufactured under any technical collaboration, licence agreement, Terms of payment of royalty if any
9. Standard raw material composition of products/Bill of materials
10. Details of process chemicals, Indirect materials
11. Details of packing materials, types of packing, stocking units
12. Details of utilities/services – separately for each type of utility like Water, DM Water, Steam, Power, Compressed Air etc.
13. Details of pollution control measures, effluent treatment etc.
14. Details of products exported, export incentives, if any
15. Finance Costs – types of loans (term loans, working capital loans), terms of loan arrangements
16. Budgetary control system, if any, methodology of budget preparation and variance analysis
17. Cost accounting system and policy in vogue
18. System of capturing of expenses and income and booking thereof

B. Data required for the Audit Period:

1. Balance Sheet and Profit & Loss Account with schedules and Trial Balance
2. Details of Inventories – quantity and value
3. Expense analysis cost centre-wise for individual heads of expenses
4. Details of all raw materials consumed including process materials/chemicals showing receipts, issues and balances
5. Raw material and process materials/chemicals consumption details both in quantity and value for individual products – material-wise
6. Packing material details both in quantity and value for individual products
7. Quantitative details of individual products from issue of raw material to the product till finished packed stage showing product-wise work-in-progress at each stage of production and finished stock details
8. Details of scrap/wastage generated at each stage of production. If the waste/scrap is recycled in the production process, quantitative adjustment thereof
9. Details of utilities self-produced/generated – utility-wise
10. Details of utilities consumed by user departments/cost centres in quantity including utilities purchased, if any
11. Cost centre-wise expense analysis in respect of individual heads of expenses
12. Cost centre-wise machine utilization details
    (a) Down time details – normal and abnormal
    (b) Product-wise running hours, production in quantity
13. Product-wise sales analysis showing domestic and export sales separately in quantity and value
14. Basis of factory/production overheads and other overheads allocation and apportionment
15. Statutory returns of GST and other statutes

Cost Audit Documentation, Audit Process and Execution

7

This Module includes:

Cost Audit Documentation, Audit Process and Execution

SLOB Mapped against the Module

1. To gain in-depth knowledge about the statutory provisions of Companies (Cost Records and Audit) Rules to ensure adherence to the regulations in conducting cost audit. (CMLO 4a, b)
2. To develop detail understanding of Cost Accounting and Auditing Standards to ensure appropriate evaluation of cost records maintained. (CMLO 4a, b)

Module Learning Objectives:

This module discusses about how 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. The Cost Auditor shall prepare audit documentation that is sufficient to enable another Cost Auditor undertaking a peer review to understanding. After studying this module, the students will be able to –

- Enumerate the relevant Cost Audit Documentation
- Know the steps of Audit Process and its Implementation

Introduction

7

Before starting Cost Audit, the Cost Auditor should be familiar with all documents to be audited by him/her. He/she should also be knowledgeable about processes of Cost Audit as well as the practical steps of the Audit Process.

Cost Audit Documentation

7.1

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.

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.

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.

AUDIT STAGES

The stages of an audit of cost statements are:

1. Planning
2. Performing
3. Reporting

Figure below gives a pictorial view of these three stages.

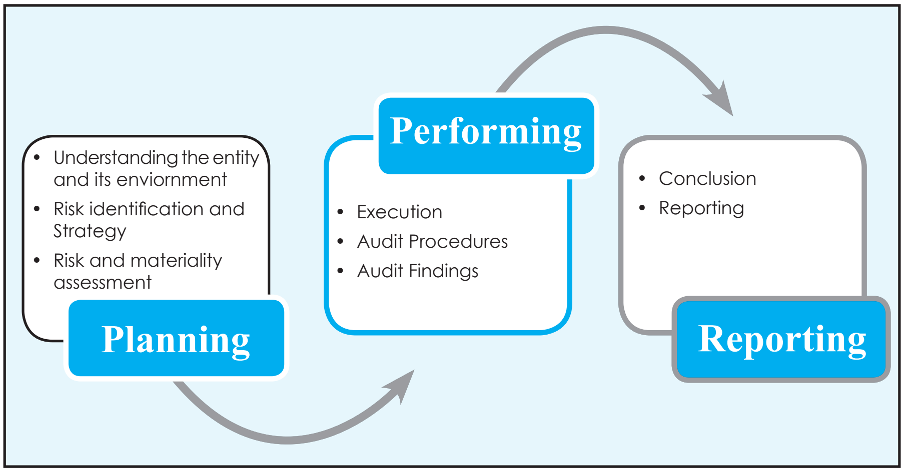


Figure 7.1: Overview of the Cost Audit

Once the entity's acceptance or continuation decision has been made, the first stage is planning the audit. Broadly, the planning stage involves: (i) gaining an understanding of the client, (ii) identifying factors that may impact the risk of a material misstatement in the cost statements, (iii) performing a risk and materiality assessment, and (iv) developing an audit strategy. The risk of a material misstatement is the risk that the cost statements include a significant error or fraud. The execution stage (or performing stage) of the audit involves the performance of detailed testing of internal controls and substantive testing of cost accounting policies & procedures. The reporting stage involves evaluating the results of detailed testing in light of the cost auditor's understanding of the entity and forming an opinion on the fair presentation of the entity's cost statements as a whole.

Planning an Audit - First Stage

"It is well said that a well planned audit is almost half way done"

The planning stage involves determining the audit strategy as well as identifying the nature and the timing of the procedures to be performed. This is done to optimize efficiency and effectiveness when conducting an audit. Efficiency refers to the amount of time spent gathering audit evidence. Effectiveness refers to the minimization of audit risk. A well-planned audit will ensure that sufficient appropriate evidence is gathered to minimize risk of material misstatement at the cost statement level.

Performing an Audit – Second Stage

The performance, or execution, stage of the audit involves detailed testing of internal controls, material consumptions, cost accumulation, allocation, apportionment, and absorption. If an auditor plans to rely on their client's system of internal controls, they will conduct tests of controls. Cost auditor will conduct detailed substantive tests of audit procedures for the period and detailed substantive tests of consumptions and balances recorded at the period end. This detailed testing provides the evidence that the cost auditor requires to determine whether the cost statements have been fairly presented.

Concluding and Reporting on an Audit – Final Stage

The final stage of the audit involves drawing conclusions based on the evidence gathered and arriving at an opinion regarding the fair presentation of cost statements. The cost auditor's opinion is expressed in the cost audit report. At this stage of the audit, a cost auditor will draw on their understanding of the client, their detailed knowledge of the risks faced by the client, and the conclusions drawn when testing the entity's controls, transactions, cost heads, item of cost and related disclosures.

Audit Process

7.2

The Processes of Cost Audit can be explained through the following table that shows connection between Activity ⟶ Purpose ⟶ Documentation at the planning, performing and reporting phases.

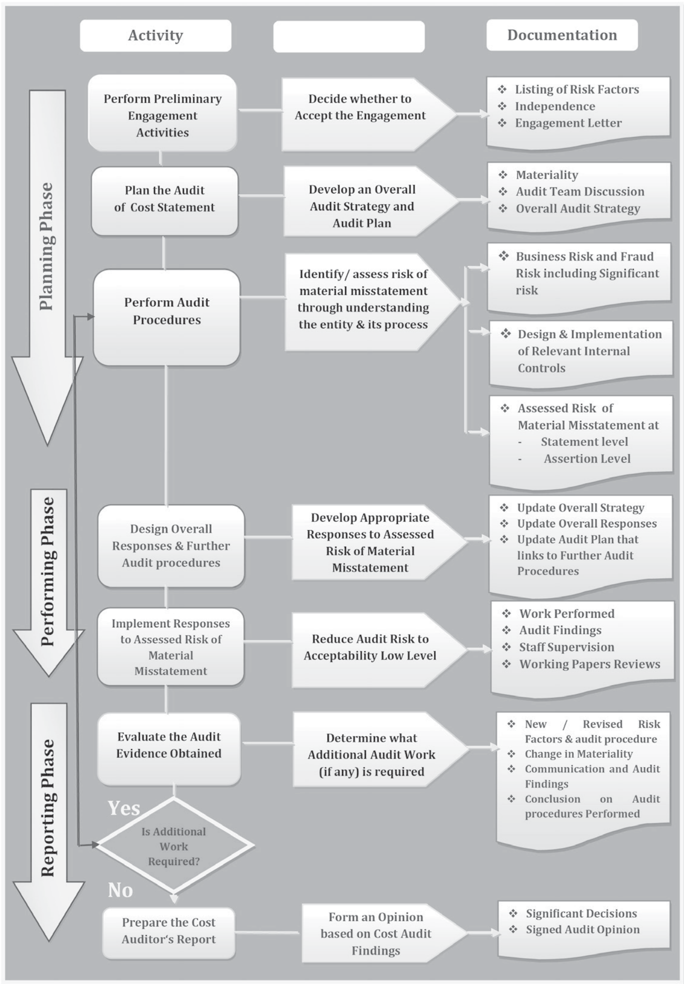


Figure 7.2: Audit Process

Practical Steps of Audit Process 7.3

The points given below summarize what a cost auditor does when he undertakes a cost audit:

Step-I : Objectives of Audit and Management Outlook

The cost auditor should understand whether the audit is meant only for meeting with the statutory requirements or the management does have any other expectations or outcomes in its mind from the cost audit, such as

(a) cost optimization or cost reduction

(b) checking parameters of operational efficiency of a unit or any utility or any other function or department

(c) suggesting product diversification or changed product-mix

(d) identifying profit making or loss making products

(e) suggesting changed marketing strategies; market expansion; market diversification

(f) complete review of business strategies

Step-II : Pre-conditions

1. The cost auditor should fully understand the

   (a) Objectives of cost audit

   (b) Area, nature and scope of audit

   (c) Number of cost auditors appointed

   (d) The applicable reporting framework

   (e) The reporting period

   (f) The statutory deadlines

2. The auditor should ascertian whether the Management understands its scope of work and responsibilities for

   (a) maintenance of cost records & producing them to the cost auditor;

   (b) preparation & presentation of cost statements & other details as per the applicable reporting framework, and in compliance with the cost accounting standards;

   (c) selection and consistent application of appropriate cost accounting policies;

(d) allowing access to the auditor all information, including the books of accounts, vouchers, cost records, other records, documents, and other matters of the company, which are relevant to the preparation of the cost statements;

(e) providing additional information that the cost auditor may request from the management for the purpose of cost audit;

(f) allowing unrestricted access to persons within the company from whom the cost auditor determines and obtains cost audit evidence; and

(g) giving proper management representation.

3. The auditee and the cost auditor decides the audit fee and payment schedule; and finally, the cost auditor gets an engagement letter. All these are called pre-conditions of audit.

Step-III : Understanding the Company's Business

The cost auditor is required to understand the company's business, its corporate structure and various systems followed. The company related details and other general details include:

(a) The company, its nature of activities, its size, product profile, unit locations, ownership structure, management structure, organisational structure, marketing set-up, accounting set-up, etc.

(b) The nature of the industry or the sector in which client company operates

(c) The applicable regulatory framework, financial reporting framework and cost reporting framework

(d) The company's production process, product details, joint or by-products, outsourcing, if any

(e) Details of subsidiaries, associates and joint ventures

(f) Key personnel in all departments including in Finance, Accounts, Costing, IT, Administration, Production, Purchase, Sales, etc

(g) Purchase policy, sales policy, pricing policy, export/import policy

(h) Inventory receipt, storage, issue & pricing policies; physical verification system; inventory management system

(i) Related parties and nature of transactions with them

(j) Indirect tax structure, as applicable

(k) Internal Control Systems followed by the company

(l) Internal Audit System, its scope & adequacy of coverage as well as effectiveness

(m) Accounting Systems & Policies followed by the company

(n) Cost Accounting System & Policies followed by the company

(o) Company's MIS system, risk identification & management system

(p) IT structure followed for financial accounting and for cost accounting, IT policy, control checks, authorization checks, IT data security policy

(q) Previous auditor's report

Step-IV : Planning the Audit

Planning the audit include:

(a) Timing [dates] and duration [no. of days] of audit period including plan to visit the unit(s)

(b) Level and number of audit personnel to be deployed including supervision and review of work done by the audit team

(c) Audit partner to be deployed and his expected days & dates

(d) Drawing up an overall audit plan and audit strategy – this will act as guide to the audit team

(e) Deciding the materiality levels & sampling levels

(f) Formulating appropriate audit procedures

- ➢ Management Representation
- ➢ Management Assertion
- ➢ Test of Controls
- ➢ Test of Details
- ➢ Substantive procedures
- ➢ Analytical procedures

(g) Formulating risk assessment strategies & procedures i.e. methodology to measure material misstatements

(h) Planning for discussions with key personnel of the company, previous cost auditor, statutory financial auditor, and internal auditor

(i) Key inputs for planning are

- ➢ results of preliminary activities as specified above
- ➢ knowledge from previous audits and other engagements with the company
- ➢ knowledge of business
- ➢ nature and scope of the audit
- ➢ statutory deadlines and reporting format
- ➢ relevant factors determining the direction of the audit efforts
- ➢ nature, timing and extent of resources required for the audit

(j) Documenting the Audit Plan and sharing it with the company

(k) Ensuring adherence to the Guidance Manual for Audit Quality

Step-V : Execution of Audit

(a) Performing the audit checks and procedures, as planned

(b) Collecting all required audit evidence enabling the auditor to form his opinion

(i) validating their relevance and reliability

(ii) checking their accuracy, completeness and sufficiency

(iii) checking the source and consistency

(c) Preparing draft observations & discussing with key management personnel

(d) Preparing final audit report

Step-VI : Audit Documentation

(a) Documenting audit plan, audit strategy

(b) Documenting all working papers

(c) Documenting all the audit evidences

(d) Documenting draft observations and discussions

(e) Documenting final report

(f) Preserving all documents in a bound folder/filing for the prescribed period.

Preparation and Filing of Cost Audit Report

8

This Module includes:

Preparation and Filing of Cost Audit Report

SLOB Mapped against the Module

To focus on basic cost information, appropriately computed cost centre wise, system-based cost data support for decision-making processes. (CMLO 5a)

Module Learning Objectives:

Every Cost Auditor or every Lead Cost Auditor on behalf of all the Cost Auditors in a Company, has to file their Cost Audit Report and other documents with the Central Government as per sub-section (4) of section 233B of the Act, and rules made there under. Companies operating in the above mentioned industries and meeting the criteria, should have cost auditors to conduct their cost records and file in XBRL format and those are discussed in the module. After studying this module, the students will be able to –

- Identify the Critical Elements of Cost Audit Report and Related Evidences
- Ascertain and understand a Qualified Audit Report and an Adverse Audit Report
- Perform the Filing of Cost Audit Report to MCA in XBRL Format

Introduction 8.1

A Cost Auditor is required to submit his report in Form CRA-3 which is required to be prepared on the ,basis of data and information available in the cost accounting records and other data maintained by the company in accordance with CRA-1 of the rules. The format of the Cost Audit Report and Annexure thereto has been prescribed by the Companies (Cost Records and Audit) Rules, 2014 [amended as on 15th October, 2019].

The primary responsibility of preparation of the Annexures to the Cost Audit Report lies with the company. However, the same should be prepared in consultation with the cost auditor to ensure that the reporting conforms to the prescribed rules and at the same time the report is in conformity with the cost accounting records.

If, as a result of the examination of the books of the accounts, the cost auditor wants to point out any material deficiency or give a qualified report, he shall indicate the same against the relevant paragraph (i) to (vi) in the prescribed form of the cost audit report giving details of discrepancies noticed by him. It implies that the cost auditor should put his comments in the respective paragraphs of the cost audit report itself.

The report, suggestions, observations and conclusions given by the cost auditor shall be based upon data duly verified, and reference to which shall be made in the report and shall be included after an opportunity is given to the company to comment on them. The cost auditor is required to point out any deficiency or reservation to the management first. In case he is satisfied with the response of the management, he may decide to drop the issue. However, if he is not satisfied with the explanation of the management, he may decide to qualify the report to that extent.

Critical Elements of Cost Audit Report and Related Evidences (Physical and Digital)

8.2

The Institute of Cost Accountants of India defines 'cost audit' as an audit of efficiency of minute details of expenditure while the work is in progress and not a post-mortem examination like Financial audit, which is a 'fait accompli'.

A cost audit comprises the following:

Verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing technique. Examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objective.

Cost audit **helps in detection of errors and frauds**. The management gets accurate and reliable data based on which they can make day-to-day decisions like price fixation, margin, continuity or outsourcing, make or buy etc. It helps in cost control and finding avenues of cost reduction.

The Cost Audit and requirement of details are informative for better and clear understanding of the Users of Report. CRA – 1, prescribes 30 (thirty) broad headings for detailed cost accumulation. The Headings are:

1. Material Cost,
2. Employee Cost,
3. Utilities,
4. Direct Expenses,
5. Repair and Maintenance,
6. Fixed Assets and Depreciation,
7. Overheads,
8. Administrative Overheads,
9. Transportation Cost,
10. Royalty and Technical Know-how,
11. Research and Development Expenses,
12. Quality Control Expenses,
13. Pollution control Expenses,

14. Service Department Expenses,
15. Packing Expenses,
16. Finance Cost,
17. Any other item of Cost,
18. Capacity determination,
19. Work-In-Progress,
20. Captive consumption,
21. By-product and Joint product,
22. Adjustment of cost variances,
23. Reconciliation of Cost and Financial Account,
24. Related Party,
25. Expenses or Incentives on Exports,
26. Production Records,
27. Sales Records,
28. Cost Statements,
29. Statistical Records,
30. Records of Physical verification.

Accordingly, the prescribed Format (Ref. CRA -3) i.e the Cost Audit Report includes Unit-wise, Product/Service-wise Cost Statements and Schedules, deviation for the same need to be reported. Part – D of CRA-3 is a measure towards performance orientation which includes the following aspects :

(a) Product and Service profitability statement

(b) Profit reconciliation

(c) Value addition and distribution of earnings

(d) Financial position and ratio analysis

It is needless to point out that appropriate documentation (Working papers, Files, process document in physical or electronic form/ mode) and additional supporting, if any, to be to be filed along with XBRL.

The above requirements are to accomplish the objectives of cost audit:

(i) To verify that the cost accounting records (or costing books) are accurate.

(ii) To certify that costing principles have been fully adhered to in maintaining cost accounts.

(iii) To find out whether the predetermined cost accounting procedures and processes have been strictly followed by the management.

(iv) To detect errors and frauds, which might have been committed intentionally or otherwise in preparing cost accounts.

(v) To check whether each item of expenditure involved into the relevant components of goods manufactured has been properly incurred.

(vi) To see how far the existing practices of cost records are helpful for the management to take decisions.

(vii) To disclose the deficiencies or inefficiencies in the use of material, labour and machines with a view to assist the management.

(viii) To assist the external auditor in conducting detailed checking by reducing the volume of audit work through the use of internal cost audit system.

(ix) To exercise moral check on the cost accounting staff and to attain efficiency in cost accounting systems and procedures.

The following critical elements must be stated in the cost auditor's report:

(a) Whether the machines and labour remained idle during the year because of the shortage of raw materials.

(b) Whether a large quantity of raw materials were stocked which remained unutilized for a long time, thereby locking up the working capital of the company.

(c) He should state whether the cost records maintained by the company were adequate for the purpose of audit.

(d) He should state whether the broad policy laid down by the management was faithfully followed.

(e) The report should concentrate more on the cost of production, comparative profitability, and operating efficiency of different lines in which the company is engaged rather than the routine statistical or financial information.

(f) The cost auditor should state if there has been a rise in the cost of production as compared to that of the previous year. He should analyse the causes of such a rise. He should clearly point out where the problem originates from.

(g) The report should state if there has been any wastage during the process of manufacture and how it could be avoided.

(h) The cost auditor should also mention the areas in which it is possible to reduce the cost of production.

(i) He should state whether or not the cost statement reveals a true and fair view of the cost of production.

Every Company covered under this rules, within a period of 30 days from the receipt of the cost audit report to submit /upload in XBRL Format the detail and report with full information and explanations on every reservations or quantification contained therein in CRA-4 as specified in the Companies Filing of Documents and Forms in XBRL Rules 2015 in MCA Portal. This helps Companies to integrate Financial and Cost datum across all operational areas for better control.

Qualified Audit Report

8.3

A qualified audit report is given by the cost auditor when the cost statements are materially misstated due to misstatement in one particular cost element, class of transaction or disclosure that does not have pervasive effect on the cost statements and when the cost auditor is unable to obtain audit evidence regarding particular cost element, its allocation and apportionment, class of transaction or disclosure that does not have pervasive effect on the cost statements.

A qualified audit report issued when the cost auditor encounters any of these situations which do not comply with the generally accepted cost accounting principles and is not in conformity with the principles laid down in CRA-1.

8.4 Adverse Audit Report

An adverse audit report on the cost accounting records and cost statements of a company means that the cost statements are materially misstated and such misstatements have pervasive effect on the cost of production, cost of sales and margin of the products. An adverse opinion is issued when the cost auditor determines that the cost statements of an auditee are materially misstated and when considered as a whole, do not conform with the generally accepted cost accounting principle. It is considered the opposite of an unqualified or clean opinion, essentially stating that the information contained is materially incorrect, unreliable, and inaccurate in order to assess the company's operational results.

Filing of Cost Audit Report to MCA in XBRL Format (As per TAXONOMY)

8.5

Before we discuss about cost audit report, let us know in detail about XBRL, its Glossary and Format as per Costing Taxanomy.

Rule 6(6), of the Companies (Cost Records and Audit) Rules, 2014, as amended by the Companies (Cost Records and Audit) Amendment Rules, 2016, vide Gazette notification No: G.S.R. 695(E), dated 14th July, 2016 mandates that:

"Every company covered under these rules shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in Form CRA-4 in Extensible Business Reporting Language format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.".

Accordingly, all the cost audit reports have to be filed online, with MCA, in XBRL format, attached to the prescribed Form CRA-4. XBRL international, and the MCA portal, provide detailed information about XBRL and its applications. The necessary information and procedure for understanding XBRL in general and filing of cost audit report in that format, as extracted from these portals is briefly recited below:

XBRL is the open international standard for digital business reporting, managed by a global not for profit consortium called "XBRL International". XBRL is used around the world, in more than 50 countries. Millions of XBRL documents are created every year, replacing older, paper-based reports with more useful, more effective and more accurate digital versions. The change from paper, PDF and HTML based reports to XBRL is like the change from film photography to digital photography, or from paper maps to digital maps.

XBRL makes reporting more accurate and more efficient. It allows unique tags to be associated with reported facts, allowing:

- people publishing reports to do so with confidence that the information contained in them can be consumed and analysed accurately.
- people consuming reports to test them against a set of business and logical rules, in order to capture and avoid mistakes at their source.
- people using the information to do so in the way that best suits their needs, including by using different languages, alternative currencies and in their preferred style.
- people consuming the information to do so confident that the data provided to them conforms to a set of sophisticated pre-defined definitions.

Comprehensive definitions and accurate data tags allow the:

- preparation
- validation
- publication
- exchange
- consumption
- analysis

of business information of all kinds.

Information in reports prepared using the XBRL standard is interchangeable between different information systems in entirely different organisations. This allows for the exchange of business information across a reporting chain. People that want to report information, share information, publish performance information and allow straight through information processing all rely on XBRL.

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.

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.

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.

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.

Costing Taxonomy

Costing Taxonomy is a dictionary of all cost elements required in the cost audit 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.

Conversion of cost audit report 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 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.

Process 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.

STEPS FOR FILING COST AUDIT REPORT IN XBRL FORMAT ON MCA PORTAL

1. Creation of XBRL instance document

The first step for creating the instance document is tagging of the XBRL taxonomy elements with the information in the Cost audit report of the company by means of mapping of the taxonomy elements with the Cost audit report. This converts the report into XBRL form. We need to have a tool to create an 'xml' file and convert it into an instance document. There are several vendors, who provide and sell this application, that has to be acquired for the purpose.

Mapping is the process of comparing the concepts in the Cost audit report to the elements in the published taxonomy, assigning a taxonomy element to each costing concept published by the company. Once the tagging of Cost audit report elements with the published taxonomy elements is done, the next step is to create the instance document. An instance document is a XML file that contains business reporting information and represents a collection of costing information and report-specific information using tags from the XBRL taxonomy. It is to be noted that no extensions to the core Taxonomy will be allowed. Separate instance documents need to be created for the Cost Audit report, for the periods prior to and beginning after 01.04.2014.

Once the instance document has been prepared, it needs to be ensured that the instance document is a valid instance document and all the information has been correctly captured in the instance document. MCA Validation Tool provides for 'human readable' PDF printable form as well as a view of the instance document.

2. Download XBRL validation tool

A separate tool has been provided on the MCA XBRL portal for validating the generated XBRL instance document. Validating the instance document with the MCA XBRL validation tool (for costing taxonomy) is a pre-requisite before filing the Cost audit report on MCA portal.

You are required to download the tool from the portal and validate the instance document before uploading the same. The MCA XBRL validation tool (for costing taxonomy) can be downloaded from the XBRL website of the Ministry (www.mca.gov.in/XBRL).

Before Validating an Instance document, the applicable taxonomy is to be selected by the user from the drop down option 'Taxonomy'. In case the user is under LAN network, then he/she is required to click the link 'Proxy Settings' under 'Taxonomy' menu in the tool to enter the Proxy Host and Port along with user name and password. This is to setup the Internet connection, required to download the taxonomy through the XBRL Validation Tool.

3. Load the instance document

To load the instance document, you need to click the open button, select the instance document and open it. You need not exit the tool to load another instance document just click on 'open' again in the menu bar to open the next document. The detail of the company is available under the General Information tag in the XBRL viewer.

4. Validate the instance document

The next step is to validate the instance document. The following validations shall be performed by the tool-

- Validating that the instance document is as per the latest and correct version of taxonomy prescribed by MCA
- All mandatory elements have been entered
- Business Rules as specified by MCA
- Validations relating to XBRL Technical Specifications as per taxonomy

In case the instance document is not properly created, then the tool will through up the list of errors, in a separate window, and they need to be corrected and validated again for successful uploading of the report. The List of common errors and interpretation of validation errors as provided in Annexures –I & II, which are given at the end of this chapter.

5. Pre-scrutiny of the instance document

Once the instance document is successfully validated from the tool, the next step is to pre-scrutinise the validated instance document with the help of the same tool using a working internet connection. In the Pre-scrutiny, the server side validations (i.e. validations which are to be validated from the MCA21 system) shall be performed, using the MCA21 data base.

6. Convert to PDF and verify the contents of the instance document

Once the instance document has been successfully pre-scrutinized, the next step is to generate PDF by using 'Export to PDF' functionality in the tool to verify the final instance document. This step is essential to ensure that the textual information entered in the instance document is clearly readable. The company and the cost auditor/ cost accountant can use this feature to verify the accuracy of the instance document.

In case there is PDF conversion error or the size of the converted PDF is zero kilobytes, then check the textual information entered in the instance document and follow the html guidelines provided under the technical specifications to correct the instance document and validate and pre-scrutinize again.

7. Attach instance document to the Form CRA-4

Form CRA-4 is available on the MCA portal for filing in XBRL instance documents by the Company. First the Form has to be filled up correctly and thereafter, the validated and pre-scrutinised instance document for Cost Audit Report has to be attached to Form CRA-4.

8. Submitting the Form CRA-4 on the MCA portal

After the form is correctly filled, it is required to pre-scrutinize and then sign the form [with a valid digital signature of the person authorized by the board resolution] and then upload the same as per the normal e-Form filing process.

XBRL CONVERSION AND FILING ERRORS AND INTERPRETATION

Once the validation has been performed the list of errors, which may have occurred will be displayed by the tool. An "error" indicates that a mistake has happened, either in respect of the value of an item, or the format in which the value of the item is to be entered, not the value of an item, not matching with the values as in the data base of the MCA. E.g.: Date format 10-05-2021 is not the correct format, and it has to be entered as 10/05/2021.

A. List of common errors [Annexure – II]

Following are the few errors that may crop up in the process:

(1) Issue in net connectivity. Please check your connection.

(2) The PDF is not getting generated or PDF generated is of zero kilobytes in size.

(3) The format of the date entered is not as per the valid format.

(4) For Boolean data types 'Yes' or 'No' has been entered.

(5) 0-100 entered for Percentage Data Type fields

(6) Wrong Currency code like Rs entered.

(7) Mandatory fields have not been entered.

(8) In case the mandatory line-items of a table are not entered in the instance document.

(9) The elements are not entered for any abstract.

(10) The elements are not entered for ordered explicit members.

(11) In case of mandatory table, there is no element present.

(12) The value of element should be provided in at least one of the dimensional member.

(13) All details for given product or activity group code should be provided.

(14) An element having dimensional relationship is invalid with respect to scenario element in the referenced context.

B. Interpretation of validation errors [Annexure – I]

The following the instructions have to be followed to interpret those errors –

- All the Element Names will be shown within single quotes, like-'QuantityOfMaterialConsumed'
- All the values will be shown within square brackets like- [In Employment]
- All the explicit members must come within curly brackets like-{MaterialConsumed1Member}
- All the axis names will be shown within parenthesis like-(IdentificationOfProductOrActivityGroupAxis)
- Errors which start with "cvc" are those which have occurred for the reason that the instance document generated is not as per valid taxonomy schema and the XML is not properly formed.

  This is a basic level error and the software vendor needs to be contacted for these errors like: cvc-complex-type.2.2. [The schema validator used is Xerces from Apache (http://xerces.apache.org/) which is Industry Standard Schema Validator]
- In case of Costing Taxonomy, in some of the errors you might see terms like: "table", "axis", "explicit-members" and "typed-members".

The same has been explained below for better understanding:

- Table (Hypercube): is a collection of axes (dimensions) when grouped together define an entity.
- Axis (Dimension): is a category used to analyze the information about the items having relationship with a table.
- Explicit-members: are domains that are used to express an explicit dimension. It is an element defined in the taxonomy.
- Typed-members: are domains that are used to express a typed dimension. The dimension value for simple type domain is decided by the user creating instance document.

Solved Questions:

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).

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.icmai.in) 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. 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.

15. What process is to be followed to file the reports in XBRL Format?

The following steps have to be followed in sequence to file the reports in XBRL Format:

- 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 an XBRL instance document.
- Download XBRL validation tool.
- Validating the instance document with the validation tool of MCA.
- Pre-scrutiny of the instance document.
- Use available tool to convert the instance document to a human readable pdf format and check correctness of data.
- Attaching the instance document to the e-Form and filing on MCA portal.

16. Is it 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.

17. 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.

18. 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.

19. 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 I-XBRL and A-XBRL are to be used for filing of Cost Audit Report and Compliance Report respectively in the XBRL format.

SECTION - B
MANAGEMENT AUDIT

Basics of Management Audit

9

This Module includes

Basics of Management Audit

SLOB Mapped against the Module

To obtain in-depth knowledge about management audit processes to identify the scope of improvement at various functional areas of the organisation. (CMLO 2a, b)

Module Learning Objectives:

Management Audit is a future-oriented, independent, and systematic evaluation of the activities of all levels of management for the purpose of improving organisational profitability, efficiency and increasing the attainment of the other organisational objectives through improvements in the performance of the management function, achievement of program purpose, social objectives and employees' development. After studying this module, the students will be able to –

- Understand the Nature and Scope of the Management Audit.
- Understand the need and importance of Management Audit.
- Enumerate Management Audit Process and its functions.
- Identify the Role of CMAs in the Management Audit Process.

Basics of Management Audit

9

Two words can exactly answer the most pertinent question-why management audit is necessary for an organisation? They are **efficiency** and **profitability**.

There may be loopholes in the organisational structure, methods, and practices in the management of a business organisation that needs to be identified. An independent person (sometimes an internal employee) is assigned for the task who takes a neutral, non-biased view to point out the lapses in management techniques. This happens to be the prime aim of management audit.

In short, the role of a management auditor is to provide a critical appraisal of the business structure. The critical analysis thus becomes a pointer to necessary actions required to be taken to sort out the lapses, thereby promoting the overall efficiency of the workforce and enhancing business profitability.

Definition

9.1

Management Audit means an impartial evaluation of management performance beyond that implicitly provided by historical results.

- Burton

Management Audit may be more specifically defined as being an investigation of a business from the highest level downwards to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with the outside world and the most efficient organisation and smooth running internally.

- Leslie Howard

The Management Audit may be defined as a comprehensive and constructive examination of an organisation structure of a company, institution, or branch of Government, or any component thereof, such as division or department and its plan and objectives, its means of operation, and its use of human and physical facilities.

-William P. Leonard

Management Audit is a future-oriented, independent, and systematic evaluation of the activities of all levels of management for the purpose of improving organisational profitability and increasing the attainment of the other organisational objectives through improvements in the performance of the management function, achievement of program purpose, social objectives and employees' development.

- The Institute of Internal Auditors Inc.

A Management Audit is an independent review, analysis, and assessment of the competencies and capabilities of a company's management in carrying out the corporate objectives. The purpose of a Management Audit is not to appraise individual executive performance but to evaluate the management team's effectiveness with respect to work in the interests of all the stakeholders, maintain good relations with the employees, and uphold reputational standards.

There is as such no formal management audit committee for the board of directors. However, the board members assess the performance of management team individual executives by using quantitative information on like organic sales, EBIT margins, segment margins, operating cash flows, cost rationalization and EPS and unquantifiable or intangible elements like efforts toward acquisition, integration, etc.

A Management audit is an assessment of how well an organisation's management team is applying its strategies and resources. A Management Audit is carried out by internal team as well as by outsourced agency, who evaluates whether management team is working in the interests of shareholders, employees, and the company's reputation.

Area of Management audit is beyond conventional audit. It is an audit of the overall performance of management. It covers planning, organising, coordination, processes and control, etc. Management audit detects and diagnoses the problem and suggests various means to avoid and resolve the problems. Management audits are often conducted before mergers, restructurings, bankruptcies, and succession planning etc.- they can identify weaknesses in a company's management.

Objectives of Management Audit:

- It helps management in setting appropriate decision making.
- It suggests management in getting desired results and revealing any defects and irregularities in the process of management.
- Management audit helps the management in the effective discharge of their duties and responsibilities.
- It helps in identification of process gaps and strengthening of controls.
- Suggests appropriate cost effective implementation of plans.

Nature and Scope

9.2

Management Audit might address many important issues like:

- Appropriateness of Organization Structure and reporting
- Coordination among Departments to accomplish management objective
- Suggesting a 'risk management' structure for better governance
- Stakeholder management
- Project evaluation including growth budget and appropriation methodology

Management Audit encompasses all areas where management decision making and actions are involved.

Qualities of Management Auditor:

The management auditor should have the following qualities:

- A management auditor should have good knowledge and experience of all Managerial Functions.
- An Auditor should have good knowledge of financial, cost statements analysis techniques.
- She/he should know about economics and business laws, etc.
- Understanding of Organisation structure and decisions taken by management the, working of the organisation and its problems is also required.
- Thorough understanding of all processes and control aspects.
- She/he should know and understand the objectives of the organisation very well.
- She/he should understand planning, budgets, rules, and procedures to be applied in management reviews.
- She/he should be well-versed with the entire production process.
- She/he should have enough knowledge and experience to understand the reason behind the lack of coordination between different departments.
- She/he should have the quality of giving practical and achievable solutions to the problems in the organisation.

Need for Management Audit and Reporting

9.3

The reports on matters of policies and their implementation are very important to improve effectiveness, the efficiency of the management. Management Auditors advise the management on various matters related to the performance of functions/operations as well as of the organisation as a whole. It can be said management audit helps in improving the performance and efficiency of management.

Management audit is not compulsory under any law. No specific qualifications have been prescribed for the Management Auditor.

Advantages of Management Audit:

- It helps management to make plans and policies with more objectivity.
- It is beneficial for achieving the set objectives of the management.
- It is helpful to management by providing input on process gaps and way forward to improve, evaluate the performance of management.
- It is helpful to strategies resources and improvement planning.

Audit of Management Process and Functions

9.4

Management Audit Programme means the planning of the outlines for the whole process and procedures from the beginning to the end.

The programme can be designed in the following way:

- To study the organisation structure
- To understand decision making process and line of command.
- To have a detailed understanding about discussion with the top management about the objectives and the plans.
- To study the current policies adopted to achieve the desired objectives.
- To discuss and decide the areas of improvement post review of operations.
- To give recommendations for improvements required in areas of operation and decision making processes.
- To study whether the control system of an organisation is in place, adequate and effective.

The report submitted by a management auditor should provide proper assessment of the management decisions and on ground implementation along with implications therefor. The management auditor should cover the following areas in his report:

- She/he should highlight the areas of weakness and the suggest for improvement.
- She/he should also review the Stakeholder relationship and benefits passed on to them for maintaining a cordial and desired relationship (Stakeholder management). She/he should cover the methods and procedures of production.

Functions of Management Audit:

Management audit is a difficult and complex task. It performs the following functions:

1. Management audit requires a tight rope walking with clear, identified roles to perform while dealing with top management.
2. It examines all the scope of work with respect to areas for review. In this regard, the auditor should help management in pinning down and inter-relating the performance standards and measurements with the ownership of responsibilities.
3. Management audit provides valuable suggestions to the management after proper evaluation.

Establishing Reliability of Information

9.5

Eventually the success as Management Auditor depends on the role played by the Team. Journey from 'Police Man' as normally conceived, toward 'Policy Man' depends to some extent also on the Management of the Organisation. 'Tone at the top' is very much required from management to help the management auditor in performing and accomplishment of management objectives/ desired goal. Despite having many advantages of management audit in the modern business world, it has faced criticism too. According to managers and accountants, it is just a vague concept that serves no material purpose. The management auditors usually pinpoint shortcomings of manager's in action, therefore they hesitate to take initiative. It is believed that the normal practice of managers is to keep their records up to date instead of improving efficiency and reducing costs.

Organisational culture is an important factor for getting/fulfilling desired objectives through management audit team. It is healthy for a business organisation to have a business audit from time to time. A business owner would get an insight into:

- Whether the management style is conducive to the business purpose?
- Whether the company management has effectively been able to control overall business operations?
- How good is the management team to nurture a healthy relationship with the employees and shareholders of the company?
- Is the management team able to uphold the company's reputation?

Management Audit primarily focuses on:

- Assessing existing management policies.
- Proper and rational utilization of resources.
- Assessing the efficiency and efficacy of tactics and strategies behind current business plans.
- Appraising overall team performance, rather than an individual.

Top Objectives of having a Management Audit are:

- Clearly defined prime objectives of the organisation.
- Ensuring a clear, lean and thin Organisational reporting structure. The setting of a well-defined organisational structure with clear-cut lines of reporting.
- Goal setting process aligned with business objectivity.
- Process benchmarking for improving effectiveness. Challenge existing rules and regulations to work out on effectiveness level.

- Suggesting improvement measures for giving an impetus to business performance in the forthcoming months/ periods.
- Suggesting ways to restructure the organisation and ensure high-quality service at all quarters.
- More effective resource utilization planning.
- Incorporating management information systems to reach production and work efficiency goals.
- Identification of weak points or managerial inefficiencies with respect to core functional areas of the business, namely finance, sales, and production.

Management Audit can address financial questions too, like:

- The management's role in the annual budgeting exercise of the company.
- Plan /Budget deviations and reason therefor.
- Existence of function-based approval prior to Finance accord.
- The compliance level of the current policies employed by the finance team of the company.

Role of CMAs in Management Audit

9.6

Management Audit not having any statutory obligation, however, the Cost Accountant can perform Internal Audit as per the Companies Act, 2013 as well as can perform Management Audit also. A Cost Auditor can not perform simultaneously the role of Internal Auditor.

A Management auditor should have the following specific qualities:

(i) Ability to understand and gauge business problems.

(ii) General understanding of the organisation and its various processes at pre and post approval stage.

(iii) Thorough understanding of the applicable Rules, Regulations and legal aspects. Expert knowledge on the principle of delegation of authority, management by objective, management by exception, management planning and control and the different budgetary systems, and those of internal control devices (viz. flow chart, the flow of work, analysis of work schedules, etc.).

(iv) General understanding of different Laws - General Laws, Company Law, Tax Laws FEMA, etc. that affect the functioning of the whole of the organisation.

(vi) Background knowledge and subject matter expertise viz. about - Engineering, Statistics, Costing, Management Accounting, Financial Accounting, Industrial Psychology, Managerial Economics, etc.

(vii) Focused, dynamic and result orientation. Tactfulness, perseverance, and lastly, pleasing and dynamic personality.

A Management Auditor may embrace the following aspects:-

Formulation of plan and policy:

She/he should ensure that “accounting, economic and other data needed by the management in constructing its basic policy framework” are provided supplied by the management services unit.

Decision-making process:

Validation of prior decisions, implementation gap and suggestion to re-design.

She/he should take into account the outcome of the decisions previously applied, and see that the decisions are based on management by objectives, management by exception, management information services.

Designing organisational authority structure:

She/he should assist in the flow of information among different functional managers (responsibility-wise).

Measuring and evaluating business performance:

She/he should concentrate on key functions or operations in the profit-making process.

Tax-planning and budgeting:

She/he should appraise the appropriateness of tax implications with respect to decision to invest/sell off, and those of different information and data needed for budgetary control and preparation.

Improving communication system:

Two-way communication provides better organisational culture. The management should ensure that decisions are cascaded down for proper implementation of objectives. The flow of communication also to move towards managers at the helm of decision making to ensure effective, timely and purposive decisions having buying in from rank and file as well as from managers of different levels of the Organisation.

A strong external communication channel is also a pre-requisite.

She/he should guide in the flow of internal communication (between various departments) to strengthen the organisation structure, and in the flow of external communication (e.g., market conditions, legal requirements, social accounting, competitors' standing, economic trends, etc.) to strengthen the progress of the business.

The role of a Management Auditor in the coordination (or harmonization) of the functions of planning, organising, controlling, and appraising business, is crucial.

A Management Auditor should have the following general considerations with respect to communication and reliability of datum to:

- Indicate source of base, nature, and basis of datum.
- Purposiveness of data for perusal. Stick to essential information; that is, not matters of general knowledge.
- Avoid gathering data acquired during a previous study, except when a change in the data presents new evidence.
- Obtain the complete details where cost is an important factor.
- Look for irregularities, uncertainties, conflicts, and possible disagreements about plans, objectives, functions, systems, and operations.
- Validation of datum collected.
- Datum collection process and relevancy of datum collected.
- Channels of communication and responsibility attached with such communicators. Be alert for weaknesses in organisation systems, methods, controls, operations, and personnel.
- Role of system data administrator to avoid 'Garbage In, Garbage Out'. Substantiate all data by verification through actual observation, examination, or test checks.
- Watch out for inaccurate, incomplete, inadequate, and unnecessary reports, forms and statements.
- Determine compliance with policies and procedures by checking performance.
- Seek out methods for improvement.
- Note areas and functions for greater effectiveness in performance.
- Be on the lookout for inadequate protective and preventive methods.
- Determine whether or not responsibilities are being appropriately discharged.
- Access control and data sharing process.

Look into the matters of cost-effective utilization of all resources- human, physical financial, and national, including the scarce resources and utilities of public nature.

- Take note of fluctuations in production, work-loads, and services.
- Communication channels and openness in the Organisation. Ascertain the ultimate use (i.e., utility aspects) of each activity, record, and report to determine value or necessity.
- Information sharing among multiple locations of the entity and possibility of data loss, if any. Look for problems, bottlenecks, waste, unnecessary work or function, poor coordination, low morale, inadequate motivation, and other defects in all functions and areas under study.

To Sum Up:

A management audit is an independent and systematic analysis and evaluation of a company's entire business areas and related overall activities and performances therefor. It is a valuable tool used to measure determine the efficiency, functions, accomplishments, and achievements to move towards business excellency of the company.

The primary objective of the management audit is to identify gaps, errors in management objectives and activities, for suggesting improvement and possible changes. It guides the management to manage the operations most effectively and productively.

In other words, a management audit is involved in the evaluation and assessment of the management system and information in the various departments or the entire company. Its reach has been extended to review system and sub-system, authorization, procedure, accountability, quality of data generated, quality of personnel, etc.

A management audit is vast as compared to a financial review because it not only evaluates finance but also other features of a company. It has an efficiency for assessing management from top to lower level. A few main scopes of management audit is described below:

- Assess the effectiveness of the Management- It audits the entire level of management of a company.
- Evaluation of processes deployed.

Execution of Principals and Policies: It reviews whether the policies and the principles deployed by the company are effective and successful.

Suggest improvement based on such evaluation.

- **Locate and Examine the Differences:** It helps to identify the differences in productivity and if the pattern set by the company is not fulfilled.
- **Suggest for Improvement:** The management audit suggests improvement in areas, e.g. purchase, sale, finance, administration, human resources, etc.

Annexure - I

Management Audit Checklist is used to ensure that management systems and processes are effectively addressing the objectives and goals of the business/entity or company. The following template (A Specimen) can be used by compliance teams or management auditors to record and report any act of non-conformity. Few steps are given hereunder.

Administration:

- Whether roles and responsibilities are assigned for administrative functions? Does the organisation have policies and procedures manual?
- Whether policies and procedures are in place for monitoring activities?
- Are members aware of the policies and procedures?
- Are management committee meetings held at intervals prescribed by the constitution?
- Is the annual report distributed to the members?
- Is access to information regarding members limited to certain committee members?
- Whether management decisions are articulated properly for carrying out responsibilities.
- Whether functional reporting hierarchy is in place?
- Whether administrative lapses are flagged and resolved immediately?
- Are the computer files backed up on a regular / frequent basis (i.e., weekly / monthly)?
- And the backup is stored in a different location w.r.t the main computer?
- Is inward and outward correspondence monitored by the committee?

Finance:

- Whether budgetary process and approval mechanism is in place? Are all transactions recorded?
- Whether Cash Flow Statement prepared and reviewed by senior management on regular basis? Is a financial report produced for management committee and general meetings?
- Whether financial goals are set with assigned responsibility for achievement? Is a process followed for approving expenditure?
- Are multiple signatures required for monetary transactions?
- Does the company have an annual operating budget?
- Is the annual operating budget regularly reviewed?

Insurance:

- Whether all Company Assets across locations are covered with adequate insurance against insurable perils?
- Whether 'loss of Profit', Earthquake, Burglary etc. are covered?

- Does the company have insurance cover for the following?
  - Amateur accident insurance
  - Public liability insurance
  - Directors' and officers' insurance
  - Event liability insurance
  - Contingency insurance
- Whether the members aware of the insurance coverage and related policies?
- Whether renewals are made as per timeline defined?
- Whether Claims are made prudently as per stipulation in Policies?
- Whether claims received accounted for with accuracy?

Policy:

- Whether the Company having documented policy guideline for all critical areas of business?
- Whether general coverage of multiple Rules and Regulations are looked into while framing Policy guidelines?
- Whether the Policies are communicated/distributed to all employees?
- Are the policies reviewed and monitored at regular intervals annually?
- Whether updated guidelines are immediately brought to notice?
- Are there policies on the following issues?
  - Harassment
  - Drugs
  - Alcohol
  - Coaching ethics
  - Child protection
  - Disabilities

Planning:

- Whether a culture of action oriented (operational, marketing etc. including contingencies) planning process is in place? Does the company have a strategic plan or development plan?
- Whether the entity company have a risk management plan?
- Whether deviation against Plans are mapped and adequate 'root cause' analysis made to overcome such issues in future?
- Does the company have an operational plan?
- Does the company have a marketing plan?
- Are the members aware of these plans?

- Are the jobs completed in the time frame stated in the plans?
- Are there adequate resources to implement the plans?
- Does the company have an emergency evacuation plan?
- Are the plans reviewed annually?

Personnel Management:

- Whether the entity having a Human Resource Policy in place? Are the job descriptions accessible to the members?
- Whether the company set appropriate codes of conduct? Is it applicable and made known to all?
- Whether benchmarked practices are followed to retain resources and avoid attrition?
- Do the committee members share responsibilities equally?
- Whether a procedure to handle feedback and complaints available to address matters raised?

Contracts:

- While entering into any Contract (long or short term), the evaluation and possible outcome/impacts are assessed?
- Whether appropriate legal safeguard evaluated for any expected shortcoming or execution problems?
- Whether Financial impact analysis carried out to pre-empt possibility of any breach? Is the company involved in any of the following contracts?
  - Employment
  - Lease
  - Membership
  - Sponsorship
- Are the employees aware of the contracts and who they apply to?

Hazard Identification and Control:

- Whether Industry specific HAZOP exercise carried out to protect the probable impact on mishap?
- Are work health and safety inspections carried out on the following?
  - Buildings
  - Equipment
  - Grounds
  - Parking
- Whether appropriate declaration to relevant authorities made on hazardous operations? Are the work health and safety inspections carried out by qualified personnel?
- Is any maintenance required from Government inspection carried within time frame?

- Does the company have a maintenance schedule?
- Is there a procedure for reporting maintenance needs?
- Whether self-assessment carried out and result reported to responsible controller of the entity? Does the company carry out internal safety checks on a regular basis?
- Are risk assessments created for events?
- Is there a procedure for reporting accidents, injuries, and incidents?

Event Management:

- Whether Risks and Mitigation planned against each and every Event planned? Are risk assessments conducted when planning an event?
- Are all the risks identified?
- Have appropriate steps been taken to reduce risks?
- Are risk management procedures maintained and updated?
- Are there suitable first aid personnel on site during events?
- Whether a documented contingency plan in place documented?
- Whether budgetary approval accorded with a note on positive outcomes of the event? Are permits sought to hold certain events?
- Whether failure mode analysis carried out, in case of shortfall in outcome?
- Is the manager in charge of permitting the event?
- Is the feasibility and risk considered high priority when conducting an event?
- Is a budget prepared for all events?
- Does the company take responsibility for the participant's actions?
- Has a "Code of Behaviour" been set?
- Are players, member's etc. aware of the "Code of Behaviour"?

Legislation and Industry standards:

- Whether appropriate legislative and industry standards are made known to related responsibility owners?
- Whether penal actions on non-compliance also appraised to the persons accountable to ensure compliance? Does the company comply with the government standard set?
- Is the company aware of the government standards?
- Whether a 'good governance' practice is circulated to ensure 'beyond compliance'? Are the employees aware of "Duty of Care"?
- Whether legal experts are manned to ensure compliance issues?

Annexure - II

(1) Steps of management audit: Management reviews can be carried out for the area pre-planned or as directed from time to time. The steps of a management audit are:

1. Understanding of the objective and scope of the review. Select an area of operation of management.
2. Collection of appropriate document and datum to establish the context and outcome.

   Discuss and appraise management about gaps and recommendations with respect to mitigation.

   Issuance of formal report.
3. Determine whether the actual results meet the standards, norms, or targets. If not, why not?
   (i) Is the target too difficult?
   (ii) Is failure to achieve the target costing the organisation?
4. Establish what is done to ensure the achievement of the norms, targets, and standards. What steps are taken for:
   (i) Planning
   (ii) Operations, execution, and implementation e.g., use of up-to-date technology
   (iii) Measurement of performance and controls.
5. Carry out a detailed investigation, collect evidence as well as a document for audit findings.
6. Report the findings of the audit and make recommendations.

(2) Management auditing procedure:

Audit procedures should be tailored to the specific needs. of each situation examined. The process may be followed:

1. Clarity of understanding with respect to selected area. Make a preliminary survey of the activity under audit to obtain the necessary background and other working information for use in conducting the audit.
2. Responsibility owner and preliminary discussion to understand 'pain points'.
3. Data and document collection to align with audit objective/scope.
4. Thorough analysis in support of accomplishment of objective.

   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.
5. 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.
6. Identification of weakness, inaccuracy, process gaps and take it forward for discussion with process owner/ responsible management representative/s.
7. 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 the source of her/his information are as follows:

(i) Identification of possible control weakness by survey

During the preliminary survey work, though practical working information is obtained on how the activity is supposed to function and how control procedures are supposed to work, key features or aspects can usually be identified that appear to be difficult to control effectively or be susceptible to abuse. 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 received. If about 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

MIS (Management Information System) for various areas and Reports created and distributed for perusal by management from time to time.

System driven reports or generation with manual intervention for ensuring accuracy and comparison with prevalent situation. 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

Using the outcome of other professional work, always having an issue of quality and depth of coverage. However, once ensuring the same; the Reports can be perused for understanding gaps and management actions against recommendations, if any, w.r.t the same. These reports can also be a valuable source of information on problem areas. Of particular interest to the management and 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 the management system that have not previously been referred to the management for resolution.

(iv) Physical inspection

Physical inspections are carried out to ensure existence, quality of assets, usage, physical condition etc. Mishandling, change of location (transfer to other Unit/s) having higher implications to management. The organisation's activities and resources can be a useful way of identifying possible inefficiencies. Examples are excess accumulations, idle or little-used equipment, employee idleness, rejections of the product by inspectors (or customers), executive rework operations, or disposal of apparently useful materials or equipment.

(v) Test examination of transactions

Transaction testing methods are used to ensure prescribed rules/guidance being adhered to through selection of sample representing the universe. A very useful way to obtain practical insight into the efficacy of procedures is to pursue several transactions about 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 transactions, the usefulness (or pertinence) of a prescribed procedure, the capabilities of personnel involved in the various operating phases, and possible weaknesses in procedures or practices that 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. Even buying in and implementation of recommendations becomes easier for such clarity of understanding emanated out of discussion. 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 require some preliminary review work to obtain information on how they work and an insight into their effectiveness and usefulness. Based on 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:

- Understanding of process flow.
- Auditing in depth for selected transaction/s.
- Auditing in and around computer.
- Whether the policies of the organisation 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, efficiently and economically.
- 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 areas warranting a more detailed audit include –

- The use by management of standards or goals in judging accomplishment, productivity, and 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 organisational patterns.
- Ineffective or useful use of employees and physical resources.

This; the 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 a 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 discharging her/his responsibility depends on the area of review.

As for example, 'Financial performance related reviews' calls for use of 'Break Even Point', Make or Buy, Cost rationalization, Cost benefit analysis, Marginal Cost and Standard Costing etc.

(i) Accounting or economic techniques

(a) Break-even analysis

(b) Budgetary control including a 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 the 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 e.g. Linear Programming, Transportation and Assignment etc. are perused for desired outcome

(a) **Computer Models:** There are many types of problems that can be solved on a computer e.g. decision on the material mix, product, mix, make or buy, etc.

(b) **Network Analysis:** To analyze strings of tasks to arrange them in sequential or parallel order to complete the project in the shortest possible time.

(c) **Mathematical programming for solving by heuristic (trial and error) techniques:** To determine the best material mix, best use of the organisation's transport fleet, the best mix of products to obtain, to maximize profits and optimum use of labour, finance, equipment, etc. Linear programming is usually effective when relationships vary in linear order whereas quadratic programming may be used when the variations are in the order of the square root of some other factors.

(iii) Statistical techniques are in use to point out comparatives, scenario planning etc.

(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, several variables are drawn from a large statistical population which has an equal choice of being selected and obtaining the best sample possible.

(c) Exponential smoothing.

(d) Inter-firm comparison.

(iv) Personnel techniques like interviewing, Training methods are perused for manpower and the quality related assignments

(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 –

- Analysing 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
- Evaluate 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:

Evidences are supporting documents in favour of review outcome. Evidences are collected from both internal and external sources as well as database analyzed. Unlike financial audits 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 risks to be properly covered.

The auditor's evidence comes from his discussions with the people concerned in the organisation, the survey, and reviews of various reports of the organisation, including internal audit reports, inspection reports or any investigation reports, physical inspection, test examination of various transactions, an 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 detail depending on 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 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):

A management audit programme is an essential prerequisite to conducting the audit. The programme is the basic guide to Team members with allocation of area aligned with accomplishment of audit objective with a definitive time span allocation. Such a comprehensive list helps in reviewing the work and also ensures completeness i.e. without missing any check point as to control assessment of operations, adherence to statutes or value add. 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.

She/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 organisational 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 a suitable monitoring system through a management information system (MIS)

(ix) Check on adherence to the statutory obligation

(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 an audit.

A management auditor shall shrewdly assess weak and risk areas in the organisation and deal with such areas in more detail. She/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 auditor is expected to offer special skills and expertise to his clients. He, therefore, has a special responsibility to exercise special care in the performance of his duties to ensure a positive response to his opinion to motivate action thereon.

A management auditor should be technically competent enough to handle the assignment with adequate knowledge. Thinking ability and unbiased approach is the key to success of a management auditor. Sometimes resources of different disciplines are selected for Management Audit, in the exercise of his audit function and formulation of his opinion based on such audit. He should be a person 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 education, training, and experience all around. The management auditor should be supported by a good organisation i.e. a team of people who can competently execute his audit.

Qualifications of Management Auditor

The prime qualification of a management auditor is to process broad business experience in an 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 streams, because cross-fertilization of ideas from different business fields can be a stimulating factor. Management audit should aim at highlighting any team of administration or managerial efficiency or otherwise affecting the performance of the 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 organisations, 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, the flow of work, analysis of work schedule, use of a computer, etc.

(vi) Sufficient knowledge about engineering statistical techniques, cost, and management accounting, general financial accounting, production planning, control, etc.

(vii) General understanding of different laws viz. company laws, tax laws, 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 continuously or several audits at the same time has to build-up a competent team of people, who possess the educational qualifications as well as requisite skill set to operate as attributed to a management auditor.

As a management auditor is concerned with all aspects of the business and the organisation, ranging from manufacturing to marketing and finance, the management audit team should be multi-disciplinary to make a multidimensional approach to the audit function.

A competent management audit team, internal to an organisation, could effectively be represented by seniors having prior exposure to the heads of various departments viz., production, materials management, maintenance, personnel, marketing, finance, industrial engineering, quality control, etc. areas. 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 completeness and quality assurance that she/he has not omitted any areas that require to be audited. The organisational areas covered fall under the broad Checklist can be prepared for all operational and business areas to be reviewed.

- Planning
- Organising
- Staffing
- Coordinating
- Communicating
- Directing
- Motivating
- Controlling and
- Innovating

In these areas, an auditor should look for any weakness which may affect the efficiency of the organisation. Her/his checklist can be made area-wise and may be overlapping or complementary between different areas as follows:

(a) Directorial weakness

(b) Management weakness

(c) Organisational weakness

(d) Financial weakness

(e) Systems weakness

(f) Procedural weakness

(g) Functional weakness

(h) Operational weakness

(i) Marketing weakness

(j) Industrial relations weakness

(k) Weakness in meeting social responsibilities, and

(l) Security lapses etc.

Management Audit Report (MAR)

MAR is the reflection of the quality of review performed in various areas. It is important to prepare a good MAR. A good MAR can motivate the management and get the required results.

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) Appropriate

(vi) Data based to support outcome

Contents of the report

Management Audit reports are often labelled as 'exception reporting'. The deviations from laid down processes, unauthorized activities, performance deterioration, value destruction are normally dealt with in reports. Benchmarking of activities, industry norms and practices are also highlighted as 'scope of improvement'. Fraudulent activities, reputational risk, system and control lapses are also forming part of reports. Corrective measures are suggested to rectify the position and address management concerns. The top policy executive is generally interested in four factors in operating statements – facts, the person responsible, deviations in actual performance from standards, and the effect of the result on the financial or physical status of the organisation.

The report must allow management to study comparisons, review organisation, and appraise the effectiveness of the executives. Departmental weakness can be quickly seen by the management if the report is properly prepared.

The management audit report should create awareness among the management of prudent management practices that can make the organisation come alive. It is a very important function of management audit to help the change management mindset.

Report discussion with management and buying in of suggestions for implementation in time bound manner improves governance and a hallmark of progressive management and Organisation.

A management audit report should also be discussed with the people concerned in various areas before reporting. Every point that is raised in the report should have the acceptance of the people involved in the concerned function. A report that indicates suggestions that had come from the people themselves would have a better than coming as a suggestion from the 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.

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

The form and content of financial statements and schedules are important to the lender but explanatory notes to the statements and schedules are perhaps more important to them. They require accuracy in reports and confirmation of statements 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, the reliability of the report is an important factor. All statements by the auditor should be clear and positive.

(2) Report to shareholders

The report is 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 about the organisation's business. The report should also convey the right and correct message to a layman. The report is often used as a public relations exercise to improve relations with investors and to promote loyalty. In India, an 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 a 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, competition, 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 when the relations with employees are strained. Auditor's views will be expected to be 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 is specifically directed to a person or a small group of persons only. A great deal of reporting for small businesses is subjective, due to a lack of adequate data. This poses problems in analyzing and comparing data. Suggestions in the report must be based on a proper appraisal of the problem.

Conclusion: The report of the management auditor will leave a permanent impact on the user regarding his competence, integrity, and honesty. She/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 or interested in the organisation. She/he cannot escape the duty to judge right and wrong. The best report is one that motivates the person receiving the report to act in the manner desired in the report.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Management auditor should have a thorough knowledge of_______.
   (a) Financial Accounting
   (b) Production techniques
   (c) Costing systems
   (d) All of the above

2. A management auditor can recommend the most suitable system of flow of information_______.
   (a) Internally
   (b) Externally
   (c) Internally and externally
   (d) None of the above

3. Management auditor should be well versed with_______.
   (a) Management by exception.
   (b) Management by objectives.
   (c) Principles of delegation of authority.
   (d) All of the above.

4. Which of the following statements are true about management audit?
   (a) The management audit is made compulsory and statutory.
   (b) Management audit is a programme of one year.
   (c) Management audit cannot be conducted by an independent person.
   (d) No, time limit can be fixed for submission of the report under management audit.

5. Cost audit is a verification of cost records to estimate the _______ efficiency of a business.
   (a) External
   (b) Internal
   (c) Both internal and external
   (d) None of the above

6. The management auditor's work begins
   (a) After the work of a statutory auditor ends
   (b) Before the work of a statutory auditor begins
   (c) Varies from firm to firm
   (d) None of the above

7. Management audit is useful for
   (a) Suggestion for targets
   (b) Assistance to management
   (c) Good staff relationship
   (d) All of the above

- **State True or False**

1. Management auditors should be conversant with the nature of production activities in the organization.
2. Management auditing is a part of statutory auditing.

- **Essay Type Questions**

1. Discuss the scope of the management audit?
2. State the essential qualities required of a Management Auditor.
3. What are the objectives of a management audit?
4. Discuss the concept of evidence for Management Audit

Answer:

- **Multiple Choice Questions (MCQ)**

1	2	3	4	5	6	7
(d)	(c)	(d)	(d)	(b)	(a)	(d)

- **State True or False**

1	2
T	F

Management Reporting Issues and Analysis

10

This Module includes

Management Reporting Issues and Analysis

SLOB Mapped against the Module

To develop detail understanding about management reporting system to facilitate preparation of reliable reports which will ensure accurate data driven cost effective decisions and will build brand image. (CMLO 5b)

Module Learning Objectives:

Reporting can be defined as the communication with related information between the two parties. The process of providing information to the management is known as management reporting. These reports are provided to the various levels of management on regular basis to keep the management abreast of the effectiveness of their respective responsibility. The process of reporting to management is concerned with the proper selection of financial and operating data, arranging information in a proper form, analysing and interpreting the data, and then reporting it to the management through an appropriate method. After studying this module, the students will be able to –

- Analyse the Performance parameters of the Organisation like Capacity Utilization, Productivity, Utilities, Energy efficiencies, etc.
- Interpret Profitability Parameter and infer its importance.
- Learn about the Importance of Working Capital Management and Liquidity Management.
- Implement Various Management Accounting Tools which helps the Organisation's development and growth.

Introduction

10.1

The purpose of reporting is to provide the information needed by the concerned service requisitioners and/ or the Users of the function. The report is the essence of the management audit function for the areas reviewed.

Introduction

Reporting can be defined as the communication of statements with related information between the two parties. The process of providing information to the management is known as management reporting. A report is a statement containing facts.

The quality of the Report brings clarity on the Objective for which the service was sought for, efficiency and ability of the Team deployed for review, depth of skill and handling specifics. These reports are provided to the various levels of management on regular basis to keep the management abreast about the effectiveness of their respective responsibility.

Reports are of various types and depends on the requirement of the Management. Management Team of respective entities feel for the different reports as per their requirement of exercising ready results/outcome of their function and imbibe suitable control measures and effectiveness of the controls. The operational purpose and level (organisation hierarchy) of the User determines the frequency, format and size of report.

As for example, CFO wants 'Daily collection Report at Branches with total (all SKU) Inventory level'; National Sales Head (NSH) requires a different report having same information with a more granular way i.e. SKU-wise daily collection in respective Branches.

As evident from above, the size of report varies due to difference between objective of CFO and SH.

Let's take another example, the Production Head (PH) of every Plant (multiple locations) wants Hourly Production of each Product. The National Plant Head (NPH) requires a report shift-wise and location-wise for each Product. Here also the objective is different due to hierarchy /level in the Organisation and objectivity/purpose.

The Frequency of Report also varies depending upon requirement of the management hierarchy e.g. Managing Director (MD) wants a cost benefit analysis at Product level on monthly basis whereas the Costing Head monitors the performance of each Product at individual Plant level.

The aforesaid Reports are mostly generated from designed ERP process to cater the requirement of Organisation and its' management Team and commonly called as 'Operational Reports', 'Business Intelligence'.

The distinguish function of Management Audit is there in the Organisation to:

(i) help management in taking right decision at the right point of time by providing analytical views;

(ii) imbibe a better control culture by suggesting appropriate controls in process. Timely flagging to the notice management such goals can be achieved.

As for example, to achieve higher sale in the month, last minute 'push' given by extending credit limit and invoicing against the same. For a huge conglomerate, the management auditor can take help of generating ERP based Report to analyze the cost of such extended credit and quality of sales made on account of fund blockage. This may help CFO and NSH to reconsider the 'credit limit' and 'cost of fund' w.r.t additional sales achieved.

(iii) The Management Audit Reports are of analytical nature, of course, datum collected from the database maintained by the Company, IT Department. At the instance of Management Audit function, to facilitate decision making process, tailormade reports are suggested to have better and quick database as per requirement.

(iv) Management Audit Team carries out process improvement reviews also and for the sake of smooth operational flow and cost reduction, ERP based reports are suggested. As for example, Truck-wise TAT (Turn Around Time) monitoring increases the possibility of reduction in transit time and ensure availability of more Trucks. Accordingly, Fixed Cost incurred by the Truckers will be reduced when compared with number of Trips and a percentage of the same, if passed on to Company, the Transportation rate can be reduced.

(v) Depending on the organisational hierarchy the Management Audit Report also may vary in length. For the topmost hierarchy, it should be as crispy, sharp and to the point as possible, while for middle and junior level the same report can be elaborate with action orientation.

(vi) Management Auditor at time handles 'Special Assignments' also, scope of which varies assignment purpose-wise.

Characteristics of Management Reports

Management Reports are purposive and depends upon management requirement. The reports prepared should be simple and clear in respect of various operating activities.

a. Financial Reports: This type of report includes cash flow reports, borrowing vs. cost of borrowing, Performance vs Budget etc. Normally current period and comparative with earlier period/s, annual with prior year/s considered for comparison purposes.

b. Information Reports: These reports are of three types, viz., trend reports, analytical reports, and activity reports. In trend reports, comparative information is provided over a period regarding the direction or trend of different activities. Analytical reports are based on the horizontal comparison of results. This analytically provides information about the comparison of different activities for a particular period. When reports are prepared for any particular activity of the business then they are known as activity reports. Segment reports are also information reports.

c. Control Reports: Various responsibility centers are established in every business to have effective control. To know the performance of each responsibility center, periodically reports are prepared.

Reports Based on Nature:

a. Enterprise Reports: These are the reports, which give a detailed description of the various operating activities and financial position of the business. They are generally meant for external users i.e., bankers, financial institutions, shareholders, and government authorities.

b. Investigative Reports: These reports are specially prepared only when to investigate a particular problem.

Functional Classification of Reports:

These reports are normally for a particular function or a particular department or joint activity.

They are also of two types:

a. **Individual Activity Report:** Report is prepared for the individual activity of a single department working under the supervision of one executive is known as an individual activity report.

b. **Joint Activity Report:** This report is prepared when joint efforts are made in performing the activity e.g. Central Procurement Department with Project Department for a big Project, where delay in commissioning can be gauged with responsibility fixed.

Performance Analysis

10.2

Business goals are the prerequisite for measuring performance against the same. A performance analysis is an evaluation of how a business or individual has performed within the limited timeframe against set parameters. Any variations from projected metrics, need to be under focus to understand the next course of action to preempt the possibility of any future failure/shortcoming.

What's included in a business performance analysis?

A business performance analysis includes company performance metrics and goals. Depending on the scope and focus of the analysis, these may be more or less comprehensive. Here are some specific metrics or goals a company might consider during a performance analysis:

- parameters against which performance to be measured.
- past parameters and measuring yardstick.
- ensuring no change in parameters and yardstick.
- measurement of actual delivery.
- assumptions used for both micro and macro conditions with impact thereon.
- adjustment at base level for the actuals at different point of time.
- process of monitoring and review of parameters and actuals against the same.
- equal period or timeframe for evaluation and period of appraisal.
- 'root cause' analysis for deviations from expected performance.
- feedback to employees on business performance improvement.

Capacity Utilisation Analysis

10.3

Capacity utilization refers to the manufacturing and production capabilities that are being utilized at any given time against the pre-fixed tagged capability. It is the relationship between the output produced and the potential outputwith the given resources. The utilization can be disclosed by way of comparison of whole number or/and percentile.

The formula for Capacity Utilization:

The mathematical formula for calculating capacity utilization is:

$$\textbf{Capacity Utilization} = \frac{\textbf{Actual Level of Output}}{\textbf{Maximum Level of Output}} \times \textbf{100}$$

Suppose XYZ Company is producing 20,000 and it is determined that the company can produce 40,000 units. The company's capacity utilization rate is 50% [(20,000/40,000) × 100]. If all the resources are utilized in production, the capacity rate is 100%, indicating full capacity. If the rate is low, it signifies a situation of "excess capacity" or "surplus capacity." or 'under utilization of capacity'.

One example may bring more clarity - Industry and respective entities under specific industry facing both the scenarios e.g Indian Cement industry overall capacity is higher than Demand, some players of which functioning over 100% of their respective Plant capacity while some even failed to achieve even 70% of the available capacity.

Economic Significance of Capacity Utilization:

Capacities are build-up in anticipation of demand projection of the Product. Any change in market dynamics causes fluctuation in demand and consequential impact on capacity utilization. Economies with a capacity ratio of much less than 100% can significantly boost production without affecting the associated costs.

The capacity utilization rate is an important indicator for companies because it can be used to assess operating efficiency and provides an insight into cost structure. It can be used to determine the level at which costs per unit go up or down. When there is a rise in output, the average cost of production will decrease.

It means that the higher the capacity utilization, the lower the cost per unit, allowing a business to gain an edge over its competitors. Many companies aim to produce to the extent of fullest capacity. Low-capacity utilization leading to opportunity loss, since fixed cost recovery will be a challenge.

Productivity and Efficiency Analysis

10.4

Productive efficiency, also known as production efficiency, is the economic concept of producing the largest possible output from the available resources. Productivity enhancement and/or efficiency improvement are positives for growth and profitability.

How Productive Efficiency Works:

Productive efficiency often comes into play when a production process relies on scarce resources. In microeconomics, this could involve two industries competing for the same raw materials and ending up limited by similar externalities.

As an example, consider the production of most rechargeable batteries, which require a steady supply of the mineral lithium and cobalt. When companies allocate these minerals toward the maximum production efficiency of car batteries, they reduce the available resources for other types of batteries that rely on the same core materials. If the car battery manufacturing process has reached its maximum productive efficiency, there will be higher marginal costs for any additional unit produced. In competitive markets, companies may be able to evade such situations by improving workflows, technical efficiency, and exploiting economies of scale. In the short run, they bump up against the limits of production efficiency.

What Is the Production Possibility Frontier?

The production possibility frontier (PPF) refers to a graphic curve used in both macroeconomics and microeconomics to describe the output limits on two products that compete for the same finite resources. These resources can be physical materials such as wood or minerals. They can also refer to human capital, land, equipment, and production technology.

A PPF is represented on an XY coordinate plane where the X-axis represents the production of one commodity and the Y-axis represents the production of a different commodity. The PPF appears as a curve that tracks these metrics concurrently. A production possibility frontier is calculated via the combination of inputs from both products. An increase in the production of one product will lead to a decrease in the other product because both products must be made using the same pool of finite resources.

Productive vs. Allocative Efficiency: What's the Difference?

Productive efficiency and allocative efficiency measure common characteristics, but the two terms are not synonyms.

Productive efficiency represents the maximum output of a product given scarce resources. The production of any additional units results in opportunity costs- one which is the reduced output of another product. This metric focuses entirely on monetary costs and resources.

Allocative efficiency measures the distribution of goods and services. Allocative efficiency is a state of market equilibrium where both producer and consumer benefit. Specifically, it means the marginal cost of production for each unit sold will equal the marginal benefit to the customer buying that good. To have true allocative efficiency, both producers and buyers must benefit from the overall condition of the market. On a macroeconomic level, this applies to entire societies such that producers benefit in an open market and consumers pay reasonable prices for an enhanced quality of life.

Both efficiencies are limited by externalities. A corporation or small business can do a great deal to improve its productive efficiency levels and reduce inefficiency. This includes ramping up its level of production, performing preventive maintenance on equipment, reducing factory downtime, tracking key performance indicators (KPIs), reimagining production lines, and incentivizing higher productivity levels among its workforce. However, even when a company streamlines and optimizes in every possible way, it can still be hampered by the production of another product that taps into its same supply chain.

Utilities and Energy Efficiency Analysis

10.5

Energy efficiency is defined as using lesser energy to provide the same product or service, such as lighting, heating, and transportation. Together with the move to renewable energy sources, increasing energy efficiency is considered to be one of the twin pillars of sustainable energy policy.

Energy-efficiency experts worldwide have identified several areas where the greatest savings in the use of energy can be made, including industry, transport, homes and buildings.

The International Energy Agency (IEA) has stated that improved energy efficiency in industrial processes, transportation, and buildings could lead to a 30% reduction in the world's energy needs by 2050 and help control global emissions of greenhouse gases.

Energy Efficiency in Industry:

The global energy intensity of industry-measured as the amount of primary energy demand needed to produce one unit of gross domestic product (GDP) – fell by nearly 20% between 2000 and 2016, primarily as a result of energy efficiency policies. The size of these reductions is similar both in the 29 member countries of the IEA and in major emerging economies. Out of the hundreds of opportunities for substantial savings specific to large industries that have been identified by energy-efficiency experts.

Inefficient electric motors are found throughout the global industrial sector. Enormous savings for the industry can be made by replacing older inefficient electric motors with more efficient modern motors, producing savings that exceed the purchase price after just a few weeks of usage, even when the cost of lost production time while replacing the motors is taken into account. These newer industrial motors are easier to operate and more reliable.

The steel industry has saved huge amounts of energy and drastically reduced CO_2 emissions through advance technology/process known as "thin-slab casting" and "direct casting". Traditionally, steel mills have heated steel twice; first, to melt the metals into thick cast sheets, and then a second time to recast the steel into the particular form desired.

The new, more efficient process involves directly casting the steel from its liquid state into the final form desired, with the bonus of producing both a lighter and stronger steel than with the older process, as well as at lower cost.

Further savings for industries such as paper milling have been achieved through the use of more efficient fluid handling. By redesigning piping systems to optimize fluid flow, and by replacing older, oversized, and inefficient pumps with more efficient, modern pumps, many companies have reduced maintenance and production costs, made huge energy savings, increased productivity, and achieved greater reliability and product quality.

Large amounts of heat are produced by most industrial facilities and this wasted thermal energy can be profitably captured and reused, or sold for heating and cooling nearby buildings. CHP (combined heat and power) systems, also known as cogeneration systems, use the thermal energy produced during electricity production to turn turbines to produce more electricity, effectively using fuel twice and significantly and profitably increasing efficiency in a short period. Studies carried out in the U.S. have shown that fossil fuel use and CO_2 emissions could be reduced by 20 percent if all wasted thermal energy from factories were to be captured and recycled.

Many European cities use district heating and cooling systems, where hot water generated at a single point of supply is piped under the streets and into heat exchangers and absorption chillers for heating and cooling nearby buildings, including large institutions such as universities and hospitals. Finland is one of the world leaders in the use of CHP and district heating and cooling systems. According to the International Energy Agency's CHP/DHC Collaborative, CHP produces 74% of Finland's district heating. The system has generated so much electricity that the surplus is sold to other countries in Scandinavia.

The potential savings from the use of new LED lightbulbs to replace older, incandescent bulbs are truly astounding, not only for homeowners and businesses but also for towns and cities through the use of more efficient street lighting. Switching to LED lighting can yield energy savings of over 75%. By 2022, 90% of indoor lighting worldwide is expected to be provided by compact fluorescent lamps (CFLs) and LEDs. In addition, intelligent use of motion sensors to detect when people are present can also be used to achieve further savings and reductions in emissions.

Efficient Homes and Buildings:

"Every day," says Bernie Sanders, "we are paying more for energy than we should due to poor insulation, inefficient lights, appliances, and heating and cooling equipment – money we could save by investing in energy efficiency."

The use of LED lightbulbs in homes and buildings is only one of many ways for reducing energy costs and CO^2 emissions, and achieve substantial reductions in electricity bills.

Efficient Transportation:

Transport was responsible for 28% of global final energy consumption in 2016 and is one of the biggest sources of greenhouse gas emissions, with road transport such as trucks, buses, and cars emitting the most greenhouse gases. The use of improved engine technologies, hybrid cars, and plug-in electric vehicles have already produced gains in savings and reductions in emissions as well as more mileage. Global sales of electric vehicles grew by 40% in 2016, mainly in China and Europe, and there are now more than 2 million electric vehicles worldwide.

Electric vehicles are much more efficient than diesel or gasoline alternatives but are not yet at a scale to have a significant influence on global fuel economy.

Mass transit systems such as bus and light rail networks in urban areas, along with complimentary walking and cycling infrastructures, can sharply reduce both CO_2 emission and subsequent health benefits due to improved air quality for local inhabitants. According to the World Health Organization, "Safe, equitable, and energy-efficient urban transport can help achieve multiple health and sustainability goals.

Several companies in the aviation industry have developed much lighter and stronger materials which, together with more efficient fuel use and aircraft design, have achieved gains in energy efficiency. Yet, despite these advances, the environmental impact of aviation continues to be of great concern.

Recycling:

The recycling of commonly used materials such as paper, glass, plastics, and aluminum is another area that results in huge reductions in energy use and CO_2 emissions. According to Stanford University, in the U.S. alone, "the amount of lost energy from throwing away recyclable commodities such as aluminum cans and newspapers is equivalent to the annual output of 15 power plants.

Aluminum is the most efficient recyclable material. It never degrades and can be reused indefinitely with no need to bring new materials into the production cycle. Processing recycled aluminum would reduce the energy used in the production of the metal from bauxite ore, currently one of the most energy-intensive processes in the global economy, by an incredible 95 percent.

However, according to the Container Recycling Institute, sales of canned and bottled beverages in the U.S. have continued to grow over the last few decades but recycling of the containers has stagnated, resulting in higher rates of landfilling, incineration, littering, and other negative environmental impacts.

Glass can be recycled indefinitely. The energy savings from recycling glass are relatively less, as recycled glass still needs to be re-melted at very high temperatures to make new glass products. However, according to a report by the Environmental Protection Agency, creating glass from recycled materials rather than raw materials generates 20 percent less air pollution and 50 percent less water pollution, as well as helps to reduce the size of landfills, preserve natural resources like sand, soda ash, and limestone, and eliminate the costs involved with transporting these heavy materials.

Paper is one of the most recycled materials in the world. Manufacturing recycled paper saves thousands of trees each year in the U.S. alone and uses only 60 percent of the energy required to produce paper from fresh pulp. Emerging research on biodegradable inks and even erasable paper could soon solve the problems faced by manufacturers of producing high-quality, bright white paper due to ink residue.

Every year, more than 100 million tons of plastics are manufactured across the globe, yet only 14% of this amount is recycled. 8 million tons of plastic end up in our seas and oceans each year and some plastic materials can take hundreds of years to break down in a landfill. However, many plastics can be recycled and turned into items such as clothes, containers, bags, carpets, bottles, garden products, car components, furniture, and insulation, to name just a few. Recycling a single plastic bottle can conserve enough energy to light a 10W LED bulb for up to 36 hours! It's easy to see why recycling plastic is so important.

Barriers to Success:

1. Fear for high initial Investment.
2. Lack of understanding and clarity over benefit accruals.
3. Less concerned over environmental negative impacts.
4. Mentality to stick to old, 'old is gold'.

Key Costs and Contribution Analysis

10.6

Contribution Analysis is useful in understanding the effect of variable costs on the net income (performance indicator). It helps a company understand the contribution of individual business lines or different products by calculating the contribution margin (contribution/sales) of each in terms of rupees and percentage. To arrive at the contribution margin, direct and variable costs related to the manufacturing process are subtracted from the revenue

Suppose, the contribution of products is 10%, which is lower than other products of a business. If a company is unable to reduce the variable costs of this product, it may eventually decide to drop the product. Moreover, contribution analysis is done to understand the strong and weak points of the business or the product. It also tells how each unit helps in recovering the fixed cost.

During contribution analysis, the managers also consider the effect of internal and external factors.

Formula to calculate Contribution in rupees per unit is (Total Revenue- Variable costs) / Number of units sold.

For example, a company sells 15,000 units of shirts for a total revenue of ₹ 4,00,000. Cost of goods sold is ₹ 1,50,000, labour expenses of ₹ 1,00,000. The contribution margin per shirt is (₹ 4,00,000 – ₹ 1,50,000 – ₹ 1,00,000) / 15,000 = ₹ 10.00 per shirt.

Contribution Analysis is done largely to support the decision-making process. For better results, a company uses such analysis along with the budgeting process and management accountant functions.

Profit-Volume-Chart:

Not every manager is technical, and therefore, a graph helps them with an easy understanding of the concept. A Profit Volume chart explains the relationship between volume and profit through graphical representation. In the graph, the contribution figure is considered as a variable. Through this graphical representation, managers can understand the profit at a given level.

Calculation of Break Even:

A break-even point is where the business makes no profit or loss. One can calculate the break-even point using a formula = Fixed cost/Contribution per unit.

Asses Losses:

Every business needs to calculate a margin of safety to come up with future strategies. One can easily do so by using contribution analysis. To make it easier for the managers, contribution analysis is expressed in percentage terms. For instance, if the break-even unit is 2,500, it means, the company would be profitable once they sell 2501th unit.

In case, the company has set a target of selling of 5,000 units, then the margin of safety would be (5,000 –

2,000)/5,000 ×100 = 60%.

Advantages of Contribution Analysis: Ease of Use:

This metric is relatively easier to use and understand. Thus, it is effective in helping managers to arrive at decisions. Understanding the exact amount of profit that each unit would start generating beyond the break-even point gives the company a better picture of its performance. Contribution analysis alone helps in understanding some of the most critical points in profit.

Disadvantage:

In Contribution Analysis, the assumptions can sometimes be far from reality. Assumptions such as constant selling price or linear pricing are some of the shortcomings in this approach.

Another Approach:

For non-business entities also this perspective can be used for a political campaign, economic analysis, and more.

Profitability Analysis

10.7

The overall objective of any business is to maximize profitability. From the first day on, the activities of the business culminate in an attempt to create sustainable and ample profit. Business leaders rely on a variety of tools and analysis to help identify ways to maximize profit and create new ways of generating profit. One tool they rely on is profitability analysis, which assists them in understanding how profitable the business is.

What Is Profitability Analysis?

Profitability analysis is part of enterprise resource planning (ERP) and helps business leaders to identify ways to optimize profitability as it relates to various projects, plans, or products. It is the process of systematically analyzing profits derived from the various revenue streams of the business.

Why Is Profitability Analysis Important?

To maximize profits,business leaders first need to understand the drivers behind their profits. This helps to create efficiencies in the processes and activities that generate revenue and/or finding ways to reduce overhead and other costs that impact profitability.

The analysis helps to identify ways to enhance product mixes to maximize profits both in the short and long term. This makes it helpful for budgeting purposes as managers work to create reasonable goals and map how they will achieve them.

One helpful piece of information created when analyzing various products is which products are the most and least profitable. This information is sometimes taken into consideration when business leaders choose to drop or reduce weightage of certain products. Finally, profitability analysis examines the various relationships with customers and vendors.

Common Methods of Performing Profitability Analysis:

Profitability Ratios:

Profitability ratios are financial metrics that are used to understand revenue relative to its cost, assets, and equity over time. Some of the more common profitability ratios are operating profit margin, Return on Assets (ROA), and Return on Equity (ROE), Earning Before Interest and Taxes (EBIT) etc.

Customer cluster wise Profitability Analysis:

Segment, Market and Customer centric Profitability analysis. It provides unique insight into customers' behaviour. This indicates percentage of profit attributable to each customer segment.

Qualitative Analytics:

This helps to identify trends and business cycles and allows leaders to plan appropriately.

Product Profitability Management:

- Market performance of each Product.
- Contribution from each Product.
- Profitability (Product-wise).
- Price leadership.
- Regulate pricing policies.

Conduct Product Costing Analysis:

- Specify cost of goods sold (COGS);
- Control material consumption costs per unit of finished product;
- Determine and control product-wise labour costs;
- Element-wise Cost optimization;
- Define average sales price per product unit sold;
- Regulate product development costs, including staff and IT expenses;
- Calculate periodical product-wise profit (or loss).

Product Rationalization Metrics:

Sales-to-Stock Ratio = (Net Sales/Average Inventory)**:**

The inventory to sales ratio means a company's investment into inventory in comparison to its sales amount. The sales-to-stock ratio is a method to measure the relationship between stock and sales. By evaluating Stock turnover ratio customer demand, adequacy of supplies, requirement of inventory built-up etc. can be handled suitably.

Gross Margin = (Gross Profit /Net Sales)**:**

Calculating Gross Margin of a product or service is a good indication of profitability. In general terms Gross Margin is Gross Profit (total sales revenue minus its COGS, cost of goods sold) divided by Net Sales, expressed as a percentage: this number shows how much a company earns from selling certain product or service, involving the costs it incurs for producing or acquiring this product or service. This measure is used to represent the margin made on every rupee of net sales: the proportion of each rupee from revenue that a company retains as gross profit to service its other business operations and obligations.

Working Capital and Liquidity Management Analysis

10.8

Working capital represents the net current assets available for day-to-day operating activities. It is defined as current assets over current liabilities.Successful management of working capital is essential to remain in business.

Working capital management requires great care, e.g. extending the credit period to customers may lead to additional sales, but absence of sufficient cash flow results in further borrowing with consequential interest burden on borrowing.

Working capital management is central to the effective management of a business because:

- Current assets comprise the majority of the total assets of some companies.
- Shareholder wealth is more closely related to cash generation than accounting profits.
- Failure to control working capital, and hence to manage liquidity, is a major cause of the corporate collapse.

Objectives of working capital management:

One of the two key objectives of working capital management is to ensure liquidity. A business with insufficient working capital will not be in a position to meet financial obligations on time. Late payments may cause reputational risk and downgrading of credit rating. Non-payment (default) can lead to the compulsory liquidation of assets to repay creditors.

A company with a high level of working capital may fail to achieve the return on capital employed (ROCE).

The trade-off is perhaps most obvious with regards to the holding of cash. Although cash provides liquidity it generates little return, even if held in the form of cash equivalents such as treasury bills / Money Market Instruments.

Although an optimal level of working capital may exist it may not be achievable due to factors beyond management's control, such as an unreliable supply chain influencing inventory levels.

However, businesses must at least avoid the extremes:

- Over trading: Insufficient working capital to support the level of business activities. This can also be described as under-capitalization and is characterised by a high and rising proportion of short-term finance to long-term finance.
- Over-capitalisation: An excessive level of working capital, leading to inefficiency.

Liquidity ratios:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

If the current ratio falls below 1, this may indicate problems in meeting obligations as they fall due. Even if the current ratio is above 1 this does not guarantee liquidity, particularly if inventory is slow-moving. On the other hand, a very high current ratio is not to be encouraged as it may indicate inefficient use of resources (for example, excessive cash balances).

The level of a firm's current ratio is heavily influenced by the nature of its business for example:

- Traditional manufacturing industries require significant working capital investment in inventory (comprising raw materials, work in progress, and finished goods) and trade receivables (as their business customers expect to be offered generous credit terms). Therefore, companies operating in such industries may reasonably be expected to have current ratios of 2 or more.
- Modern manufacturing companies may use just-in-time management techniques to reduce the level of buffer inventory and hence reduce their current ratios to some extent.
- In some industries, a current ratio of less than 1 might be considered acceptable. This is especially true of the retail sector which is often dominated by 'giants' such as Wal-Mart (in the US) and Tesco (in the UK). Such retailers can negotiate long credit periods with suppliers while offering little credit to customers leading to higher trade payables as compared with trade receivables. These retailers are also able to keep their inventory levels to a minimum through efficient supply chain management.

$$\text{Quick (acid test) ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}} = \frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}}$$

The quick ratio is particularly relevant where inventory is slow-moving.

Efficiency ratios:

This shows how quickly inventory is sold; higher turnover reflects faster-moving inventory.

However, working capital ratios are often easier to interpret if they are expressed in 'days' as opposed to 'turnover':

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Average inventory}}$$

Inventory days estimate the time taken for inventory to be sold. Everything else being equal, a business would prefer lower inventory days.

$$\text{Inventory days} = \frac{\text{Average inventory}}{\text{Annual cost of sales}} \times 365$$

Receivable's days estimate the time taken for customers to pay. Everything else being equal a business would prefer lower receivables days.

$$\text{Trade payable days} = \frac{\text{Average trade payables}}{\text{Annual credit purchases}} \times 365$$

Payable's days estimate the time taken to pay suppliers. A business would prefer to increase its payables days unless this proves expensive in terms of lost settlement discounts or leads to other problems such as a damaged reputation – a 'good corporate citizen' is expected to pay promptly.

$$\text{Sales to working capital} = \frac{\text{Annual sales}}{\text{Average working capital}}$$

In this ratio working capital is defined as the level of investment in inventory and receivables less payables. In exam questions, you may have to assume that year-end working capital is representative of the average figure over the year.

The sales to working capital ratio indicate how efficiently working capital is being used to generate sales. Everything else being equal the business would prefer this ratio to rise.

Cash operating cycle:

The cash operating cycle (also known as the working capital cycle or the cash conversion cycle) is the number of days between paying suppliers and receiving cash from sales.

Cash operating cycle = Inventory days + Receivable's days – Payable's days.

In the manufacturing sector inventory days has three components:

(a) Raw materials days.

(b) Work-in-progress days (the length of the production process), and

(c) Finished goods days.

The longer the operating cycle the greater the level of resources tied up in working capital. Although it is desirable to have as short a cycle as possible, there may be external factors that restrict management's ability to achieve this:

- Nature of the Business: A supermarket chain may have low inventory days (fresh food), low receivables days (perhaps just one to two days to receive a settlement from credit card companies), and significant payables days (taking credit from farmers). In this case, the operating cycle could be negative (i.e., cash is received from sales before suppliers are paid). On the other hand, a construction company may have a very long operating cycle due to the high levels of work-in-progress.

- Industry Norms: If key competitors offer long periods of credit to their customers it may be difficult to reduce receivables days without losing business.

- Power of Suppliers: An attempt to delay payments could lead to the supplier demanding 'cash on delivery' in the future (i.e., causing payables days to fall to zero rather than rising).

Interpretation of Ratios:

For a meaningful evaluation to be made of a firm's working capital management it is necessary to identify:

Trends: The change in a ratio over time.

External Benchmarks: Industry average (sector) ratios are commonly published by business schools or consultancies. The following table is provided for reference purposes:

Sector	Sales/Working capital (times)	Inventory days	Receivables days	Payables days	Cash operating cycle days
Aerospace, defence and security	5.5	71	46	45	72
Automotive	15.6	51	30	60	21
Chemicals	5.8	68	48	49	67
Communications	35.7	22	5	106	(79)
Energy, utilities and mining	15.2	28	37	46	19
Engineering and construction	4.7	91	78	90	79
Entertainment and media	11.4	22	89	123	(12)
Forest, paper and packaging	6.3	66	49	54	61
Healthcare	27.8	26	38	60	4
Hospitality and leisure	16.1	35	26	40	21
Industrial manufacturing	5.3	63	64	57	70
Metals	7.0	74	32	49	57
Pharmaceuticals and life sciences	4.9	105	57	66	96
Retail and consumer	10.8	69	26	57	38
Technology	7.2	41	65	60	44
Transportation and logistics	11.5	22	44	36	30
Average	**9.0**	**52**	**44**	**57**	**39**

Example:

Topple Co has the following forecast figures for its first year of trading:

Sales ₹36,00,000

Purchases expense ₹ 30,00,000

Average receivables ₹3,06,000

Average inventory ₹4,95,000

Average payables ₹2,30,000

Average overdraft ₹5,00,000

Gross profit margin 25%

Industry average data: Inventory days 53

Receivables days 23

Payables days 47

Current ratio 1.43

Assume there are 365 days in the year.

Required:

Calculate and comment on Topple Co's cash operating cycle, current ratio, quick ratio, and sales to working capital ratio.

Workings		**Days**
Inventory days	$\frac{4,95,000}{27,00,000} \times 365$	67
Receivables days	$\frac{3,06,000}{36,00,000} \times 365$	31
		98
Payables days	$\frac{2,30,000}{30,00,000} \times 365$	(28)
Cash operating cycle		70

$$\text{Current ratio} = \frac{4,95,000 + 3,06,000}{2,30,000 + 5,00,000} = 1.10 \text{ times}$$

$$\text{Quick ratio} = \frac{3,06,000}{2,30,000 + 5,00,000} = 0.42 \text{ times}$$

$$\text{Sales to working capital} = \frac{36,00,000}{4,95,000 + 3,06,000 - 2,30,000} = 6.3 \text{ times}$$

The length of the cash operating cycle indicates that there will be 70 days between Topple Co receiving cash from sales and paying cash to suppliers. This is significantly longer than the industry average of 29 days (53 + 23 – 47) and is likely to lead to liquidity problems, as evidenced by the size of the overdraft.

Topple Co expects to take approximately the same credit period from its suppliers as is taken by its customers, whereas the industry norm is to take a significantly longer credit period from suppliers (47 days) than is taken by customers (23 days). Therefore, slow inventory turnover is the main cause of Topple Co's long working capital cycle. This may be inevitable in the first year of trading but is it important that systems are implemented to ensure efficient inventory management. The extent of future reductions in inventory days may be limited by the nature of the business as the industry average is 53 days.

It is perhaps unsurprising that Topple Co's receivables days is also above the industry average as the firm may have been forced to offer generous terms of trade to attract customers away from its more established competitors, in addition, Topple Co may still be in the process of establishing and implementing credit control procedures.

On the other hand, Topple Co is paying its suppliers much more quickly than the industry norm. Although this puts pressure on liquidity, Topple Co may be taking advantage of settlement discounts offered by suppliers or, as a new firm without an established trading history, it may simply not be offered extended credit periods by suppliers.

The above comparisons to sector data must be treated with caution as working capital management may be poor across the sector, leading to benchmarks that Topple Co should not endeavour to replicate. As a long-term target, Topple Co should benchmark its performance against the leader in the sector.

The current ratio indicates that, over the year, there will be ₹1.10 of current assets per ₹1 of current liabilities, which does not compare favourably with the industry average of 1.43 and may not be sufficient as Topple Co's inventory appears to be slow-moving. More relevant, therefore, is the quick ratio which indicates only ₹0.42 of liquid assets per ₹1 of current liabilities, although no industry average data is available to benchmark this figure.

The overdraft would need to be continuously monitored to ensure it remains within an agreed limit, and contingency plans put into place for refinancing. However, if Topple Co is started up with an appropriate level of long-term finance then an overdraft may be avoided entirely.

Each ₹1 invested in working capital is expected to generate ₹6.30 of revenue. Although this may not appear to be a particularly efficient use of resources, the first year's trading may not be representative. Once Topple Co becomes more established it should benchmark its sales to working capital ratio against sector data if available.

Manpower Analysis

10.9

Manpower planning is a very important tool and technique of human resource management. An ideal manpower deployment ratio is one of the major contributor to profitability.

Importance in "Manpower Planning":

At the micro-level, it may cover its manpower needs for its various departments and different types of personnel. With the advent industrial usage of robotics, machine learning, automation etc.; development of fresh skill set is required and hence technology driven organisations facing shortages of the right type of human resources. Manpower planning enables to get the right type of personnel in the organisation.

Manpower Estimation and Its Dimensions:

For the sake of smooth operational flow, management has to ensure right sizing of manpower. The number, type, qualifications, qualities, skill set etc., of the employees needed must be determined keeping in mind the cost involvement for the same. Many environmental and other factors affect this determination of manpower.

Important factors amongst them are business forecast, development, expansion, and growth of the organisation itself, management philosophy and policy, government policy, product and human skills, competition, etc., Manpower estimation is very important in the human resource or manpower planning process.

It has been made clear that the objectives of an organisation are decided and defined by the top management. The role of the human resource department is to sub-serve the overall objectives by ensuring the availability and optimum utilisation of human resources. Therefore, manpower estimation is required to be done properly which involves the estimation of the quantity and quality of the right type of people or human force.

The basis of the manpower estimation should be the annual budget and also long-term corporate plan. For this purpose, certain techniques such as managerial judgment, ratio-trend analysis, and the Delphi technique can be used.

The main dimensions of estimation of manpower are as follows:

(a) Total number of employees presently available and their types, nature of work, wages, etc.

(b) A detailed job description for each position of employee working in different departments.

(c) Age distribution, qualifications, experience, etc., of the employees.

(d) Estimation of short, medium, and long-term manpower needs.

Manpower estimation can help an organisation to retain the desired employees longer and keep them functioning more efficiently and more productively at a reasonable cost.

Specifically, it can help to achieve the following objectives:

(i) To make available the human resource in adequate quantity and of the required quality.

(ii) To reduce recruiting and replacement costs.

(iii) To reduce labour costs associated with attrition. (iv) To improve employee morale and satisfaction.

(v) To control unnecessary expansion or rapid expansion or reduction in workforce.

(vi) To monitor staffing and retention policies.

(vii) To focus on training resources properly.

Manpower estimation helps an organisation to manage its human resources in a better way and more effectively with dynamic situations. It should be noted that all organisations, especially those which have a high labour turnover must systematically do their short-term, medium-term as well as long-term manpower estimation and human resource planning. Further, to meet the changing conditions, periodical reviews and adjustments are also necessary.

To achieve effective HRP by doing manpower estimation properly, the duties involved and the skills required for performing all the jobs in an organisation, necessary information is required to be collected in respect of various jobs to be performed. Hence, job analysis becomes essential. Job analysis refers, in simple language, to the process of collecting information about a job. The job analysis process results in two sets of data i.e.,

(a) Job description, and

(b) Job specification which is then used to carry out job evaluation.

Preparing Manpower Inventory:

"Manpower Inventory involves the classification of characteristics of personnel in an organisation, in addition to counting their number."

The term 'inventory' is often used about counting tangible objects like raw materials, goods in progress, finished products, etc. In manpower inventory, the items are intangible.

It involves cataloguing the characteristics of personnel in the organisation, besides counting their number. Both present and future characteristics of personnel are recorded in the manpower inventory.

It involves the following steps:

(a) The first step in manpower inventory is to decide who should form a part of it. Generally, inventory is prepared for persons working on important posts- the executives and some persons from the operative staff are covered in it. From operative staff, only those persons are included in inventory who have the potential of taking up higher responsibility posts.

(b) After determining the persons to be included in manpower inventory, the second step is to collect information about them. Some information may be collected from records while some may be collected through interviews or talks with the concerned persons.

The factual information such as age, experience, education, health, appraisal reports, attitude, etc. will be noted from the records. The brief interviews with persons will help in understanding his caliber, attitude, aspirations, motives, etc.

A summary statement of information is prepared about each person and is kept ready for consultation. The information will help management to find out the suitable persons in the organisation for taking up senior positions in the future. This will also enable management to determine whether persons from outside will be required in the future or not.

(c) The next step in manpower inventory is to appraise the talent catalog. The present and future capabilities of persons are assessed. Some scale is prepared for appraising the person.

Besides appraisal tests, remarks about persons are also given. The remarks may relate to their talent, decision-making ability, training required, specific limitations, etc. Besides appraisal tests, specific remarks are useful in picking up persons for future positions.

The manpower inventory will enable managers to know the present and future potential of all individuals and their suitability for various jobs.

Strategic Processes for Manpower Planning:

Manpower planning is described as a process. It is a continuous process in the sense that the work of estimating demand for and supply of employees is required to be carried on as long as the organisation carries on its business. The process of manpower planning is one of the most important, crucial, complex, and continuing managerial functions.

It entails consideration of several steps with relevant input before the estimation of manpower requirements can be arrived at and also involves, the identification of the source of supply to meet the requirements, taking into consideration various constraints.

The manpower planning process seeks to ensure that the people with the right fit in the required number are placed at the right time in the organisation.

Strategies for manpower planning are as follows:

(a) Collection, maintenance, and interpretation of relevant information regarding human resources.

(b) Periodical review of manpower objectives and requirements.

(c) Development of procedures and techniques to determine the requirements of different types of manpower over some time.

(d) Development of measures for the utilisation of manpower along with independent validation, if possible.

(e) Employment of suitable techniques for the effective allocation of work to improve manpower utilisation properly.

(f) Conducting surveys for determining the factors hampering the contribution of individuals as well as of the groups in the organisation for modifying or removing those handicaps.

(g) Development and employment of methods of economic assessment of human resources, reflecting its features as an income generator and cost.

(h) Evaluation of the procurement, promotion, retention, etc., of the effective manpower resources about the forecast of manpower requirements of the organisation.

(i) Analysis and controlling of organisational processes and structure for encouraging maximum individual and group performance without incurring excessive costs.

These strategies also throw light on the objectives of manpower planning and we can get an idea from these points about the steps involved in manpower planning.

The process of manpower planning begins with the determination and review of the objectives of the organisation. This enables the management to estimate the manpower requirements and internal supply of human resources. The manpower planning consists of a series of activities such as:

(a) Forecasting of future manpower requirements.

(b) Making an inventory of present manpower resources and also assessing the extent to which these manpower resources are employed optimally.

(c) Anticipation of manpower problems by projecting the present resources into the future and making the comparison with the estimation of human requirements to determine their adequacy, both qualitatively and quantitatively.

(d) Planning for the programs of selection, training, development, utilisation, promotions, etc., to ensure adequate manpower supply in the future.

Important steps involved in the process of manpower planning:

(a) Anticipation of manpower requirements for the organisation.

(b) Proper planning of job requirements and descriptions.

(c) Analysis of skills required to determine the nature of manpower needed.

(d) Selection of adequate and suitable sources of recruitment.

The Process of Human Resource Planning: Analysis of organisational plans.

(a) Demand forecasting- Forecasting of overall human resource requirements by the organisational plans.

(b) Supply forecasting- Obtaining the data and information about the present inventory of human resources and forecasting of the future changes in the human resource inventory.

(c) Estimation of net human resources or manpower requirements.

(d) In case of future surplus, plan for redeployment, retrenchment, and lay-off.

(e) In case of future deficit, forecasting of the future supply of human resources from all sources concerning plans of other companies.

(f) Plan for recruitment, development, and internal mobility if future supply is more than or equal to net human resource requirements.

(g) Plan to modify or adjust the organisational plan if the future supply is expected to be inadequate concerning future net requirements.

The persons who perform manpower planning work have to decide the period for which the plan should be prepared.

Manpower planning can be done for:

(i) Short term such as one year or so.

(ii) A medium-term which is for more than one year but up to five years.

(iii) For a long term which is for a period of more than five years, ten years, or up to fifteen years.

It is regarded that manpower planning for a very long period does not serve many purposes. Manpower planning is generally done for a period of five to seven years with a break-up given for each year.

The following important steps are expected to be completed in Manpower Analysis:

1. Analysis of the objectives of the organisation about human resource planning:

Objectives of the organisation act as a guideline for estimating the demand for manpower in the future. The objectives should be stated in clear terms so that the work expected to be done for achieving the objectives can become clear to the people involved in manpower planning. Hence, the process of manpower planning should start with analysing the organisational plans into a production plan, technological plan, expansion and diversification plan, marketing and sales plan, etc., and further, each plan should be analysed into sub-units as per requirements.

Analysis of organisational plans helps in estimating the demand for manpower as it gives the idea about the quantum of future work activities. It is to be done to relate future manpower needs to the future organisational needs to maximise the future returns on investment in manpower or human resources.

If the objectives are stated in terms of market share to be obtained or the type of product to be manufactured and the volume in which it is to be manufactured, it becomes possible for the planners to estimate the manpower which will have to be employed in various departments and sections to complete the expected production. Objectives decided in terms of expansion, modernisation, and diversification programmes also enable the planners in preparing a proper manpower plan.

If the organisation is small, manpower planning can be done to cover the entire unit, but, if it is large, manpower planning is done for separate departments or units or by class of employees at each level or a cluster of levels.

2. Forecasting future human resource needs (estimating manpower requirements):

The concept of 'Forecasting future human resource needs' implies estimating the manpower requirements or estimating the need and demand for manpower for the fixed period for which the manpower planning activity is undertaken.

When manpower planning is done, the person in charge has to find out the requirements of human resources to undertake various activities. The human requirements forecast must be both in terms of quantity as well as quality. While doing so, forecasting the supply of manpower is also required to be considered to adjust the demand of human resources with its supply.

While forecasting or estimating manpower requirements, the existing job design and analysis is required to be reviewed thoroughly keeping in mind the future required capabilities, knowledge, skills, etc., of the present employees. If required, various jobs are redesigned considering the organisational and unit-wise plans and programs, the quantum of future work, activities, tasks, etc.

After analysis and estimation of the objectives of the organisation, in the light of expected changes in the process of production, job designs, etc., the requirements of human resources for the existing departments of the organisation as well as for new vacancies are found out.

The demand for the employees depends upon the objectives of the organisation. It becomes necessary to estimate the future demand for the product or products which the organisation is manufacturing. The demand for the product itself is affected by many factors such as the degree of competition faced by the organisation, likes, and dislikes of the customers, state of the economy, policies of the Government in respect of imports and exports, etc.

Once the demand for the product of the organisation is decided, in the light of it, the number of employees needed for manufacturing the required quantity is calculated. Need for employees are also required to be decided by considering the type of technology which the organisation intends to use in its work. Technology changes at a very rapid rate and, therefore, it becomes difficult to know what will be its effect the number of employees which the organisation will need.

Along with the external factors, internal factors like budget constraints, level of production, policies of management regarding new products to be introduced, labour intensive or capital-intensive methods of production to be adopted, future organisational structure planned by the management also affects the demand for the manpower and due consideration of these factors also becomes necessary on the part of persons doing demand forecasting for the manpower.

3. Forecasting supply of manpower:

After completing the second step of demand forecasting, planners doing manpower planning have to forecast the supply of manpower. The first step in supply forecasting is to consider the present manpower available with the organisation. For this purpose, manpower inventory is prepared.

(i) Manpower Inventory:

Manpower inventory is the data collected about the present employees of the organisation. Information about all the employees is collected concerning the department in which the employee is working, his status or position, age, sex, qualifications, experience, training programs completed, pay-scale, skills possessed, abilities and capabilities, etc. This information is classified in a proper way to enable the planners to understand how many employees are available with the organisation at present.

(ii) Manpower Audit:

Manpower audit is carried out to find out how the present employees are utilised. The manpower audit points out the information about the performance of the employees and whether the skills and abilities of the present employees are fully utilised or not. It also enables the planners to identify the employees who can be developed for undertaking more responsible jobs in the future. Information about absenteeism of the employees, productivity of the employees also becomes available through manpower audit and this information can be used by the management for improving the performance of the employees.

(iii) Job Evaluation:

Every job has to be justified as per requirement of the organisation an the quality of manpower required to handle the responsibility. Succession plan, promotion, suitability of the person for the job etc. or the outcome of specific job evaluation.

4. Comparing demand forecast with supply forecast:

The total number of employees needed as calculated by demand forecast is compared with the total supply of manpower expected to be available in the plan period. Such a comparison may show that there is a shortage of manpower or there is excess manpower available with the organisation. The persons doing manpower planning would find out what is the position of manpower in the organisation so that accordingly, necessary plans can be prepared for meeting that situation.

5. Preparing plans and programs:

Based on the information available from the 4th step mentioned above, the planners have to prepare a plan and a program. If there is a shortage of manpower, plans are prepared for recruitment and selection of new employees. For this, the sources of recruitment are decided and information available about prospective employees is obtained. Depending upon the type of person to be selected, an adequate selection program is prepared and implemented.

If instead of shortage of manpower, it is found that there is excess manpower available, the arrangement is made to redeploy the surplus employees by providing training to them so, that they can perform the new jobs satisfactorily or schemes like ‘golden handshake’ are prepared and the equilibrium between the demand for and supply of manpower is achieved.

Plans are also prepared for full utilisation of the human resource available. Transfer of employees, training of employees, and career development plans for the employees are prepared with the objective of making proper and full use of the abilities of the employees and also to help employees get job satisfaction, one of the leading factors of retention.

6. Execution of the plans and evaluation of the manpower planning:

The plans prepared for obtaining additional employees or for reducing the excess number of employees are implemented. The effectiveness of the entire manpower planning is evaluated by finding out whether manpower planning has enabled the organisation to achieve the objectives as per expectations. In case the objectives are not satisfactorily realised, manpower plans may be required to be modified or the organisational objectives may be altered.

Thus, in the human resource planning process, there is a forecast of personnel needs i.e., employees needed, assessment of the supply factors through various personnel-related programs. Of course, the HRP process is influenced by the overall organisational goals and objectives as well as the environment of business.

Manpower Planning Process:

The process of manpower planning works in a stepwise manner.

The steps for the same are listed below:

(a) **Need identification:** Each department has to identify its targets and get resources allocated accordingly.

(b) **Succession plan:** Then, a succession plan must be formulated by the personnel managers of each department ensuring that they incorporate additional training programs to alleviate the labour turnover rate of the company.

(c) **Planning:** Planning is done for recruiting candidates if there is a shortage of staff in the organisation.

(d) **Redundancy plan:** A redundancy plan must also be developed in case the organisation feels that there are employees in a company not required due to lack of adequate knowledge to handle the job/perform.

(e) **Approval:** These plans and proposals made by the personnel managers are then sent to the higher management team for approval. If these are approved, then each department seeks to implement them, and depending on the needs of individual departments and cost constraints, these plans are evaluated and managed.

Techniques Used to Determine the Requirements of Personnel:

The four methods generally used to determine the requirements of personnel are:

(i) Annual estimate of vacancies;

(ii) Long-range estimates of vacancies;

(iii) Fixed minimum manpower specification-wise requirements; and

(iv) Specific position estimations.

Annually the top management team and the directors must examine their organisation structure and its adequacy for the assigned functions as well as its adaptability for change anticipated shortly. This analysis or audit includes a review of the current vacancies and probable future changes in the organisations' personnel.

For example, adequate forecasts of organisational changes can indicate the number of executive positions which will have to be filled as well as the duties and responsibilities for such positions. From this can be ascertained the nature of training and development required for the existing staff to fit these positions adequately.

A crystallisation of the future job requirements can help the selection of persons who should participate in the management development program. In this way, manpower planning is helpful in both the selection and developmental activities.

Approaches to HR Demand Forecasting:

There are two approaches to HR demand forecasting- quantitative and qualitative. When concentrating on human resources needs, forecasting is primarily quantitative and, in large organisations, is accomplished by highly-trained specialists.

Quantitative approaches to forecasting can employ sophisticated analytical models, although forecasting may be as informal as having one person who knows the organisation anticipate future HR requirements. Organisational demands will ultimately determine which technique is used. Regardless of the method, however, forecasting should not be neglected, even in relatively small organisations.

1. Quantitative Approaches:

Quantitative approaches to forecasting involve the use of statistical or mathematical techniques; they are the approaches used by theoreticians and professional planners. One example is trend analysis, which forecasts employment requirements based on some organisational index and is one of the most commonly used approaches for projecting HR demand.

Following several steps typically does trend analysis:

First, select an appropriate business factor. This should be the best available predictor of human resources needs. Frequently, sales or value-added is used as a predictor in trend analysis.

Second, plot a historical trend of the business factor about several employees. The ratio of employees to the business factor will provide a labour productivity ratio.

Third, compare the productivity ratio for at least the past five years. Fourth, calculate human resources demand by dividing the business factor by the productivity ratio. Finally, project human resources demand out to the target year.

2. Qualitative Approaches:

In contrast to quantitative approaches, qualitative approaches to forecasting are less statistical, attempting to reconcile the interests, abilities, and aspirations of individual employees with the current and future staffing needs of an organisation. In both large and small organisations, HR planners may rely on experts who assist in preparing forecasts to anticipate staffing requirements. For example, expert forecasts – In this method, managers estimate future human resource requirements, their experiences, and judgments to good effect.

Management forecasts are the opinions (judgments) of supervisors, department managers, experts, or others knowledgeable about the organisation's future employment needs. For example, at the Ripe Tomato, a growing family dining chain, each restaurant manager is responsible for employment forecasts.

Another qualitative forecasting method, the Delphi technique, attempts to decrease the subjectivity of forecasts by involving a group of pre-selected individuals and soliciting and summarising the judgments. Thus, a group decision-making process is invoked which in turn, requires a great deal of process orientation to enhance coordination and cooperation for satisfactory forecasts.

This method works best in a situation where dynamic technological changes affect staffing levels. Ideally, HRP should include the use of both quantitative and qualitative approaches. In combination, the two approaches serve to complement each other, thus providing a more complete forecast by bringing together the contributions of both theoreticians and practitioners.

Whatever technique one might utilise, they need to be done systematically.

HR planners many times go further and analyse the demand based on the following:

(i) **Workforce analysis** to determine the rate of influx and outflow of employees – It is through this analysis one can calculate the labour turnover rate, absenteeism rate, etc. Qualitative methods go a long way in analysing the internal flow created by promotions, transfers, etc.

(ii) **Workload analysis**, with which one can calculate the numbers of persons required for various jobs concerning a planned output – This takes into consideration factors such as absenteeism, idle time, etc. Both quantitative and qualitative techniques are utilised for accurate results.

(iii) **Job analysis:** Job analysis helps in finding out the abilities or skills required to do the jobs efficiently. A detailed study of jobs is usually made to identify the qualifications and experience required for them. Job analysis includes two things – job description and job specification. Job description, thus, is a factual statement of the duties and responsibilities of a specific job. It indicates what is to be done, how it is to be done, and why it is to be done. Job specification provides information on the human attributes in terms of education, skills, aptitudes, and experience necessary to perform a job effectively.

II. Manpower Supply Forecasting Techniques:

After determining the manpower needs of a company, the manpower planner should think about the supply of manpower to fulfill the needs. There are two types of sources for manpower supply, viz., internal sources and external sources. Let us see each in detail-

Manpower Supply from Internal Sources:

The manpower supply from internal sources depends on two factors. They are:

1. The extent to which the present employees survive in the organisation; and
2. The rate of internal turnover (i.e., transfer and promotions) of personnel in the organisation.

(1) Analysis of Retention:

Before studying this method, we should have a clear understanding of the terms 'Wastage' and 'Labour turnover'. When the employees leave the organisation, it is wastage. A method to measure this wastage is the labour turnover rate. The following formula is generally used to calculate the labour turnover rate.

$$\text{Labour turnover rate} = \frac{\text{No. of leavers in the year}}{\text{Average no. of employees during the year}} \times 100$$

The results obtained by this method are not much helpful for guiding manpower planning. However, the method is useful for comparison between different companies. The calculations by this method do not show how many workers were stable in their positions during the year.

Let us take a hypothetical example. There are two firms A and B. There are 100 positions in both the firms. In firm A, all the 100 employees leave the organisation and new 100 employees are recruited. In firm B, 90 employees remain stable in the organisation, but the remaining 10 positions were left by employees 10 times in the year.

Thus, the number of leavers during the year in both the firms. The average number of employees during the year in both the firms is also 100. Therefore, the labour turnover rate for both firms would be 100 percent. The similarity in the labour turnover rate may misguide us to believe that working conditions in both firms are similar. There are different problems in both the firms, demanding different types of solutions.

The better method to determine labour turnover is the "Stability Index".

(2) Stability Index:

The stability index is useful in finding the proportion of the employees maintained in the organisation during the year. The formula to calculate stability index is as follows-

$$\text{Stability index} = \frac{\text{Employees in service for at least one year}}{\text{Total number of employees}} \times 100$$

Stability index is used along with labour turnover rate. The main limitation of the stability index is that it does not take into account the period of service of the employees who left the firm.

(3) Cohort Analysis:

The third method to measure the stability of employees is known as "Cohort Analysis". Cohort means, "A homogeneous group of employees who joined the organisation during a fixed period". Cohort analysis involves the drawing of the graphs based on leaving a pattern of the Cohort group. Based on these graphs, the wastage rate or stability rate can be determined.

The main disadvantage of the Cohort analysis is that, if we are dealing with a relatively stable group (i.e., one with a very low wastage rate), the behaviour of the group would have to be followed over a longer period to enable the management to have a meaningful analysis.

The Cohort analysis would be useful, however, if relatively unstable groups, such as apprentices, are to be observed.

(4) Census Method:

In Cohort analysis, the stability or instability of a homogeneous group is observed; while in the Census method, a section is selected from the whole labour force and its behaviour is examined for a short period, usually a year. The histograms are drawn to show the length of services of those persons who have left the organisation, i.e., leavers.

The main advantage of the Census method is that we can know about all the employees instead of a particular group. Moreover, every individual in the selected group contributes to the wastage pattern which can be quickly calculated and put to use for testing and forecasting.

Until now we have considered only the external movement of labour. We would now think about the internal movement of labour caused by promotion, transfers, etc.

Determining Manpower Gaps:

The final stage is to balance out the demand and supply gap. The closer the gap the better it is for the company when it goes into recruiting.

A comparison chart can be developed to find what is available and to what extent it can fulfill the demand forecast. This exercise helps us have an idea of the quantitative and qualitative gaps in the workforce. A reconciliation of demand and supply forecasts will give us the number of people to be recruited or made redundant as the case may be. This forms the basis for preparing the manpower plan.

In this process, a company always needs to keep repeating this step as it operates in a changing environment. Changes in product mix, union agreements, and competitive action are some of the important things that need special attention.

The human resource requirements thus identified are translated into a concrete manpower plan, backed up by detailed policies, and other human resources instruments and strategies (for example, recruitment, selection, training, promotion, retirement, replacement, etc.).

The manpower plan is further divided into the following resultant operational plans:

1. Recruitment plan to show how many and what type of people are required and when they are needed;
2. Redeployment plan to help chart out the future movement in terms of training and transfers.
3. Redundancy plan will indicate who is redundant, when and where; the plans for retraining, where this is possible; and plans for a golden handshake, retrenchment, lay-off, etc.
4. Training plan to chart out if training is required. If yes, when and to which level; whether it will be done in-house, done in phases, or included as part of a formal induction program. This includes the cost and benefits analysis of all the options available.
5. Productivity plan will indicate reasons for employee productivity or reducing employees costs through work simplification studies, mechanization, productivity bargaining, incentives, profit-sharing schemes, job redesign, upskilling etc.
6. Retention plan will indicate reasons for employee turnover and show strategies to avoid wastage through compensation policies, changes in work requirements, and improvement in working conditions.
7. Check/reviews points. The success of the entire exercise is dependent upon frequent reviews so that none of the factors are left out and changes are constantly taken care of. The important thing is to demarcate points for periodical checks to incorporate deficiencies and periodic updating of manpower inventory based on training and performance reviews, in the light of changing circumstances.

Need for Strategic Manpower Planning:

1. **Predicting Manpower Needs is Crucial:**

   The ability to predict manpower needs is crucial for the industry. On the demand side, companies formulate manpower planning strategies based on these forecasts, while, on the supply side, they provide job seekers with a basis to assess the attractiveness of a given sector.

2. **Economics of Manpower Planning is Even More Crucial:**

   Manpower forecasts are also important for assisting the government in the policy-making process by serving as pointers to help avoid redundant investments and achieve efficient and balanced growth for the industry. Meanwhile, forecasts based on an inaccurate market analysis can cause imbalances such as – undersupply or oversupply of manpower.

3. **Economics of Demand and Supply of Manpower Forecasting:**

   Forecasting errors most often stem from a superficial and partial analysis of a market, which overlooks its structural characteristics, or one that is narrowly focused on the present, or a given industry, without taking into consideration dynamic changes that may occur over time or delayed feedback effects, or linkages the market may have with other related industries.

4. **Get the Right People:**

   Static and unilateral analysis, in sum, is the most common culprit for erroneous predictions of supply and demand for manpower. These approaches can yield particularly severely flawed forecasts with cutting-edge industries and emerging industries which, while entertaining complex relationships of interdependence with other industries and experiencing rapidly-growing manpower demand, are characterised by a longer period required developing needed human resources.

Manpower Planning-Framework:

1. **Models of Manpower Planning:**

   The models of manpower planning deal on a high level of abstraction with employee movements from function to function throughout the organisation. As a consequence, functions, and employees are seen as numbers with no characteristics.

2. **Functions in an Organisation Develop Over Time:**

   Within the organisation, the requirements of functions develop over time. As a result, employees are needed with different competencies. To decrease the level of abstraction we must avoid the pitfall of implementing too much behaviour of employees. It is not possible to model the many interactions and career patterns of employees and the occupation of function in a very detailed manner.

   The modelling of "soft" factors such as preference, or dislike of specific functions by employees is, therefore, saved for later research. Our approach is to first cover the "hard" factors of employee characteristics and function requirements, for example, education, age, and experience based on earlier fulfilled functions. To model, verify, and explain these interactions patterns that will occur over time is the first aim.

3. **Change in Competencies is Governed by Peter Principle:**

   The competencies of the employees, which are useful for the organisation, can also decrease by several causes. In the first place, after reorganisation, a shift in the competency demand of the organisation arises. The number of employees stays the same, but the amount of competencies of the employees, which are still valid for the organisation can decrease.

   As these competencies are no longer necessary for the organisation, they are not taken into account anymore. Secondly, the employee's competencies get out of date after some time.

   Fighting obsolescence is a joint responsibility of the employee and the organisation. Solutions can be to take courses or to change position in the organisation to gain new experience.

   The factors mentioned here do not change the quantity of the employees, but just the set of available competencies. Besides the mentioned processes, three other factors have an influence on the available competencies in an organisation – inflow, outflow, and absence. The inflow of employees creates growth in competencies available for the organisation.

   The other two factors decrease the competencies. Insight into the trends of absence (through illness, vacation, and other causes), inflow, and outflow can be gained by analysing historical data and by looking at the developments in the labour market.

   These three factors change the obtainable competencies in the organisation by changing the number of employees within the organisation. Of course, there is a difference between inflow in the 'lowest' functions in the organisation and horizontal inflow in higher functions.

In the latter case, one can expect the new employees to have a larger set of suitable competencies for the organisation. In organisations with an internal labour market, employees usually only enter the organisation at the bottom in a fixed set of functions. The inflow can be controlled by the organisation, but it of course depends on the status of the labour market for the needed competencies. Outflow and absence can only be influenced indirectly.

However, at the macro level, the competencies, whether regarding existing or new employees, are governed by Peter Principle which articulates – “In time, every post tends to be occupied by an employee who is incompetent to carry out his duties” and adds that “work is accomplished by those employees who have not yet reached their level of incompetence”.

Approaches for Developing Manpower Planning:

1. **Planning for the Status Quo:**

   Planning involves steps to replace any employees who are either promoted or who leave the firm. An example is management succession planning which seeks to ensure that there is at least one qualified manager to replace any higher-level manager in the organisation.

2. **Thumb Rule:**

   This is based on the firm’s beliefs about forecasting human resource needs. For example, one firm believes that a ratio of one production supervisor for every 12 workmen is optimal. This firm maintains this 1:12 ratio because it has proved successful in the past. Another thumb rule is based on experience that one person can produce 2000 units of output per day and accordingly 5 employees are needed for 10,000 units as a matter of forecast.

3. **Markov Analysis (MA):**

   Markov chains are a powerful analysis technique that, used in manpower planning, can help it successfully achieve its goal. Markov chains make it possible to predict the size of manpower per category as well as transitions occurring within a given period in the future (resignation, dismissal, retirement, death, etc.). More importantly yet, with a Markov chain, one can obtain long-term average probabilities or equilibrium probabilities.

   However, to predict manpower supply and demand with accuracy using a macroeconomic model, one needs a vast array of data for each of the many variables used. To collect these data, one must first get hold of sufficiently broad-ranging time-series data for each industry. For this reason, a method of this type proves to be inadaptable for emerging sectors undergoing fast-paced growth with only small amounts of statistical data on the industry as a whole and manpower available.

4. **Unit Forecasting:**

   This refers to the estimate of supervisors and managers about forecasting Human resource needs for the next year unit-wise – this approach is called the “Bottom-up approach” for forecasting as the selections are made by lower-level management and added together at a higher level of the organisation.

5. **Ratio Trend Analysis:**

   The basic principle here is to say if it takes six people, for example, to perform an existing amount of work, it will take twelve people to do twice as much. Organisations measure activity levels in a variety of different ways. The ratio between 'direct' and 'indirect' in manufacturing is a classic one.

Individual departments in an organisation will also have their rule-of-thumb measures. A sales department, for instance, may have an idea of the number of customer calls a salesperson should make in a week, and, indeed, use this as one criterion for monitoring sales efficiency. If the business plan projects an increase in the number of new customers, this can be translated into a proportionate increase in the sales force.

6. Delphi Method:

This method relies on expert opinion in making long-range forecasts-this involves obtaining independent judgments from a panel of experts usually through a questionnaire or interview schedule on certain issues affecting the nature and magnitude of demand for an organisation's products and services.

7. Computer Simulation:

This is one of the most sophisticated methods of forecasting human resource needs. A computer is a mathematical representation of major organisational processes, policies, and human resource movement through organisation-computer simulations are useful in forecasting for human resources by pinpointing any combination of organisational and environmental variables.

8. Time and Motion Study:

Here the Industrial Engineer observes records and movement of workman and productivity vis-a-vis time required to conduct specific activities.

9. Most-Maynard Operation Sequence Technique:

This method is well accepted in automobile industries where lots of manual activities are involved. It is based on the walking and moving of the workmen to conduct the specific activity.

MOST is an acronym for Maynard Operation Sequence Technique. It was developed at H.B. Maynard and Co. Inc., the USA in the 1970s. It is a revolutionary PMTS System. MOST is an activity-based work measurement system that enables us to calculate the length of time required to perform a task i.e., a system to measure work. This technique is based on fundamental statistical principles and basic work measurement data compiled over many years. MOST concentrates on the movement of objects.

It was noticed that the movement of objects follows certain consistently repeating patterns, such as reach, grasp, move, and position of the object. These patterns were identified and arranged as a sequence of events followed in moving an object. This concept provides the basis for the MOST Sequence models.

Advantages of Manpower Planning:

Besides this, the following points also throw light on the advantages and manpower planning:

(i) Manpower planning involves forecasting manpower requirements in an organisation and helps the management in anticipating personnel shortages and surpluses and also to develop ways to avoid or correct problems before they become serious. Further, forecasting long-range manpower requirements help forecast the compensation costs involved in that connection.

(ii) A proper and systematic forecasting of human resource requirements helps an organisation to determine proper sources and methods of recruitment. Further, an organisation can also adopt a proper selection procedure depending upon the needs of the jobs. Proper tests can be designed to select the right candidates for the right jobs. Thus, the importance of manpower planning is immense in recruiting and selecting personnel.

(iii) From the viewpoint of training and development, the importance of manpower planning is great. Manpower planning ensures the training of employees in an organisation. Training involves imparting knowledge and developing attitudes, skills, social behaviour, etc., of the employees.

Manpower planning identifies the training needs of the personnel of an organisation beforehand so that necessary arrangements and training programs can be chalked out accordingly to give training to the employees.

Training helps the organisation to utilise its human resources to the optimum. Manpower planning is not only important from the viewpoint of an organisation but it also helps the employees of an organisation in developing and in the application of skills, abilities, knowledge which affect their capacity positively as for as efficiency, earnings, etc., are concerned.

(iv) So far as performance appraisal is concerned, manpower planning plays an important role in that area too. Performance appraisal refers to the identification of strengths and weaknesses of the employees of an organisation relating to their jobs. It is conducted to know whether the existing human resources possess the necessary qualities and qualifications as per the requirements of the jobs.

Manpower planning makes available necessary strategies to correct the weaknesses of the employees by making the proper arrangements for corrective training, retraining, and orientation programmes. All these are interrelated activities.

(v) Importance of manpower planning is none-the-less in respect of controlling the labour costs. Efforts are made in manpower planning to assure the timely and sufficient supply of labour, thus, avoiding the shortages and surpluses of labour which leads to saving and controlling labour costs.

(vi) Manpower planning facilitates the career development of employees. Career development refers to the upward movement of the personnel employed in an organisation. Taking into consideration the long-range plans of the organisation, a career path of an employee can be projected along with what is expected from him in terms of competence levels. The employees can then plan their careers accordingly within the organisation. The clarity plays a significant role in enhancing the levels of motivation of employees – a very important role of Manpower Planning.

(vii) Manpower planning if done properly and systematically, problems of low productivity, absenteeism, inter-departmental conflicts, resistance to change, etc., can be tackled and solved efficiently. The effort leads to higher productivity and efficiency levels, thus stressing the importance of this major function under HR organisation.

Thus, it can be said that manpower analysis helps to increase the prospects of an organisation in managing its resources in a better way and coping more effectively with dynamic situations.

Other Areas Suggested to be covered in the Report on Performance Analysis

10.10

Performance analysis is an important aspect of managing any business.Who Benefits from Performance Analysis? The benefits from performance analysis methods are far wider-reaching than just an organisation's bottom line.

Employees Grow from Performance Analysis:

Quantifiable goals in workflow allow team members to strive for completion and understand their achievement and points requirement for improvement, if any.

Performance Analysis Sets Clear Expectations:

Performance metrics create transparent expectations by which assessment can be derived.

A Better Process Means Better Results:

If the individual goals of employee workflows are clearly set and performance met the expectation then the business succeeds, and motivated employees can stake out their own in the individual initiatives that lend to the greater objective.

Regular performance evaluation of an organisation, helps to measure the progress towards achievement of goals and provides opportunity of course correction with respect to visible gaps/shortcoming.

A sales manager, executive, or small business owner may use performance analysis to understand how a business has performed relative to projections over a month or a year. A manager may also use performance analysis techniques to measure individual performance for periodic reviews or employee evaluations. For each situation, different metrics and goals are relevant. In individual performance analysis, a manager may only need information on individual and department performance, while for whole business analysis, company and department data are more useful than information on each employee.

A business performance analysis includes company performance metrics and goals. Depending on the scope and focus of the analysis, these may be more or less comprehensive. Here are some specific metrics or goals a company might consider during a performance analysis:

Itemized income from different product lines, regions, or product types.

- Return on sales and return on investment.
- Profit per employee and sales per employee.
- Financial ratios between assets, liabilities and net worth.
- Company goals over the next three, five, and 10 years.
- Market share and status.

- Reviewing and adjusting costs or spending regularly, etc.

Here are some metrics and goals that might be useful for analysing individual performance:

- Individual sales metrics.
- Projects completed by a deadline.
- Contribution to specific projects.

Here are the steps to conduct performance analysis for an entire department or organisation:

1. **Variance analysis:**

   Variance is the difference between the projected and the actual performance.

2. **Research variances:**

   Finding the 'root cause' for the variance leads to corrective actions to preempt possibility of future expectation gap.

3. **Analyse metrics:**

   Understanding non-financial key business metrics can be a helpful tool in researching the causes of variances.

4. **Review competitor performance:**

   Data need to be collected from authentic market sources about performance of the competition. Strength, Weakness, Opportunity, Threat (SWOT) analysis to be carried out to understand strength of own brand vis-a-vis others, price effect, entering into new geography etc.

5. **Decide on changes:**

   Gaps noticed post analysis of performance, scope for improvement need to be explored. Possibility of multiple alternatives for the same shortcoming also can't be ruled out. Hence, zeroing on the best option for optimum benefits and implementation of the same is the main motto of performance review.

Management Accounting Tools 10.11

Managerial accounting describes the collection, analysis, and reporting of business activities for internal control and introspection purposes. Company accountants who prepare managerial reports and analyses may be the same people who prepare financial data for external sources, or they may be dedicated to the creation of managerial accounting tools.

An accounting tool is a data set that's collected and reported according to accepted accounting principles, accounting tools are many and varied. Perhaps the most commonly known tools are balance sheets and income statements, typically used to report the financial health of a business for banks, shareholders, investors etc.

Typical managerial accounting tools are:

Break-even analysis: The break-even point is **the point at which total cost and total revenue are equal**, meaning there is no loss or gain.

Capital budgeting analysis: an examination of proposals for acquiring fixed assets and related fund allocation with avenue of financing.

Constraint analysis: a tool that examines the primary bottlenecks of a business and how these affect revenues and profits.

Inventory analysis: useful for calculating cost of goods sold as well as placing a value on raw materials and unsold products.

Margin analysis: a profit analysis typically built around revenue generated by a specific subset of data, such as customer, region, product, or business branch.

Transaction analysis: tools that look at specific transactions, such as sales to a particular customer or purchase of certain goods.

Trend analysis: tools that look at changes to data over time to permit examination of changes to business conditions, helpful for creating forecasts.

The various tools used at present in management accounting may be classified into the following groups.

1. Based on Financial Accounting Information

- Analysis of Financial Statements through Ratio Analysis.
- Analysis of Financial Statements through comparative statements, trends, graphs, and diagrams.
- Fund flow and cash flow analysis.
- Return on capital employed techniques.

2. Based on Cost Accounting Information

- Marginal costing (including cost volume profit analysis).
- Direct or incremental Costing and differential costing.
- Standard Costing.
- Analysis of Cost Variances.

3. Based on Mathematics

- Operations Research.
- Linear Programming.
- Network analysis.
- Queuing theory and Games Theory.
- Simulation Theory.

4. Based on Future Information

- Budget and Budgeting.
- Budgetary Control: Analysis of Budget Variance / Revenue Variance.
- Business Forecasting.
- Project Appraisal or Evaluation.

5. Miscellaneous Tools

- Managerial Reporting.
- Integrated Auditing.
- Financial Planning.
- Revaluation Accounting.
- Decision-making Accounting.
- Management Information System.

Important tools and techniques used in management accounting

Some of the important tools and techniques are briefly explained below.

1. Financial Planning:

The main objective of any business organisation is the maximization of profits. This objective is achieved by making proper or sound financial planning. Hence, financial planning is considered the best tool for achieving business objectives.

2. Financial Statement Analysis:

Profit and Loss account and Balance Sheet are important financial statements. These Statements are analysed for different period to get a comparative view of one or more periods.

3. Cost Accounting:

Cost Accounting presents cost data product-wise, process-wise, department-wise, branch-wise, and the like. These cost data are compared with predetermined one. The comparatives help the management in decision making.

4. Fund Flow Analysis:

This analysis finds out the movement of funds from one period to another. Moreover, this analysis is very useful to know whether the fund is properly used or not in a year when compared to the previous year. The Working Capital Changes and funds from the operation are also found out through this analysis.

5. Cash Flow Analysis:

The movement of cash and the purpose therefor during a period can be observed through Cash Flow Statement. Comparison for different periods also can be done.

6. Standard Costing:

Standard Costing is a predetermined cost. It provides a Yard Stick for measuring actual performance. It is used to find the reasons for the deviations if any.

7. Marginal Costing:

Marginal Costing Technique is used to fix the selling price, selection of best sales mix, best use of scarce raw materials or resources, to take make or buy decision, acceptance or rejection of bulk order and foreign order and the like. This is based on the fixed cost, variable cost, and contribution.

8. Budgetary Control:

Under Budgetary control techniques, future financial needs are estimated and arranged according to an orderly basis.

9. Revaluation Accounting:

The fixed assets are revalued as per the accounting guideline to find 'fair value' of the assets.

10. Decision-making Accounting:

A business problem can be solved by choosing any one of the best and most profitable alternatives. To select such an alternative, the relevant costs are compared. Thus, accounting information is used to solve the business problem which is arising out of the increasing complexity of the nature of business.

11. Management Information System:

The free flow communication within the organisation is essential for the effective functioning of the business. Hence, the management can design the system through which every employee of an organisation can assesses the information used for discharging their duties and taking quality decisions.

12. Statistical Techniques:

Number of statistical techniques are used for the specific purposes e.g. correlation analysis, regression analysis, linear programming etc.

13. Management Reporting:

Reports are prepared to get on overview of the relevant areas as required by the Management, to assess strength and weaknesses in different areas of operating activities and financial activities. These identifications are highly useful to management for exercising control and decision-making.

14. Historical Cost Accounting:

It means that costs are recorded after being incurred. Unless revalued, assets are maintained in Books at historical cost.

15. Ratio Analysis:

A ratio is anexpression of relative magnitude of two selected numerical values, selection of which to be made with logical corelation, expressing a ratio of Fixed Asset with Bad Debt having no relation while Bad Debt compared with Turnover and observed ratio is meaningful. It paves the way for effective control of business operations by undertaking an appraisal of both the physical and monetary targets.

To Sum Up:

Management reporting plays an important role in the current business environment. It gives a clear picture to executive teams about the operational aspects and competition role. Major characteristics of a good Internal Management Reporting Environment would be to meet all of the goals setout below:

Accuracy: Despite the inherent complexity, management reports need to be accurate. The reports can be drawn from specifically designed ERP Systems with minimum human intervention or manually prepared from extracted data/details.

Purposive: The specific purpose of the requirement needs to be fulfilled through the Report. With change in requirement, the Report modification can be thought of.

Detail: Requirement of detail must be understood before report generation. Report should not be burdened with unrelated and irrelevant information.

Balanced scorecard: The methodology is an analysis technique designed to translate an organisation's mission statement and overall business strategy into specific, quantifiable goals and to monitor the organisation's performance in terms of achieving these goals.

- Financial Perspective- Financial Performance.
- Customer Perspective- Satisfaction.
- Learning and Growth- Knowledge and Innovation.
- Internal Business Process- Efficiency.

Illustration 1.

A Company introduced a new product EZY with advanced technology in a product market where there is huge competition with many competitors having an individual market share of 5% to 10%. A survey of the present market estimates that demand will increase by 80,000 units per year. The company is presently targeting 50% of the additional market demand as competitors will need at least two years to match its product.

The Product EZY passes through three departments. Direct cost per unit of product at a present rate: Material cost ₹ 65 and Labour Cost ₹ 45. Overheads are absorbed based on normal capacity. The following relevant information is given:

Production Dept	Unit of Measurement	Normal monthly capacity	Monthly Allocated Fixed Overheads (₹)	Full Overhead cost Rate (₹)	Hours consumed by the product
X	Machine Hour	12,500 machine hrs	₹ 50,000	10.50	2
Y	Direct Labour Hour	15,000 labour hrs	₹ 60,000	9.00	1.5
Z	Direct Labour Hour	25,000 labour hrs	₹ 75,000	6.00	3

The company has set a target of Selling and Distribution costs of ₹3,00,000 irrespective of sales volume. The company normally sets a price by adding a mark-up on costs between 30% to 40%.

You are required to suggest the price to take care of competition from the right perspective.

Solution:

Department	Normal monthly capacity	Allocated monthly Fixed Overhead (₹)	Fixed Overheads per Hour (₹)	Full overhead cost per hour (₹)	Variable cost per hour (₹)	Fixed overhead per unit (₹)	Variable overhead per unit (₹)
X	12,500	50,000	4.00	10.50	6.50	8.00	13.00
Y	15,000	60,000	4.00	9.00	5.00	6.00	7.50
Z	25,000	75,000	3.00	6.00	3.00	9.00	9.00

50% of the additional demand = 80,000 × 0.50 = 40,000 unit.

Cost of the product:

Direct Material	₹ 65.00
Direct Labour	₹ 45.00
Variable Factory Overheads	₹ 29.50
Fixed Factory Overhead	₹ 23.00
Selling & Distribution Overheads (₹ 3,00,000 ÷ 40,000)	₹7.50
Total cost	₹ 170.00

The Selling price will be in the range of ₹ (170 × 1.3) and ₹ (170 × 1.4) i.e., between ₹ 221 and ₹ 238.

Suggestion: The company can go for a lower price as it covers the full cost and ensures good profit. Lower price will give better penetration in the market and keep competitors away for the long term to match technology and price.

Illustration 2.

ABC Co. has two Department producing small electrical goods. New Technology for the production of X will induce the following cost:

Costs	Department-A	Department-B
Direct Material	₹ 240	₹ 200
Direct Labour Rate / Hours	₹ 120	₹ 100
Direct Labour Hours	2 Hours	3 Hours
Variable OH Per Hour	₹ 50	₹ 30
Fixed Per Hour (Based on 100% Capacity)	₹ 60	₹ 40
Value of Machine on revaluation	₹ 40 Lakhs	₹ 28 Lakhs

New Technology cost = ₹ 25 lakhs, working capital = ₹ 7 lakh

The target volume of production in the 1st year is 2000 units @ 25% capacity

Variable Selling and Distribution Cost is ₹ 3 lakh for 2000 units. Expected return on investment 24%.

Suggest pricing of a new product for a new one or the existing ones at 80% capacity.

Solution:

Costs	Department-A	Department-B	Total
Direct Material	240	200	440
Direct Labour	240	300	540
Variable Overheads	100	90	190
Variable Selling & Distribution Cost	-		150
Total (₹)			**1320**

100% capacity = 8,000 units. 80% capacity = 6400 units

Fixed Costs = (60 × 16,000 + 40 × 24000) = ₹ 19.20 lakhs. Capital investment = (40+ 28+25+7) = ₹ 100 lakhs.

Return on investment required = ₹ 24 lakhs

Return required per unit = ₹ (19.2 + 24.0) lakhs /6400 = ₹ 675

Price to be charged per unit = (1320 + 675) = ₹ 1995

Illustration 3.

A company is operating at 60% capacity with a turnover of ₹ 86.40 lakhs.

(i) If the Company works at 100% capacity, the sales-cost relation is: Factory Cost is two-thirds of sales value and Prime Cost is 75% of Factory Cost.

(ii) Administrative and selling expenses (75% variable) are 20 % of sales value.

(iii) Factory overhead will vary according to operating capacity as given below:

Operating Capacity	**60%**	**80%**	**100%**	**120%**
Factory Overhead (₹ Lakhs)	19.80	21.60	24.00	30.00

The company has planned to operate at 80% capacity. Moreover, it has received an export orderandtheexecution of the same will involve 40 % of capacity. The prime cost of the order is estimated as ₹ 12.00 lakhs andthe shipping expenses involved will be ₹ 2.00 lakhs. Taking the same percentage of profit on the domestic sale, determinethe minimum price to be quoted for the export order.

Solution:

At 100% capacity.

Sale = 86.40 × 100/60 = ₹ 144 lakhs; Factory Cost =1.44 × 2/3 = ₹ 96 lakhs; Prime Cost = 96 × .75 = ₹ 72 lakhs; Factory overheads = ₹ 24 lakhs; Selling & Distribution Exp. = ₹ 28.8 lakhs; Variable S/D Exp. = ₹ 21.6 lakhs; Fixed S/D Exp. = ₹7.2 lakhs.

Particulars	**Operation 80% capacity (₹ Lakhs)**	**Export order 40% capacity (₹ lakhs)**
Prime Cost	57.60	12.00
Factory Overhead (Given)	21.60	8.40
Selling & Distribution Cost Variable	17.28	-
Selling & Distribution Cost Fixed	7.20	2.00
Total Cost of Sales	103.68	22.40
Sales Value (At 80% Capacity): 144 × 0.80	115.20	-
Profit	11.52	2.49
Profit %	10% on Sales	10% of Export Sales Value
Export Price to be Quoted		24.89

Let, Sales value = x, then Profit = 0.1x

Then 0.9 x = 22.40

Hence x = ₹ 24.89

Illustration 4.

ABC Co. has planned for an investment of ₹ 800.00 lakh with a 50% Loan from Banks at 10% interest.

Direct Cost for the year ₹480.0 lakhs and 50% of which is Material cost. Other expenses are at ₹ 80.0 lakh. The goods will be sold at 150% of the direct cost. The tax rate is assumed at 50%.

Determine:

(i) Net profit margin

(ii) Return on Assets

(iii) Assets turnover

(iv) Return on owners' equity

(v) Inventory Turnover

Solution:

Particulars	₹ Lakhs / %
Sales: 480 × 1.5	720
Direct Cost	480
Gross Profit	240
Operating Exp + interest	120
Profit before Tax	120
Net profit after Tax	60
(i) Net Profit Margin (60/720)	8.33%
(ii) Return on Assets (60/800)	7.5%
(iii) Return on Equity (60/400)	15%
(iv) Asset Turnover (720/800)	0.9
(v) Inventory Turnover (240/720) ×100	33.33%

Illustration 5.

ABC Ltd which is manufacturing consumer products has two divisions Assembling and Finishing. The two divisionsare operating as cost centers

(i) Present activities and costs involved in the Assembling division & Finishing division and a year:

Assembly Division:

No of sets assembled: 12,000

Manufacturing of parts (including material): ₹ 6.00 lakhs

Parts purchased from the market: ₹ 4.00 lakhs

Another Variable cost: Welding cost- ₹ 5 lakhs and Assembling cost- ₹ 9.00 lakhs

Fixed cost for the unit: ₹ 6 lakhs

25% of the production of the Assembly division is sold in the market for ₹ 300 per set and 75% is transferred to Finishing Division at ₹ 280

The cost incurred in Finishing Division:

Painting cost: ₹ 5.00 lakhs; Polishing cost: ₹ 1.00 lakhs; Fixed cost ₹ 4.00 lakhs.

The selling Price per set is ₹ 450.

Evaluate the following situations:

(ii) Division Assembly has proposed for expansion of their division for an enhancement of capacity by 20% for ₹20 lakhs. It is indicated that there will be no change in factory fixed cost in the operation of additional volume of job. Division Assembly proposes to maintain the transfer to the finishing division to the existing level and sell additional sets to market at the present price.

(iii) Division Finishing has proposed for a transfer of the whole of the output of the Assembly division for ₹280 per unit and the additional units can be sold in the market at the existing price which will involve advertisement expenses to the extent of ₹ 4.00 lakhs and fixed cost in the division will go up by ₹ 1.00 lakhs.

(iv) Assembly division claims that the transfer rate of ₹ 280 is irrational in a sense of undue favour to the Finishing divisionat their cost and the Finishing Division is given the advantage of the market price for their products whereas the Assembly division is deprived of that advantage. The Assembly division agreed to transfer the whole of its output to Finishing Division for ₹ 300.

You are required to give your recommendation assuming the opportunity cost of capital is 15%.

Solution:

Existing profitability of divisions & company

Particulars	Rupees in Lakhs (₹)
Assembly Division	
Total Sales Value (3,000 × 300 + 9,000 × 280)	34.20
Total Variable Cost for Division (6+4+5+9)	24.00
Contribution	10.20
Fixed Cost	6.00
Profit for Division Assembly	4.20
Finishing Division	
Total Sales Value 9,000 set @ ₹450	40.50
Variable Cost (9,000 × 280) + 6 lakhs	31.20
Contribution	9.30
Fixed Cost	4.00
Profit for Division Finishing	5.30
Total Profit of the Company	9.50

(i) Evaluation of the proposal: Expansion of assembly division & transfer to Finishing division at existing level.

Particulars	Rupees in Lakhs (₹)
Total Sales Value (5,400 × 300 + 9,000 × 280)	41.40
Total Variable Cost for Division (24 × 1.2)	28.80
Contribution	12.60
Fixed Cost + Opportunity Cost of Capital Invested (6.00 + 20 × 0.15)	9.00
Profit for division Assembly	3.60
Finishing Division	
Total Sales Value 9,000 set @ ₹.450	40.50
Variable Cost (9,000 × 280) + 6 Lakhs	31.20
Contribution	9.30
Fixed Cost	4.00
Profit for division Finishing	5.30
Total Profit of the Company	8.90

(ii) Evaluation of the proposal: Expansion of assembly division & transfer of whole assembly output to Finishing division for ₹ 280

Particulars	Rupees in Lakhs (₹)
Assembly Division	
Total Sales Value (14,400 × 280)	40.32
Total Variable Cost for Division (24 × 1.2)	28.80
Contribution	11.52
Fixed Cost + Opportunity Cost of Capital Invested (6.00 + 20 × 0.15)	9.00
Profit division Assembly	2.52
Finishing Division	
Total Sales Value 14,400 Set @ ₹450	64.80
Variable Cost (14,400 × 280) + 6 Lakhs	46.32
Contribution	18.48
Fixed Cost + Advertisement Cost (4+4+1)	9.00
Profit for Division Finishing	9.48
Total Profit of the Company	12.00

(iii) Evaluation of the proposal: Expansion of assembly division & transfer of whole assembly output to Finishing division.

Particulars	Rupees in Lakhs (₹)
Total Sales Value (14,400 × 300)	43.20
Total Variable Cost for Division (24 × 1.2)	28.80
Contribution	14.40
Fixed Cost + Opportunity Cost of Capital Invested (6.00 + 20 × 0.15)	9.00
Profit for Division Assembly	5.40
Finishing Division	
Total Sales Value 14,400 Set @ ₹ 450	64.80
Variable Cost (14,400 × 300) + 6 Lakhs	49.20
Contribution	15.60
Fixed Cost + Advertisement Cost (4 + 4 + 1)	9.00
Profit for Division Finishing	6.60
Total Profit of the Company	12.00

The proposal (iii) i.e., transfer of all unitsfrom Assembly to Finishing Division at a transfer price of ₹ 300 is recommended. With the adoption of this price, the profitability of the company as a whole will go up and each division will get its due share of profitability.

A suggestive list of Key Performance Indicators:

Annexure-I

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, a 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 the total cost ➢ Material wastage as % of total input ➢ Contribution per unit of material used
	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 utilization ➢ 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
	Delivery	➢ On-time supplies ➢ Supply of full quantity
	Quality	➢ % Of rejections
	Cost	➢ Price reductions agreed-cost-effect ➢ Price escalations gave-cost-effect
	Overall	➢ Supplier satisfaction index ➢ Accuracy of forecasts shared

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Which of the following is a kind of information report?
   (a) Trend reports.
   (b) Analytical report.
   (c) Activity reports.
   (d) All of the above.

2. Management reporting can be performed as______.
   (a) Internal reporting.
   (b) External reporting.
   (c) Both (a) & (b).
   (d) None of the above.

3. The backbone of any organisation is ____.
   (a) Information.
   (b) Employee.
   (c) Management.
   (d) Capital.

4. Which of these is usually written in a form of a memorandum?
   (a) Informal reports.
   (b) Formal reports.
   (c) Professional reports.
   (d) Business reports.

5. Which of the following is a type of matter that may be covered in a special report?
   (a) Feasibility study for a project.
   (b) Cost reduction schemes information.
   (c) Data on make or buy decision.
   (d) All of the above.

6. _____ are to be presented after making an investigation of the problem which requires to be investigated.

   (a) Memorandum.

   (b) Special reports.

   (c) Summary.

   (d) Special facts.

7. _____ is a very important method of presenting information to the management in a pictorial manner and attracts the eye of the recipient more quickly and forcibly.

   (a) Tabular Reports.

   (b) Descriptive Reporting.

   (c) Graphic Presentation.

   (d) All of the above.

8. _____ are presented in the form of comparative statements.

   (a) Descriptive Reports.

   (b) Graphics Presentation.

   (c) Transactional Analysis.

   (d) Tabular Reports.

9. Which of the following general principle is required to be followed while reporting?

   I. Report should have a proper title.

   II. Report should be in good form and should have subheadings and paragraphs.

   III. Format of the report should be changed frequently.

   IV. Report should factual.

   V. Report need not save the time of the management.

   Select the correct answer from the options given below.

   (a) I and III only.

   (b) II & IV only.

   (c) II, III, and V only.

   (d) IV, I, and II only.

10. Collecting comments and suggestions from users to discover ways to continuously improve the data and process can be described as ________ .

    (a) Implementation.

    (b) Exception.

    (c) Feedback.

    (d) Order.

11. Which of these reports provides information without any evaluation?

    (a) Informational.

    (b) Interpretative.

    (c) Routine.

    (d) Progress.

12. ——— report provides rationed findings.

    (a) Informative.

    (b) Interpretative.

    (c) Routine.

    (d) Progress.

13. Which of these is not mentioned in a progress report?

    (a) Name of the project.

    (b) Right choice of instruments.

    (c) Nature of work.

    (d) Amount of work left.

14. Which of these is not a parameter of a formal report?

    (a) Presentation.

    (b) Complaint.

    (c) Information.

    (d) Request.

15. Which of these reports is written before starting a new project?
    (a) Feasibility report.
    (b) Periodic report.
    (c) Trouble report.
    (d) Progress report.

16. Which of these must never be a basis for a technical report?
    (a) Facts.
    (b) Tests.
    (c) Personal prejudices.
    (d) Experiments.

17. Reports present conclusions based on ______ .
    (a) Intuition.
    (b) Belief.
    (c) Impression.
    (d) Investigation.

18. Which of these is not a parameter of a report?
    (a) Ability to acquire additional information.
    (b) Quality of additional information acquired.
    (c) Ability to arrive at a subjective evaluation.
    (d) Ability to provide worthwhile recommendations.

19. The chronological development of information in the body of the report is done according to the ________.
    (a) Logical sequence of events.
    (b) Order in which events occurred.
    (c) Choice of the writer.
    (d) Collection of data.

20. Which of these must be avoided in a technical report?
    (a) Facts.
    (b) Logical conclusion.
    (c) Objective evaluation.
    (d) Subjective evaluation.

Short Essay Type Questions

1. What is meant by Performance Analysis?
2. State the objective of preparing the Performance Analysis Report.
3. Discuss the steps suggested for the report on performance analysis?
4. Indicate the contents of the Performance Analysis Report?
5. What do you mean by Management Accounting Tool?
6. Discuss the various management accounting tools which are used to serve different objectives.
7. Write short notes on:
    (a) Profitability Analysis
    (b) Key Performance Indicators (KPIs)
    (c) Utilities and energy efficiency analysis
    (d) Manpower Analysis

Essay Type Questions

1. What do you mean by accounting reports? What are the different types of reports for internal use? Discuss each of them.
2. What are the special reports? What matters may be covered by the special reports?
3. Describe the reporting needs of different levels of management and how a system of reporting can satisfy it?
4. What are the essentials of a good report? Describe.
5. Explain the different types of reports that are used in an enterprise
6. "Accounting Reports are a matter of necessity for the management and not a matter of convenience" Discuss.
7. Define reporting to different levels of management. What are the different modes of reporting?
8. Explain the objectives of Management Reporting.
9. What is a control report?
10. What are the types of reports, which are required by the middle level of management?

Answer:

- **Multiple Choice Questions (MCQ)**

1.	(d) All of the above
2.	(c) Both (a) & (b)
3.	(a) Information
4.	(a) Informal reports.
5.	(d) All of the above.
6.	(b) Special reports.
7.	(c) Graphics Presentation.
8.	(d) Tabular Reports.
9.	(d) IV, I, and II only.
10.	(c) Feedback.
11.	(a) Informational.
12.	(b) Interpretative.
13.	(b) Right choice of instruments.
14.	(b) Complaint.
15.	(a) Feasibility report.
16.	(c) Personal prejudices.
17.	(d) Investigation.
18.	(c) Ability to arrive at a subjective evaluation.
19.	(b) Order in which events occurred
20.	(d) Subjective evaluation.

Management Audit in Different Functions

11

This Module includes

Management Audit in Different Functions

SLOB Mapped against the Module

To obtain in-depth knowledge about management audit processes to identify the scope of improvement at various functional areas of the organisation. (CMLO 2a, b)

Module Learning Objectives:

Management audit, as the name signifies, attempts to evaluate the performance of various management processes and functions. It is an audit to examine, review and appraise the various policies and actions of the management on the basis of certain objective standards. After studying this module, the students will be able to –

- Know the Corporate Objectives and Culture.
- Explain the Importance of Personnel Development and its impact on the growth of the Organisation
- Differentiate between Productivity Audit and Efficiency Audit
- Determine the Importance and process of Corporate Social Responsibility Audit
- Identify the ways in which the Social Cost-Benefit Analysis Audit is useful for the organisation

Corporate Objectives and Culture

11.1

A **Corporate or Business Objective** is a result that a company aims to achieve. It also includes the strategies that people will use to reach there. A business objective usually includes a time frame and lists the resources available to fulfil the objective.

Business Objective vs. Goal

Business goals and objectives are not the same. The goal includes a broad primary outcome. A business objective, on the other hand, is a measurable step people take to achieve that goal. Goals are general while objectives are specific.

A company's business objectives provide steps a picture of how it plans to achieve its goal with timeframe and resource requirement. It also states how long it will take, and what resources are available. A business goal is vague in comparison.

When we plan our business' future, we generate a list of potential achievements. We call these the goals. The actual steps we plan to take to get to those achievements are the objectives.

People commonly use the terms 'goals' and 'objectives' interchangeably. However, they are not the same. Business objectives and goals have important differentiating attributes which we use at different stages of the planning process.

Objectives are Specific, Not Goals

A business objective is more specific and easier to measure than a goal. All our basic tools that under lie our planning and strategic activities are our objectives.

Objectives serve as the basis for creating policy and gauging performance.

For example, making a profit is a business objective. Reducing the workforce, expanding abroad, or minimizing expenses are also business objectives. Expenses are what the business spends. Keeping track of expenses and outgoings can be a real chore.

Goals are statement a business makes regarding its future. They represent the aspirations its leaders have.The CEO of a company may say: "We seek to become the largest maker of bicycles in the world." This is a goal because the person does not explain how the company will achieve this.

The exact steps a company plans to take to reach its goals or aims are its business objectives. When expressing the objectives, the CEO might say:

"We will increase our sales of bicycles by 2.5% each quarter of this year. We will open new branches and factories in Hyderabad and Visakhapatnam during the next twelve months."

Business Objectives-Small Companies

The main objectives of a small or very young business might be:

Profit Maximization

Profit maximization means making as much profit as possible, of course ethically.

Survival

'Survival of the fittest', so goes the saying. Survival is a short-term business objective but the same is true for long term also.

Growth

Just like human body, the growth should be all round. Turnover, Profitability, Profit volume, Market reach, Geographical spread, higher employee satisfaction, lower attrition, gaining Customer loyalty etc. all are examples of positive growth in business area. Some believe that growth is the only route to survival.

Furthermore, the bigger a company, the more it can benefit from economies of scale.

When a Business Objective Clashes

Sometimes, one business objective can clash with another, e.g good governance with profiteering. For example, certain unethical practices endorsed by management (e.g low quality, adulterated product) to earn additional profit at the cost of Customer satisfaction.

Long-term objectives can affect the short-term prospects of a business e.g high investment in new plant, equipment, or new products, will hit cash flow in the short term.

Organisation Corporate Culture

Culture is a nebulous concept and is often an undefined aspect of an organisation. Culture differs Organisation to Organisation. Organisation culture depends values nurtured by the Promoters, Management and Employees. An employer must begin with a thorough understanding of what it meant by 'culture' specific to their organisation. Although extensive academic literature exists relating to the topic of organisational culture, there is no generally accepted definition of culture. Instead, the literature expresses many different views as to what organisational culture is.At the deepest level, an organisation's culture is based on values derived from basic assumptions about the following:

Nature and Human behaviour: Different behavioural pattern determine the relationship with Customer, Employees and Society as a whole. Are people inherently good or bad, mutable or immutable, proactive or reactive? These basic assumptions lead to beliefs about how employees, customers, and suppliers should act, react and interact and how they should be managed.

Legacy and departure therefrom: Some big houses in India follow the legacy, which their patriarch demonstrated. True Leaders guide and demonstrate the vital principle. Sometimes, the departures are not liked by the next generation. However, modern thoughts, contemporary ideas can only provide a biz currency at the requisite point in time.

The Organisation's relationship to its Environment: How does the organisation define its business and its constituencies?

- **Appropriate Emotions:** Which emotions should people be encouraged to express, and which ones should be suppressed?

- **Effectiveness:** What metrics show whether the organisation and its components are doing well? An organisation will be effective only when the culture is supported by an appropriate business strategy and a structure that is appropriate for both the business and the constituents.

Organisational culture can manifest itself in a variety of ways, e.g including leadership behaviour, communication styles, internally distributed messages aggression in setting targets , and corporate celebrations. Given that culture comprises so many elements, it is not surprising that terms for describing specific cultures vary widely. Some commonly used terms for describing cultures include aggressive, customer-centric, focused, innovative, ethical, research-driven, technology-driven, process-oriented, hierarchical, family-friendly, and risk-taking etc.

Since culture is difficult to define, organisations may have trouble maintaining consistency in their messages about culture.

Factors That Shape an Organisation's Culture

Organisational leaders often speak about the unusual natures of their company cultures, seeing their domains as special places to work, but organisations such as Disney and Nordstrom, which are well-known for their unique cultures, are rare.

Most company cultures are not that different from one another. Even organisations in disparate industries such as manufacturing and health care tend to share a common core of cultural values. For example, most private-sector companies want to grow and increase revenues. Most strive to be team-oriented and to demonstrate concern for others. Most are driven, rather than relaxed because they are competing for revenue and market share. Some of the cultural characteristics that distinguish most organisations include the following.

Values

At the heart of organisations, cultures are commonly shared values. None is right or wrong, but organisations need to decide which values they will emphasize. These common values include:

- **Outcome Orientation:** Emphasizing achievements and results.
- **People Orientation:** Insisting on fairness, tolerance, and respect for the individual.
- **Team Orientation:** Emphasizing and rewarding collaboration.
- **Attention to Detail:** Valuing precision and approaching situations and problems analytically.
- **Stability:** Providing Security and following a predictable course.
- **Innovation:** Encouraging experimentation and risk-taking.
- **Praising failure:** To nurture risk taking nature and innovative ideas, failures also praised.
- **Aggressiveness:** Stimulating a fiercely competitive spirit.

Degree of Hierarchy

The degree of hierarchy is the extent to which the organisation values traditional channels of authority. The three distinct levels of hierarchy are "high"-having a well-defined organisational structure and an expectation that people will work through official channels; "moderate"-having a defined structure but an acceptance that people often work outside formal channels; and "low"-having loosely defined job descriptions and accepting that people challenge authority.

An organisation with multiple levels and layers hinders prompt decision,the so-called bureaucratic attitude. A balanced approach is always commendable.

Degree of promptness and Urgency

Promptness in responding to stakeholder requirements is the determining factor for entity's success. Urge to respond at a higher speed is the required cultural change, which any organisation can brace for.The degree of urgency defines how quickly the organisation needs to drive decision-making and innovation. Quick response to dynamic market scenario, is the best way to survive.

People Orientation or Task Orientation

Human face of the Organisation keeps employee moral high, which results in better performance and higher productivity. Employee participation in management decision making process also a morale booster for employees and demonstration of a good organisational culture. Organisations usually have a dominant way of valuing people and tasks. An organisation with a strong people orientation tends to put people first when making decisions and believes that people drive the organisation's performance and productivity. An organisation with a strong task orientation tends to put tasks and processes first when making decisions and believes that efficiency and quality drive organisation performance and productivity.

Functional Orientation

Functional orientation is a pre-requisite for employee performance and skill development in the related field. Every organisation emphasizes certain functional areas. Examples of functional orientations may include organisational business and related areas. For example, an innovative organisation known for its research and development may have at its core, a functional orientation toward R&D. A hospitality sector company, may focus on various operations or services provided to Customers, which need to be reflected in employee and management behaviour.

Employees from different functions in the company may think that their functional areas are the ones that drive the organisation. Organisational leaders must understand what most employees perceive to be the company's functional orientation.

Organisational Sub-cultures

Any organisation can have a mix of sub-cultures in addition to the dominant culture. Sub-cultures exist among groups or individuals who may have their rituals and traditions that, although not shared by the rest of the organisation, can deepen and underscore the organisation's core values. Sub-cultures can also cause serious problems.

For example, regional cultures often differ from the overall culture that top leadership tries to instill. Perhaps aggressiveness that is common in one area, may not mesh with a culture emphasizing team building or an organisation with a culture built around equality, may face trouble with newly acquired entity.

Creating and Managing Organisational Culture

Organisational culture tends to emerge over time, shaped by the organisation's leadership and by actions and values perceived to have contributed to earlier successes. Company culture can be managed through the cultural awareness of organisational leaders and management. Managing a culture takes focused efforts to sustain elements of the culture that support organisational effectiveness.

How Culture Develops

An organisation's customs, traditions, rituals, customer handling and general way of doing things are the manifestation of its culture; they are what one sees when walking into the organisation. The prevalent current organisational culture is usually due to factors that have worked well for the organisation in the past.

Founders typically have a significant impact on an organisation's early culture. Over a period of time, such behavioral norms developed are consistent with the organisation's values. For example, in some organisations, resolution of conflicts is hashed out openly and noisily to create widespread consensus, whereas in other places disputes are settled hierarchically and quietly behind closed doors.

Though culture emerges naturally in most organisations through strong cultures often begin with a process called "ethics and values. Once the culture is framed, an organisation may establish a values committee that has a direct link to leadership. This group makes sure the desired culture is alive.

Sustaining a Culture

The management of organisational culture starts with identifying a company's organisational culture traits or "artifacts." Artifacts are the core business activities, processes, and philosophies that characterize how an organisation does its day-to-day business.

Identifying these traits and assessing their importance in light of current business objectives is a way to start managing culture.

Leaders and managers within an organisation should approach culture management by initially gaining an understanding of the common traits found in all parts of businesses. Then, they should take the following steps to manage their organisation's culture:

- Identify common artifacts or traits, including those from the standpoint of an organisation's social, material and ideological culture.
- Convene groups of employees-representatives from all levels, functions, and locations of the organisation-to assess the validity, significance, and currency of key artifacts.
- Subject those traits to a rigorous assessment of their underlying shared assumptions, values, and beliefs.
- Summarize findings and share them with all participants to solicit additional insights.
- Create a culture management action plan. The plan should enhance traits that support corporate growth or organisational effectiveness and correct traits that might hinder a company's advancement.

Typically, shared assumptions and beliefs originate with an organisation's founders and leaders. Because those beliefs proved successful (otherwise the company would not exist and the leaders would not be in their positions), often they go unchallenged; however, those assumptions and beliefs might be outdated and may hinder future success.

Corporate Services Audit

11.2

'Corporate Services' is a generic term that implies service-oriented obligations of a corporate sector entity to different interest groups such as Consumers, Employees, Shareholders, Fellow businessmen, Community, and State.

Service-oriented responsibilities of a business concern are necessarily to be different in different circumstances and situations. For example, corporate services during periods of a country's emergency (e.g., earthquake, war, etc.) are of great significance.

To cite another example, a corporate agreement to sell goods to a friendly country within the state legislation does not violate the canons of service-oriented business responsibilities, but a similar attempt to an alien enemy is certainly an undesirable service. So, the concept of the term is difficult to be defined within certain fixed parameters.

Scope of Corporate Services Audit

The scope of corporate services audit extends to the critical examination of the various aspects of services and their extent that have been satisfactorily rendered by a corporate body, and of evaluation of the degree of awareness and responsiveness on the part of such enterprise.

The performance of management towards consumers, employees, shareholders, community, fellow businessmen, and governments is separately studied and evaluated by a management auditor while conducting such an audit.

The approach of Corporate Services Audit

The concept of 'corporate services audit', according to some classical sociologists, is that its appraisal system should take into account the level of contribution business enterprises makes to society and its environment towards raising the quality of life through better product quality and services rather than profit maximization.

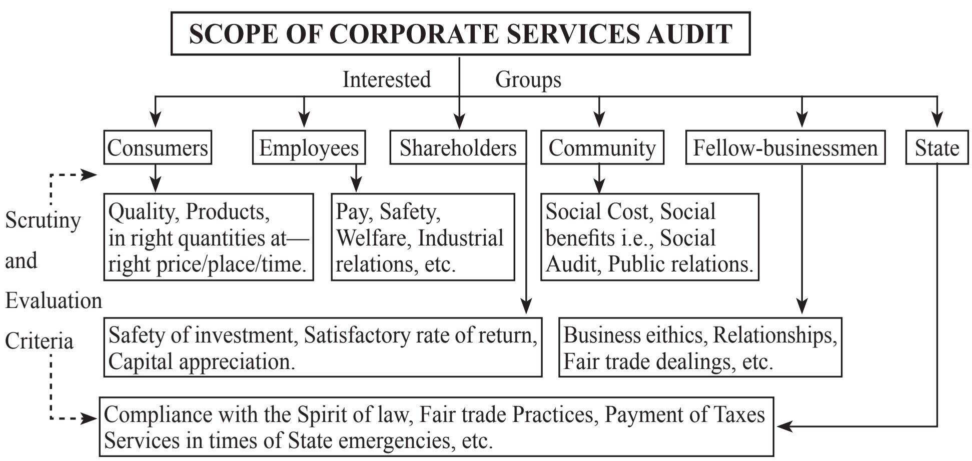


Figure 11.1: Scope of Corporate Services Audit

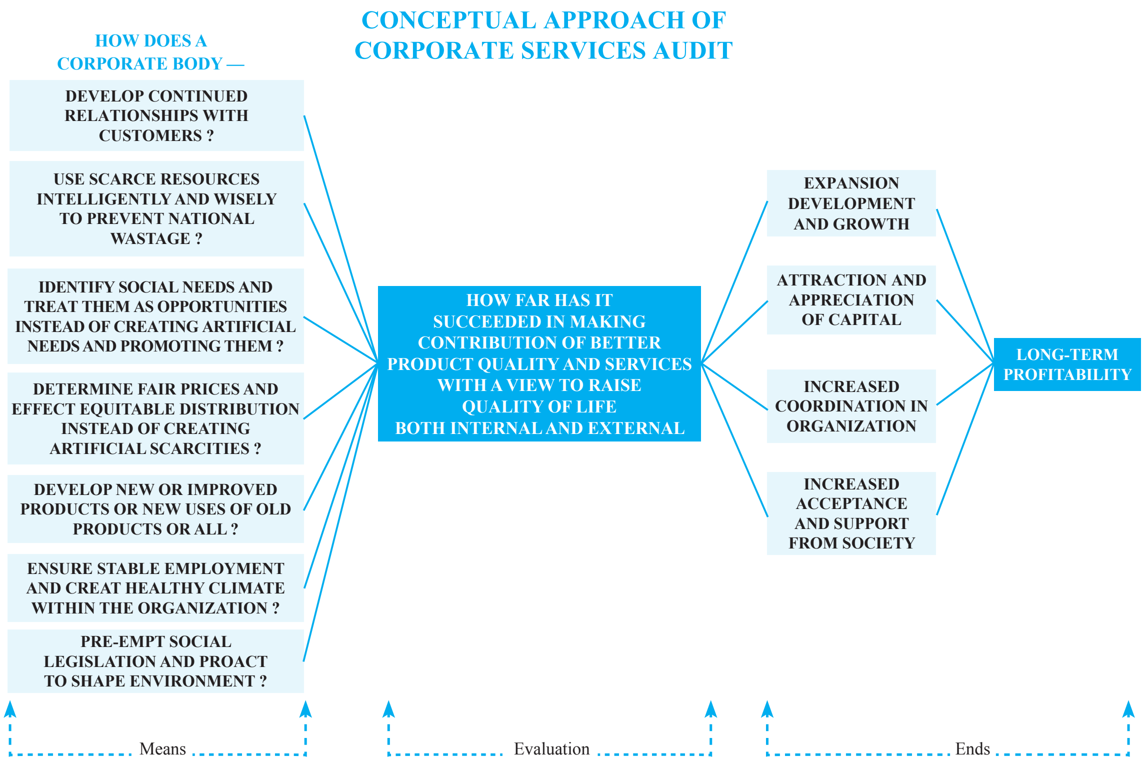


Figure 11.2: Conceptual Approach of Corporate Services Audit

So, the audit considerations include assessment of reactions to the following basic questions:

(i) What a business may do in terms of available opportunities?

(ii) What a business can do in terms of capabilities and resources?

(iii) What a business wants to do in terms of aspirations, ambitions, and values of top management?

(iv) What a business should do in terms of response to society and its environment?

This audit 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 the audit approach. Its conceptual approach can be best explained by a model, more or less along the lines of 'social audit'.

Corporate Development Audit

11.3

The term 'Corporate Development' covers both potential and kinetic aspects. The structural aspects of a corporation are concerned with the build-up of the 'potential'. The 'kinetic' aspects are manifest in the organisation in action.

There are two elements of structural aspects:

(1) Organisation as a synonym of the corporate structure itself and

(2) Organisation concerned with planning the structures, departmentation establishing the lines of command, and so on. Thus, the corporate development audit, from the above points of discussion, covers the entire gamut.

In sum, corporate development audit "approaches the structure and process of organisation, both in its potential and its transformation into kinetic energy. The premise is that unless an enterprise is structurally well equipped it cannot perform the functions entrusted to it. Such structural equipment can be seen from different points of view such as size and magnitude of its operations, technology, employment, investment, product and product-mix, growth prospects in the existing lines and diversification, manning, pursuance of adequate and sensitive policies and problems of departmentation, a delegation of power and corresponding responsibilities to each position created in the organisation and mechanisms developed for both monitoring and applying centripetal forces to centrifugal movements, promotion and development needs of the people in the organisation, and other factors that have a direct bearing on different aspects of (a corporate) organisation understood in different ways.

Since a corporate sector is conceived of as 'a going concern' and its development is an endless process, the audit about corporate development is a continuous exercise based on continuous evaluation and monitoring of the external and internal environments of a business enterprise.

In the broadest sense of the term, there are four essential dimensions involved in corporate development audits.

(i) Regularity:

That means the different elements /parts of a body corporate are under constant watch.

(ii) Systematic check:

This suggests the assessment of changing requirements of a corporate body in the context of forces generated from within and outside.

(iii) Review:

This assesses past performance, its quality, and content, and its contribution to the corporate goals as definitively pronounced from time to time. This examines the deviations from goal realisation and suggests measures for achievement.

(iv) Appraisal:

This examines in detail the character, content, and quality of the corporate goals set matches the resources employed against the attainments recorded, and suggests the future course of action on the premise that nothing is taken for granted, even goals.

Components of Corporate Development

The Components of Corporate Development Audit may be indicated by the chats (stage-wise) as follows:

Chart 1:

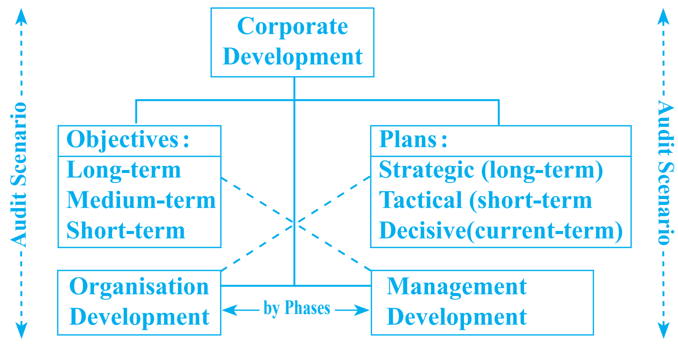


Chart 2:

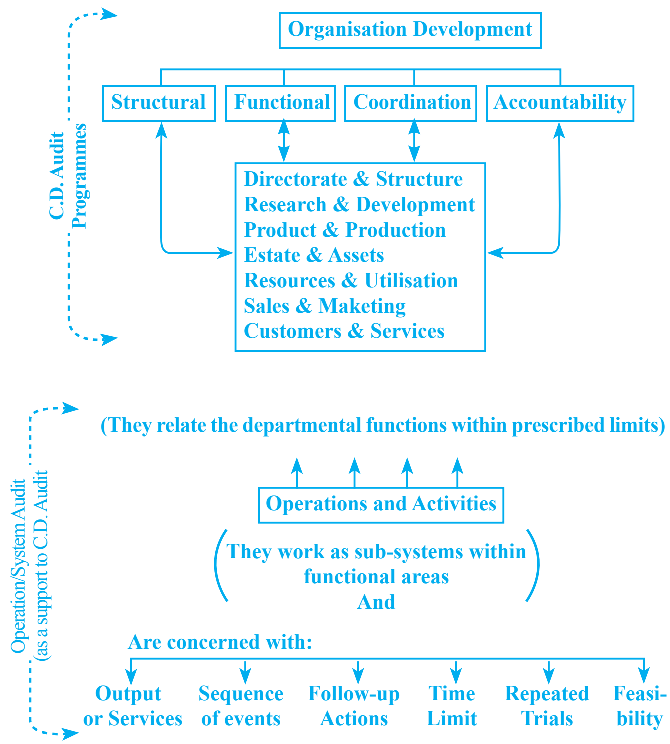


Chart 3:

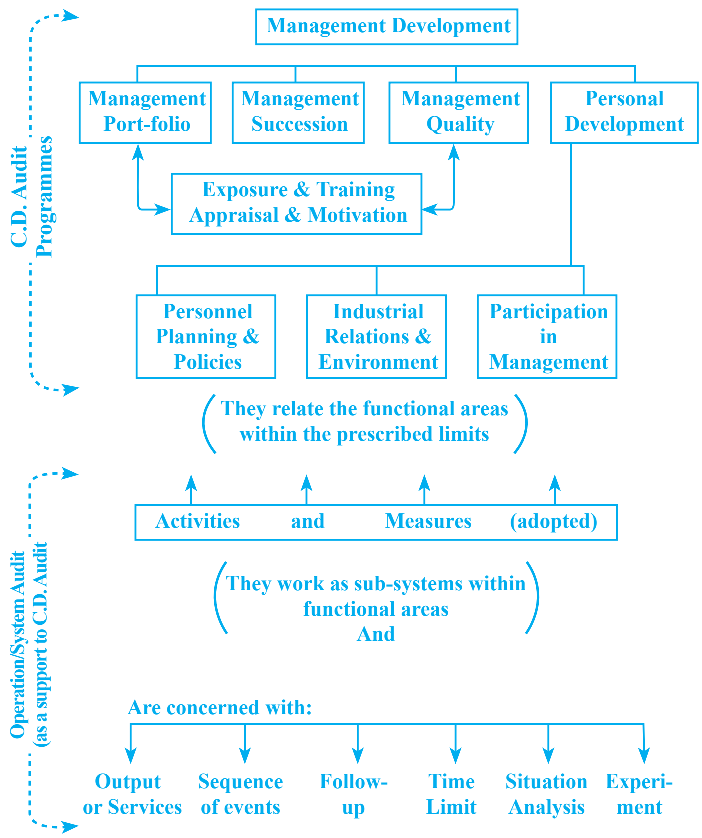


Figure 11.3: Components of Corporate Development

Scope of Corporate Development Audit

The scope of corporate development audit can be viewed from both Micro and Macro level.

The scope includes the following, among others:

1. Corporate Planning and Policy:

Planning is an exercise undertaken on a long-term basis even before the forecasts are drawn up. It requires examining the business enterprise and its whole environment in greater detail from the viewpoints of potential strengths and weaknesses. The possible audit areas are planning and policy issues on the product, production, finance, personnel, managerial-particularly 'succession', etc.

2. Corporate Forecasting:

Forecasts are usually medium-term and commonly short-term. The thrust of the audit is to ascertain by a review process:

(a) The degree of co-relationship that exists between corporate plans and total industry plans.

(b) The competitive market share position within that industry.

(c) The factors for forecasts, such as supply and demand, industry trends, enterprise's competitive performance, general economic and political trends, financial standing about the competitors, etc.

(d) How well the corporate forecasts match with national economic development plans.

3. Corporate Strategy:

For a long-term strategy, the auditor attempts to assess whether a corporate sector will survive as a viable entity. For short-term strategies, the auditor examines and evaluates how a firm analyses its ongoing strategy-the strategy of operations on existing lines.

Four broad dimensions are usually covered in any strategic audit, viz.:

(a) Product lines and basic competitive position.

(b) R & D and operating departments.

(c) Financial analysis and financial management, and

(d) Top management for each dimension, past achievements, present attainments, and future potential for each area are considered.

4. Corporate Externalities:

Certain elements external to a corporate firm have impacts on its policies and decisions. The audit, in this respect, seeks to evaluate the factors, such as economic environment, industry structure and corporate position, risk of technological obsolescence, socio-politico-cultural environment, etc., which affect the growth and development of an enterprise.

5. Corporate Internalities:

The areas covered are organisation development, management development, personnel development, and their detailed sub-systems- which provide internal strengths or weaknesses to a corporation.

Characteristics of Corporate Development

A human body passes through different stages in life cycle i.e today's baby is tomorrow's youth and future's old man. Development of body, mind and soul is the prime symptom of living being. A body corporate is run by many minds and souls and volume growth, revenue growth, increase in employment opportunity etc. (success symptoms) are the factors attributable to development. Think of a reverse situation - sluggish sales, shrinking revenue, great resignation etc. are the symptoms of degrowth.

In a nutshell, **Corporate development** refers to the strategic decisions of an entity that strives to achieve organisational success and excellence.

The following characteristics deserve mention:

Understanding of sustainable corporate development and undertaking an audit in the area depends on the following:

1. Multi -directional and multi- disciplinary Team with appropriate exposure and experience can only be able to handle such a review.
2. Planning and decision-making process and validation of decisions are the prime mover of corporate development.

3. Achievement, failures, strength, weakness, inefficiencies, threats etc. are the pointers for review.
4. The discussion and communication need to be routed through 'Point of Contact', an empowered management representative.

The scenario, in general, can be seen from two broad aspects:

(a) External environments-in relation to economic, political, technological, and socio-cultural-national as well as international.

(b) Internal environments-in relation to internal management of resources like men, materials, machinery, money, etc., where a corporate body aims at revamping their operations concerning their own 'structural build-ups' to meet the challenges and threats posed by one or more of external environment forces.

Corporate development audit seeks to assist the corporate management in assuring:

(i) The various factors and forces are working towards betterment of the Organisation.

(ii) The motivational and coordination responsibilities are appropriately understood and implemented.

(iii) The elemental responsibilities of planning, coordination, motivation, and control at departmental/functional management levels are discharged in the right spirit.

Corporate Board **"as a repository of the highest interests in the company, and a willing and able steering function through the troubled waters of the business oceans."**

The involvement of the Board Of Directors (BOD) in many corporate entities has so far been only legalistic, at best marginal. However, entity culture and 'tone at and from the Top' determines the BOD roles, interest and involvement for the Organisation.

Evaluation of Personnel Development

11.4

The best, most loyal employees are often people who started near the bottom of the organisational chart and worked their way up the ladder with the help, support, and encouragement of their manager / employer. That help, support, and encouragement are all part of employee development. In a well-managed company, there are systems in place to provide appropriate development opportunities and resources. In addition, managers are trained to support their team members with coaching, meaningful feedback, and in some cases-mentorship.

Managers have an important role to play in ensuring development of people. Some of the most important things a manager can do for their team members are:

- Delegating responsibility rather than fixing problems before they arise.
- Honest and candid feedback for the development.
- Offering or suggesting specific appropriate development opportunities to employees.
- Motivating for additional risk and reward.
- Demonstrating the meaning of true LEADERSHIP attributes. (L.E.A.D.E.R.S.H.I.P. - **LOYALTY, EMPATHY, ACCOUNTABILITY, DETERMINATION & DUTIFULNESS, ENCOURAGEMENT, RESPECT, SELFLESS, HUMBLE, INTEGRITY & INNOVATION, PASSION)**

Formal Employee Development Strategies

A. Imparting general and specific training. Training on development of "Soft" skills (interpersonal communication, public speaking, negotiation, leadership skills, etc.) to "hard" technical skills (coding, accounting, systems administration, etc.) will improve ability of the people aspiring for self-growth.

B. Psychometric studies to understand mentality to function in leadership roles, often also resorted to assess.

Informal Employee Development Strategies

In addition to formal employee development, many corporations offer informal development options. These often take the form of on-the-job training, shadowing, mentorship, or similar experiences that allow newer employees to learn from seniors. In addition, managers may choose to coach promising employees to prepare them for more challenging roles.

Performance Evaluation

Most companies conduct annual performance evaluations of employees against the task assigned in their KRA (Key Result Area).

The 'goal setting exercise' determines the role and assignment of broad areas. Periodical review exercise is carried out to evaluate and track the shortfall in achievement. Any mid term intervention or changes also can be given effect based on the requirement. Annual review (performance appraisal) is a agglomeration of earlier period /s of the appraisal period. The basic objective is to provide feedback to employees for their role and organisational requirement.

- **Rating Scales** allow managers to rate the quality of an employee's performance or skills based on numerical values, wherein minimum and maximum is specified. Actual ratings given and accepted by employee placed normally in a 'bell curve' to identify top performers out of the total population.
- **360^{o} Feedback** mechanism perused in progressive Organisations where employees' managers, subordinates, and peers to provide feedback about performance of the employee from every angle. This can be a very useful form of evaluation, as some individuals can be wonderful managers but have a difficult time interacting with peers or vice versa. By gathering a wide range of perspectives, managers can pinpoint areas of strength and opportunities for growth. On the other hand, this approach can be problematic if the employee in question is less popular for any reason or if a supervisee is unhappy about being disciplined.

Management by Objectives is a personalized evaluation technique that measures the individual employee's achievement by comparing the employee to objectives agreed upon the prior year. For example, the employee and manager may have agreed on a particular sales objective; at the end of the year, the employee's actual sales can be compared positively or negatively to the individualized objective.

Consumer Services Audit

11.5

Customer service is the experience an organisation's customers receive when they interact with an organisation. In any way; this includes business to business (e.g., where a farmer sells produce to a supermarket, or where a telecommunications company provides telephony services to a business) as well as business to consumer organisations (e.g., where an organisation interacts directly with individual customers such as a mobile phone company selling phones and contracts to an individual or a supermarket selling produce to the public).

Good customer service is about understanding the needs of different customers, keeping promises and delivering consistently high standards.

The key principles of good customer service as:

- Respect towards Customer requirement
- Commitment towards a customer
- Provision of clear, relevant, and accessible information
- Well-trained, customer-focused staff
- Clarity in communication
- Earliest resolution of customer complaints
- Effective use of customer feedback

Without customers, there is no need for the business at all:

- Customer satisfaction is monitored through customer surveys, usually administered by independent third parties or skilled internal resources.
- Customer service levels are monitored and measured against pre-defined targets.
- Customers have been identified and are consulted in meaningful ways, such as through focus groups.
- Customer satisfaction/survey/insight results are analysed, communicated and action is taken from the information to derive benefit for the organisation.
- Accurate and reliable management information is in place related to all customer insight.
- There is an appropriate governance forum to discuss all customer insight at the executive level, and board-level updates are provided on a periodic but regular basis.
- Key performance indicators and targets around customer service have been implemented and are monitored and tracked through customer insight.
- Colleague feedback is collected in real-time, analysed for trends, and action is taken where required.
- All customer input (views, complaints, feedback, online chatter, etc.) is viewed as valuable information and is analysed for trends and required actions.
- Social media is monitored in real-time and appropriate action is taken where necessary to deal with any issues or react to trends.

Specifics for customer service audit -

- Whether process of complaint registration exists?
- Whether a dedicated group of people are there to look after Customer Service?
- Whether the organisation having a documented policy to address customer complaints?
- Whether Customer WOW (wish on worth) measured for loyalty assessment?
- Whether any legal action filed against the entity for failing to cater Customer complaint?
- To track customer complaints? Tracking complaints can reveal patterns that then can be addressed. When complaints are not tracked, the same problems can exist forever.

Role of Internal Auditor

Internal audit has a key role to play in providing the board with reasonable assurance over customer service and complaint resolution process.

- The internal audit activity should utilise customer service indicators such as risk metrics, complaints, product recalls, resolution process and time taken etc. for periodical reviews and other key indicators as a useful source of information for risk assessment.
- Customer service should be considered as part of the risk assessment and should also be considered for cyclical audits and included as a necessity for periodic coverage.
- Internal audit's role is to provide periodic independent assurance that controls are in place and operating effectively.
- Customer service data and satisfaction index forfuture guidance on Product and Customer behaviour.
- Cost of Poor Quality (COPQ) to highlight as a further scope for Product development.

Approaching an audit of customer service

- As with any engagement, the internal audit team working on the audit should spend time understanding the process and accordingly fixes scope of the review.
- Since large of market data and responses are collated good amount of analytics to be carried out.

Challenges for internal audit

There are some potential challenges internal audits may need to manage during an audit of customer services.

Internal audit's approach can often be seen as very black and white, which can be a direct opposite to the customer service approach; this can lead to unnecessary friction with audit clients and misunderstandings by internal audit.

At times there can be a conflict between the response the business takes to resolve a complaint and the approach internal audit thinks should be taken.

Other than accessing customer feedback and complaints, internal audit will most probably be unable to engage directly (secretly of course, if they intend to do) with customers as part of the audit to gain input.

Customer service is a key risk for organisations, and poor management of customer service can severely impact the reputation and commercial performance of organisations. Internal audit has a key role to play in providing the board with assurance that this risk is being managed effectively. The challenges faced are-

(a) Failure to judge Customer requirement against Company's process of handling the complaint.

(b) Absence or non-availability of requisite datum.

(c) Lack of clarity over legal position and implications.

Audit of Environmental Pollution Control

11.6

Environmental audit is an independent evaluation of policy and principles, systems, procedures, practices in place and performance, and other elements of a business relating to the environment.

Some important definitions of the environmental audit are as follows:

(a) According to US Environmental Protection Agency (EPA), "Environmental audit is a systematic, documented, periodic and objective review by a regulated entity of facility, operations, and practices related to meeting environmental requirements."

(b) The Confederation of British Industry (1990) defines environmental audit as, "the systematic examination of the interaction between any business operations and its surroundings. This includes all emissions to air, land, and water; legal constraints; the effects on the neighbouring community, landscape, and ecology; and the public's perception of the operating company in the local area. Environmental audit does not stop at compliance with legislation. Nor is it a 'green-washing' public relations exercis. Rather it is a total strategic approach to the organisation's activities."

(c) The International Chambers of Commerce (ICC) in its publication Environmental Auditing (1989) defines environmental auditing as "a management tool comprising a systematic, documented, periodic and objective evaluation of how well environmental organisation, management, and equipment are performing, to help safeguard the environment by:

- Facilitating management control of environmental practices; and
- Assessing compliance with company policies which would include meeting regulatory requirements."

The definition given by ICC is unanimously accepted. Many leading companies follow the same basic philosophy and approach as given by this definition. The European Commission in its regulation on Environmental Auditing and Eco-management and Audit Scheme (EMAS) also adopts the ICC definition of environmental audit. The European Commission's Eco-management and Audit Scheme (EMAS) defines an environmental audit as "a management tool comprising a systematic, documented, periodic and objective evaluation of the performance of the organisation, management system and process designed to protect the environment with the aim of:

(i) Facilitating management control of practices that may have an impact on the environment.

(ii) Assessing compliance with company environmental policies."

Hence, an environmental audit may be defined as a means of assessing management role in exhaustive documentation and entity's role in managing & controlling environmental impacts and compliances with environmental policies, standards, environmental laws and regulations.

Features of Environmental Audit

The following are the features of environmental audit:

(i) **Role of Management:** Environmental audit performed through Internal Audit Team is generally considered as part of the internal control system and is mainly used to assess, evaluate and manage the environmental performance of a company including compliance against various legislations. It also includes recommendation for mitigation actions including proposition for Capex as to emerging risk.

This also includes evaluation of the adverse impact on the environment caused by economic activities (e.g mining, Coal Stock in the open, use of coal fired chimneys etc.) carried out by the organisation.

(ii) **Environmental Impact Assessment (EIA):** Risk and impact is the basis for any mitigation plan. EIA is a tool used to predict, evaluate and analyze environmental impacts w.r.t upcoming Projects, mostly before a project commences, expansion plans etc. It assesses the potential environmental effects of a proposed facility. Whereas environmental audit looks at environmental performance for an existing operation or activity with impact assessment on account of non-conformity.

(iii) **Systematic:** Audit is a systematic carefully planned, structured, and organized end to end process to ensure adequacy and result orientation for the environmental concerns. Since it is a part of a long-term process of evaluation and checking, it needs to be a replicable process so that over time, it can be easily used by different teams of people in such a way that the results are comparable and can reflect the change in both quantitative and qualitative terms.

(iv) **Documentation:** Like any other audit, the base of any environmental audit findings also needs to backed-up and supported by proper documents and verifiable information. Management needs to ensure appropriate methods for environment related data collection and preservation, so that same can be perused for review and/or future reference purposes.

(v) **Continuous Review:** Monitoring of environmental performance against regulations and/or benchmarking the same is a continuous process. Regular collection of actual measurement datum and review,finding out 'root cause' for deviations from norms set can help in timely intervention and taking steps. The robustness of the process will help not only the entity nay the people stay nearby from the environmental hazards.

(vi) **Objective Evaluation:** Other than environmental performance and compliance against specific regulatory matters, at times accreditation, certification, taking part in environmental survey etc. also comes up with enhanced objectivity. In addition to internal environmental audits, service of independent audit teams having specialized skills for repeat audits also resorted to. This is also required under many certification guidelines (e.g., ISO 14001).

(vii) **Environmental Performance:** As mentioned before, the essence of any environmental audit is to find out how well the environmental management function performance in creating favourable impact and achieving organisational goal for environmental balance. The ultimate aim is to ensure that organisation's environmental performance meet the goals set in its environmental policy and also to ensure compliance with standards and regulatory requirements.

Objectives of Environmental Audit

Prime objective of Environment Audit is to protect 'mother nature' and minimize the negative impact on environment for undertaking industrial activities. Regulatory requirements are mostly in place, however, mere compliance may not be fruitful in the longer term. Kyoto protocol on climate change and subsequent global conventions, dictates more to be done. At the national level, the main objective of the environmental audit is to see that the natural resources are properly utilized and proper steps have been undertaken to control or to prevent adverse effects of production, development, and other activities on the environment. The aim is to ensure that the natural resources are utilized for industrial development and national progress and at the same time, to see that proper steps have been undertaken for maintaining the health, welfare of the community, and also for dispersal of harmful wastes and social risks.

At the corporate level, there are some environmental responsibilities facing companies like meeting regulatory requirements, cleaning up pollution that already exists, properly disposing of the hazardous material, disclosing to the investors the amounts and nature of the preventive measures taken by the management, operating in a way that environmental damage does not occur, and promoting a company-wide 'protect environment' attitude. To check the fulfillment of these environmental responsibilities and to ensure compliance against stipulations by the organisation, environmental audits are conducted. The environmental audit aims at evaluating and reporting key environmental performance measures like pollution control measures, energy conservation or waste management techniques, conservation of scarce natural resources, etc. The main objective of an environmental audit at the organisational level is to ensure the conservation of scarce natural resources and promote the use of clean technologies in industrial production and minimize the generation of pollution and waste.

The following are major objectives of environmental auditing:

(i) Determine and document compliance status.

(ii) Help to improve environmental performance at operational facilities.

(iii) Assist facility management.

(iv) Increase the overall level of environmental awareness.

(v) Accelerate the overall development of the environmental management control system.

(vi) Improve the risk management systems.

(vii) Protect the corporation from potential liabilities on breaches.

(viii) Conservation policy and application guidance.

(ix) Fund allocation (Capex and Opex) and utilization w.r.t environment protection.

(x) Develop a basis for optimizing environmental resources.

Benefits of Environmental Auditing

By constructive environmental auditing, the following benefits can be derived:

(i) **Improves efficiency of Environmental Management System (EMS):** Environmental auditing encourages an organisation to examine its operations constructively towards an effective EMS. It helps in assessing the performance of the EMS, identify deficiencies in the system, and provides the basis for environmental improvement plans. Based on the findings and recommendations of the environmental audit, management can take corrective actions.

(ii) **Compliance with environmental laws and standards:** Status of adherence w.r.t environment rules and regulations can be monitored for upgrading governance process. Non-compliance may also lead to 'reputational risk'. The most important benefit of an environmental audit is that it ensures cost-effective compliance with environmental laws and regulations, industry guidelines and standards, and the company's environmental policies.

(iii) **Risk mitigation:** There is a growing belief that environmental issues represent a source of risk in terms of unforeseen or foreseen reputational damage or similar other risks. It is the concern regarding environmental risks which has led to the development of the field of environmental auditing. An environmental audit can act as an effective risk management tool for assessing compliance with environmental legislation, thereby, assisting the company in avoiding the related risks.

(iv) **Meeting stakeholders' expectations:** Multiple stakeholders having varied interest and 'wish list'. Stakeholders have heightened expectations for a company's environmental performance. They are concerned about environmental responsibilities and protection of their interest. Conducting environmental audits will help in reassuring various stakeholders, enhancement of reputation of the company as a good corporate citizen; which indicates better stakeholder management.

(v) **Cost and environmental benefits, reduction in operational inefficiencies:** Environmental auditing can highlight areas of improvement by recommending cost effective solutions for environmental issues e.g Water Treatment Plant, Solid Waste Handling Equipment, usage of AFR (Alternate Fuel) etc. By identifying operational inefficiencies, a company may be able to reduce its cost and/ or improve its environmental performance.

(vi) **Linking operating processes and environmental impacts:** Aligning operating processes with environment related compliances and desired environmental improvement scope; not only enhances awareness among rank and file, also leads to better sustainability. By pinpointing both strengths and weaknesses in the environmental management and other operating systems relating to the environment regularly, an environmental audit encourages continual improvement.

(vii) **Compliance with certification requirements:** Conducting an environmental audit can be an important step towards gaining companywide certifications like ISO 14001 or cradle to grave or product-specific certification from organisations like Energy Star, LEED, the Forest Stewardship Council, Chlorine Free Products Association, etc.

(viii) **Increases employees' awareness of corporate environmental policy and responsibility:** Environmental audit demonstrates company's commitment to environmental protection. This in turn increases overall awareness of workers w.r.t potential health hazards, risks, and other needs.

(ix) **Assists management in decision-making:** Environment Audit Reports can be perused by Management as tool for taking decisions on Investment, managing stakeholder expectations etc. Environmental audit provides an environmental database to assist management decisions, competitive advantage by raising corporate profile concerning environmental issues, obtaining various accreditation e.g ISO 14001.

Although different types of environmental audits examine different issues, all environmental audits should have four basic stages of activities: pre-audit, on-site, post-audit, and follow-up or review activities.

Stage 1: Pre-audit or Planning Stage:

A battle well planned is half won, same is applicable for environment audit also. A prior exposure is always beneficial for understanding the process and collection of relevant datum/ information. Internal Auditors of the entity and / or outsourced resources/firm having on different footings in this regard. Audit planning is vital to the success of the audit undertaken. The internal auditor must spend adequate time in planning, as this will result in better identification of important areas, potential problems, and proper assignment of work. During this stage of the audit, generally following steps are taken:

(i) Collect background information about the entity: Collection of information about environmental policy document, and goals of the organisation w.r.t environment,relevant environmental laws, regulations, and standards governing the entity, persons responsible for carrying out environmental duties, and relevant compliances environmental budget, significant environmental matters like material costs, risk areas, etc.

(ii) **Define objectives of audit:** Like any other audit assignment, goal setting is an important exercise for environment audit as well.

(iii) **Define scope:** Outcome depends of defining scope of the assignment e.g. relevant laws, operational processes, location and period of coverage etc. What parts of a facility (operations) will be audited?

(iv) **Choose audit criteria:** Against what will the facility be audited (e.g., for regulatory compliance audits, against what regulations or standards will the facility be audited?)

(v) **Select the audit team members:** The audit team leader selects team members based on appropriate knowledge, expertise and experience. The team can consist of external consultants, internal audit staff, or a combination of both.

(vi) **Develop audit plan and protocols:** Protocols are written guides for the auditors that outline the activities to be undertaken in conducting review of a given area under environmental audit. They often contain detailed information about audit criteria, such as applicable regulations. Computers are often used in creating audit protocols and in locating and sharing information between team members during the audit (e.g., regulatory databases are often utilized in creating audit protocols).

(vii) **Inform the facility:** Arrangements for on-site visits and activities to be conducted with or without hampering the normal work schedule of auditee department/s need to be intimated prior to initiate the review.

(viii) Desktop review.

Stage 2: On-site or Field Audit:

The following are steps involved in on-site or field audit:

(i) **Application of desktop review outcome and/or query listing:** During introductory phase, the formal introduction stage, the team to appraise objectives of review and share their initial understanding from desktop review to initiate activities of facility walk through and assess results on spot. Communicate the objectives and methods of the audit to key facility personnel and schedule necessary meetings and interviews.

(ii) **Facility tour:** Identify areas of concern for more detailed inspection, get a feel for the site, and modify the audit schedule accordingly.

(iii) **Site/ facility inspection and evidence collection:** It is always expected that site representative team with hands on exposure in relevant topics/area to accompany the visiting team. The areas of concern based on desktop review and site visit exposure to be enquired for appropriate feedback. Established protocols should guide the inspection. The team may also wish to inspect areas of concern or interest that have been identified in the facility tour.

Relevant document /evidence also need to be collected from site to crystalize preliminary observations and Points Of Discussion (POD) at site/with site in-charge.

Inspect the entire facility (comprehensive inspection), therefore, sampling techniques may be an important part of determining the parts of a site to be inspected.

(iv) **Evidence:** Collect sufficient, appropriate, and reliable audit evidence to check the activities, performance impacts, and reports.

(v) **Interaction with job holders:** Interaction with responsibility holders will smoother the process of evidence collection and quick resolution of queries for more clarity. However, the interactions to be recorded to avoid any future mis-communication on the subject.

(vi) **Sharing of findings and finalization of site visit report:** Findings are the result of the evaluation of evidence collected, visual inspection experience against audit scope and check-list. Exceptions, non-compliance, non-maintenance of record, difference between datum and records/evidence, commitments from site personnel etc. to be captured and presented to take it forward at appropriate level/s.It is important at this stage to review where the facility does not meet the audit criteria.

(vii) **Closing/ exit conference:** This is a chance for auditees to identify misunderstandings and to be introduced to the findings of the audit team.

Stage 3: Post-Audit:

Steps involved in post–audit are as follows:

(i) Post sharing of site visit outcome at the Corporate /Entity level with views of site incorporated, entity level feedback also considered for final version of the report. The final version acknowledged by Management taken into repository and presented to forums like Audit Committee, Risk Management Committee, environment monitoring organisations etc.

Final evaluation of findings: Findings must be backed by evidence. It is important to note areas of deficiency that were present during the previous audit, but are not yet corrected. Often finding are labelled as major or minor depending on the level and types of risks posed and the speed with which the audit team feels they should be addressed.

Stage 4: Follow up or Review Stage:

Action Plan emanated from the final report with responsibility owner and target date for complete implementation, are tracked on regular basis to measure progress and completion stage. Once completed, the action plan can be considered for a limited review to ensure flowing of desired impact. This also called the corrective action follow-up phase. While not technically part of the audit, the audit manager or team leader may be involved in developing a corrective action plan for addressing audit findings with the facility and reporting to senior management as to the progress of this plan.

Contents of Report:

A standard Environmental Audit report should include the following:

(i) Executive Summary.

(ii) Introduction/background to audit including specification of the entity/ process or activity/ system/ site in respect of which the environmental audit was conducted, and audit period.

(iii) Object and scope of environmental audit.

(iv) Audit observations

Status of conformity with internal environmental policies.

- Status of good environmental practices implementation.
- Measurement and recognition of all significant environmental costs, benefits, assets, and liabilities and identification of significant environmental risks and contingencies.

- Level of staff awareness of operational issues relating to environmental performance; and
- Overall status of environmental performance

(v) Recommendations

(vi) Actions agreed upon with target date and ownership

(vii) Audit criteria.

(viii) Evidence used.

The report must distinguish between isolated incidents and chronic problems.

Recommendations: It includes possible impacts of negative findings and suggested corrective action.

Tools and Techniques Used in Environmental Auditing:

Some of the tools which can be used in environmental audits are:

- **Checklists:** Checklists are very useful tools used to ensure that different tasks or topics are included in the assignment w.r.t scope. during the audit. They are very useful in specialized cases where a complex range of issues and questions need to be asked to ensure that nothing is missed.
- **Questionnaires:** Audit protocols or audit questionnaires provide the basis and structuring for most audits.

  They are based upon checklist questionnaires but are more complex and include more detail and sometimes logistical information and data relating to the audit and the site being audited.
- **Questioning:** Questioning is one of the most crucial aspects of auditing yet from a training and awareness point of view, it is often given the least attention. The purpose is information gathering in nature and not an interrogation. The questioner must, therefore, be sensitive to the perspective of the auditee and avoid making the questions accusatory, judgmental or aggressive.
- **Observation:** Observation is a vital component of an auditing exercise. Observation is a disciplined activity that must be carried out in a very deliberate and controlled manner. The idea of looking at something twice is important because it is part of the process that checks that the observation is accurately noted, analysed, and recorded.
- **Photographs:** These are a very valuable aid in the audit process. However, to use them, several important practical points must be borne in mind, the most important one is formal approval before using this technique.
- **Research:** It is useful to try and undertake some background research and investigation into the site or company to be audited. Familiarization with the operations, products, raw materials reports, press material, newspaper articles, etc. all provides useful background information to supplement questioning sessions and help understand the operational processes.

Audit of Energy and Utilities – Generation and Consumption

11.7

A utility audit is an audit of utility expenses. Generally, these are electric, natural gas, and water/sewer expenses.Utility Auditors are looking for billing errors/saving opportunities and consumption monitoring, equipment designing, process improvement etc. with an objective of cost reduction and better process control.

Electric/Natural Gas:

- Meter reading.
- Demand-based.
- Incorrect rate application.
- Incorrect tax.
- Multiplier/constant.
- Incorrect implementation of the contract.
- Incorrect application of tariff.
- Erroneous fees and taxes.

Water/Sewer:

- Meter reading.
- Multiplier/constant.
- Incorrect application of surcharges.
- Incorrect meter usage.

How Utility Cost Reduction Works:

Greatest concern for utility spent is high power tariff and consumption pattern. The cost reduction suggestion depends on the following:

1. Ensuring accuracy of billing rates charged by service providers;
2. Consumption recording accuracy;
3. Regulatory compliances;
4. Equipment age and power consumed.

Energy Audit

Energy Audit is the key to a systematic approach for decision-making in the area of energy management. It attempts to balance the total energy inputs with its use and serves to identify all the energy streams in a facility. An industrial energy audit is an effective tool in defining and pursuing a comprehensive energy management programme. As per the Energy Conservation Act, 2001, Energy Audit is defined as "the verification, monitoring, and analysis of the use of energy including submission of technical report containing recommendations for improving energy efficiency with cost-benefit analysis and an action plan to reduce energy consumption".

Need for Energy Audit

In any industry, the three top operating expenses are often found to be energy (both electrical and thermal), labour, and materials. Hence, cost reduction in energy consumption is of paramount importance. Energy Audit will help to understand more about the ways energy and fuel are used in any industry and help in identifying the areas where waste can occur and where the scope for improvement exists.

The Energy Audit would give a positive orientation to the energy cost reduction, preventive maintenance, and quality control programmes which are vital for production and utility activities. Such an audit programme will help to keep the focus on variations that occur in the energy costs, availability and reliability of supply of energy, decide on appropriate energy mix, identify energy conservation technologies, retrofit for energy conservation equipment, etc.

In general, Energy Audit is the translation of conservation ideas into realities, by lending technically feasible solutions with economic and other organisational considerations within a specified time frame.

The primary objective of Energy Audit is to determine ways to reduce energy consumption per unit of product output or to lower operating costs. Energy Audit provides a "bench-mark" (Reference point) for managing energy in the organisation and also provides the basis for planning more effective use of energy throughout the organisation.

Type of Energy Audit

The type of Energy Audit to be performed depends on:

- Function and type of industry.
- Potential and magnitude of cost reduction.

Thus, Energy Audit can be classified into the following two types.

- Preliminary Audit.
- Detailed Audit.

Preliminary Energy Audit Methodology:

A preliminary energy audit is a relatively quick exercise to:

- Establish energy consumption in the organisation.
- Estimate the scope for saving.
- Identify the 'low hanging fruits' i.e. most likely and the easiest areas for attention.
- Identify immediate (especially no/low-cost) improvements/ savings.
- Set a 'reference point'.
- Identify areas for more detailed study/measurement.
- A preliminary energy audit uses existing, or easily collectible data.

Detailed Energy Audit Methodology

A comprehensive audit provides a detailed energy project implementation plan for a facility since it evaluates all major energy-using systems.

This type of audit offers the most accurate estimate of energy savings and cost. It considers the interactive effects of all projects, accounts for the energy use of all major equipment, and includes detailed energy cost saving calculations and project cost. In a comprehensive audit, one of the key elements is the energy balance. This is based on an inventory of energy-using systems, assumptions of current operating conditions, and calculations of energy use. This estimated use is then compared to utility bill charges. Detailed energy auditing is carried out in phases:

- Phase I - Pre-Audit Phase.
- Phase II - Audit Phase.

Phase I –Pre-Audit Phase Activities

A structured methodology to carry out an energy audit is necessary for efficient working. An initial study of the site should always be carried out, as the planning of the procedures necessary for an audit is most important.

Initial Site Visit and Preparation required for Detailed Auditing.

Familiarize with the site, and assess the procedures necessary to carry out the energy audit. An initial site visit may take one day and allows the Energy Auditor/Engineer to meet the personnel concerned.

During the initial site visit the Energy Auditor/Engineer should carry out the following actions:

- Discuss with the site's senior management the aims of the energy audit.
- Discuss economic guidelines associated with the recommendations of the audit.
- Analyze the major energy consumption data with the relevant personnel.
- Obtain site drawings where available – building layout, steam distribution, compressed air distribution, electricity distribution, etc.
- Tour the site accompanied by engineering/production.

The main aims of this visit are:

- To identify the main energy-consuming areas/plant Facilities to be surveyed during the audit.
- To identify any existing instrumentation/ requirement of additional metering facility at User Point from consumption trend e.g., KWh, steam, oil, or gas meters.
- To identify the instrumentation required for carrying out the audit.
- To plan with the time frame.
- To collect macro data on plant energy resources, major energy consuming centers.
- To create awareness on lowering consumption.

Phase II- Detailed Energy Audit Activities

Whenever possible, checks of plant operations are carried out over extended periods, at nights and weekends as well as during normal daytime working hours, to understand requirement, if any.

The audit report will include a description of energy inputs and product outputs by the major department or by major processing function and will evaluate the efficiency of each step of the manufacturing process. Means of improving these efficiencies will be listed, and at least a preliminary assessment of the cost of the improvements will be made to indicate the expected payback on any capital investment needed. The audit report should conclude with specific recommendations for detailed engineering studies and feasibility analyses, which must then be performed to justify the implementation of those conservation measures that require investments.

The information to be collected during the detailed audit includes:

- Energy consumption by type /source of energy (Thermal, Hydro, Gas based etc.), by department, by major items of process equipment, by Utilities, support functions etc.
- Material balance data (raw materials, intermediate and final products, recycled materials, use of scrap or waste products, production of by-products for re-use in other industries, etc.)
- Energy cost and tariff data.
- Generation and distribution of site services (e.g., compressed air, steam).
- Sources of energy supply (e.g., electricity from the grid or self-generation).
- Potential for fuel substitution, process modifications, and the use of co-generation systems (combined heat and power generation).
- Energy Management procedures and awareness training programs within the establishment.

Existing baseline information and reports are useful to get consumption patterns, production cost, and productivity levels in terms of product per raw material inputs. The audit team should collect the following baseline data:

- Technology, processes used, and equipment details.
- Capacity utilisation.
- Amount & type of input materials used.
- Water consumption.
- Fuel Consumption.
- Electrical energy consumption.
- Steam consumption.
- Other inputs such as compressed air, cooling water, etc.
- Quantity & type of wastes generated.
- Percentage rejection / reprocessing.
- Efficiencies/yield.

Hence, Energy Audit is an effective tool in defining and pursuing comprehensive energy management programmes. It has a positive approach aiming at continuous reduction in energy utilization.An energy audit provides an answer to the question – what to do, where to start, when to start, at what cost, and for what benefits?

Energy Audit helps in energy cost optimization, pollution control, safety aspects and suggests the methods to improve the operating and maintenance practices of the system. It is instrumental in coping with the situation of variation in energy cost availability, reliability of energy supply, the decision on appropriate energy mix, the decision on using improved energy conservation equipment, instrumentations, and technology.

Productivity Audit / Efficiency Audit

11.8

The term productivity, if simply put, may be 'output' divided by 'input'. 'Output' may mean goods as well as services. For 'input' we may come across diverse factors, such as men, materials, machines, land, capital, energy, organisation, and a host of others.

Thus, each of these factors or elements comes within the arena of productivity audit, and for overall productivity audit, factorial productivities' audit is necessary.

A critical examination of Efficiency Ratio, (that is, actual production in terms of standard hours to actual hours worked) and 'Activity Ratio' (that is, actual production in terms of standard hours budgeted production in terms of standard hours) may also form the content of productivity audit.

The concept of productivity is rooted in the production function but that does not mean that the audit of production function is productivity audit. Where Standards, the yardsticks for measurement and comparison, and the actual factor performances are (in physical or monetary terms) subjected to closer scrutiny and evaluation; may be understood as the core of productivity audit.

Problems of Productivity Audit

The overall productivity, being the result of a contribution of different elements or factors, (such as—labour, raw materials, components, plant, machinery, organisation, management, etc.) has to be evaluated by paying due importance and attention to the results obtained out of these individual factorial productivities.

Thus, productivity audit has to take care of and pay due consideration to these factorial inputs for measurement and evaluation.

Broadly speaking, the following limitations or problems are associated with productivity measurement:

1. Factorial inputs have got different units or yardsticks of measurement.
2. Inter-dependence of the different inputs and their integrated nature of work for the common final aim of productivity measurement. That means labour productivity, machine productivity, material productivity, the productivity of management and organisation function are closely inter-woven and inter-related.
3. As a corollary to the above, the solution of the series of simultaneous equations, even if done by a computer, becomes somewhat of a subjective process. A unique mathematical solution is difficult to be worked out to the entire satisfaction of an auditor.

Propriety Audit

11.9

Propriety audit may be defined as 'Audit concerning the decisions of the executives, with an emphasis on stakeholders interest, financial discipline, basically to get audit satisfaction that such decisions are within the frame-work of sanction, authority, rule, procedure and law made by a competent body, and to advise the executives either in preventing or reducing losses and increasing productivity or improving performance by timely reporting'. Propriety audit ensures that an expenditure incurred is duly sanctioned by an appropriate authority but should also investigate the justifications and the necessity for it

The auditors, while conducting the propriety audit, should, in any case, ensure observance of the following.

Canons of Financial Propriety:

1. Benefits accrued should be more than the spent.
2. No authority should exercise its power of sanctioning expenditure to pass an order which will be directly or indirectly to his advantage.
3. Public money should not be utilised for the benefit of a particular person or section of the community unless:
   (i) The amount of expenditure involved is in significant, or
   (ii) A claim from the amount could be enforced in a court of law, or
   (iii) The expenditure is in pursuance of a recognized policy or custom.
4. The amount of allowances (e.g., travelling allowances) granted to meet the expenditure of a particular type, should be so regulated that these are not on the whole sources of profit to the recipients.

To assess the adequacy or otherwise of the effect of financial responsibilities, propriety, the audit should examine on the following broad lines:

1. Whether the technical estimates or detailed programme and cost schedules are being framed and that the same are adhered to; if not, whether there are adequate reasons for excess, delays, etc., or whether these are occasioned by inefficient handling, wastes, etc. or due to incorrect preparation of original estimates.
2. Whether there have been any serious avoidable delays in the progress of the schemes increasing the total cost of the scheme.
3. Whether there has been any wasteful expenditure including that resulting from lack of co-ordination.
4. Whether there have been any losses of recurring nature.
5. Whether the performance and cost compare with the results obtained in respect of similar schemes in other areas.
6. Whether physical targets have been achieved within the estimated or sanctioned time.
7. Whether the ultimate objectives of the expenditure have been fulfilled.

Propriety audit has its following limitations -

1. **In the decision-making process:**

   Since the auditor, examines and scrutinizes every decision for optimizing the spent; it often affects dynamism, progress and causes delay in decision making.

2. **In compliance with Regulations:**

   Since the operations are rule bound, 'out of the box thinking process' crippled by the same and does not ensure the achievement of targets or objectives.

3. **Timeliness:**

   The audit and its report, if delayed, will not be of much use. It will be a futile report on an unprofitable contract after incurring losses.

Presently the forms of organisation which is having the benefits of propriety audit are:

(i) Government companies, such as the State and Central Government undertakings. The Comptroller and Auditor General of India has a right to conduct efficiency-cum- economy-oriented propriety audit, in addition to the statutory audit under his guidelines and instructions.

(ii) Under Companies Act both Chartered Accountants and Cost Accountants are empowered to perform Financial and Cost Audit respectively to ensure Companies are governed properly, which are propriety based.

(iii) In the case of Government Companies, the Comptroller and Auditor General of India conducts the propriety audit.

In the case of limited companies, the shareholders are generally scattered all over the country. They do not have a real say or control over the conduct of the affairs of the company. The company is in the hands of the Board of Directors. The shareholders need assurance that their funds are properly managed.

Corporate Social Responsibility (CSR) Audit

11.10

Corporate Social Responsibility (CSR) can be understood as the initiative of a company to assess and take responsibility for the environment and impact on social welfare. Corporate social responsibility is a form of corporate self-regulation integrated into a business model. CSR policy functions as a built-in, self-regulating mechanism whereby a business monitors and ensures its active compliance with the spirit of the law, ethical standards, and international norms.

The goal of CSR is to embrace responsibility for the company's activities and encourage a positive impact through its activities on the environment, consumers, employees, communities, stakeholders, and all other members of the public sphere who may also be considered as stakeholders.

Thus, despite many definitions and different names, at the core they all point towards the same fundamental principle, i.e., a company is responsible for providing more benefits than just profits for shareholders. It has a role to play in developing sound corporate governance, fostering human rights, respecting cultural differences, and promoting fair trade.

Corporate Social Responsibility offers manifold benefits both internally and externally to the companies. Externally, it creates a positive image amongst the people for the company and earns special respect amongst its peers.Internally, it cultivates a sense of loyalty and trust amongst the employees in the organisational ethics.

All types of CSR information disclosure are effected by the need for credibility. Some examples are:

1. Employees, to provide confidence in systems, establish progress against targets and improve confidence;
2. Specialists, including analysts, particularly rating agencies, government officials, and NGOs;
3. Business partners, to strengthen the supply chain; and
4. Communities, to establish credibility with neighbours and local organisations.

In a report entitled "The State of Sustainability Assurance" published by Accountability, some of the main points were that:

(i) Sustainability assurance is seen as a key element in building the quality and credibility of sustainability reporting, despite huge variations in the approach adopted, different forms of assurance conclusion, and a lack of credibility amongst preparers and stakeholders;

(ii) Investors, regulators, and other stakeholders will become a powerful driver of sustainability assurance;

(iii) Effective sustainability assurance will involve multi-stakeholder teams and enable disclosed information to have a better focus on what is material.

ISAE 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" issued by the International Audit and Assurance Standards Board of IFAC addresses several broad principles, many of which are relevant to assurance on CSR reporting. ISAE 3000 addresses several important issues that are of general relevance to the assurance of non-financial information, e.g., planning and performing the engagement, using the work of an expert, obtaining evidence, and preparing the assurance report based on the concept of reasonable assurance. ISAE 3000 is used by many accountants as a basis for assurance on CSR/ sustainability reports.

The AA1000 Assurance Standard is a principle-based standard that provides an approach specifically aimed at full sustainability assurance. It provides a platform to align the non-financial aspects of sustainability with financial reporting and assurance. It provides a means for assurance providers to go beyond mere verification of data, to evaluate the way reporting organisations manage sustainability, and to reflect that management and resulting performance in its assurance statement.

Internal Auditors might be involved in CSR at various levels:

(i) Internal Auditors might facilitate or advise management on CSR self-assessment activities.

(ii) Internal Auditors might be involved in auditing CSR programs, either as individual components of the audit plan, or as a broad-based review of how CSR is managed, and whether the company is achieving its CSR objectives.

(iii) Internal Auditors might become involved in co-ordinating or participating in CSR Report verifications.

(iv) Proposed expenditure is made in areas demarcated /specified.

Internal auditors have an opportunity to make value additions to the Corporate Sustainability Reporting process of their organisation. They must have a good knowledge and understanding of prevalent CSR concepts. Important role internal auditors can play includes:

(i) Assist in the design/ implementation of the CSR management system.

(ii) Perform limited scope audits requested by top management.

(iii) Perform compliance audits.

Economic Performance:

(i) Direct economic value generated and distributed, including revenues, operating costs, employee compensation, donations, and other community investments, retained earnings, and payments to capital providers and governments.

(ii) Financial implications and other risks and opportunities for the organisation's activities due to climate change.

(iii) Significant financial assistance received.

Social Cost-Benefit Analysis Audit

11.11

Social cost-benefit analysis has been defined in many ways.

"As a methodical and rational process of identifying, evaluating and assessing the benefits (outputs) and costs (inputs) associated with alternative activities which will effectively accomplish economic targets and social goals."

Social cost-benefit analysis is a relatively new concept and as such, there is a divergence of opinion on various assumptions. It is a kind of economic measurement of costs and benefits of the private sectors' social responsibility performance designed in addition to the traditional financial and cost accounting.

Presently, the appraisal process of a private concern's project takes into account:

- Financial aspects i.e., viability based on return on investment, etc.
- Commercial aspects i.e., marketing plan and strategies, etc., and
- Technical aspects i.e., technical parameters of project specification.

But it ignores the socio-economic aspect i.e., whether the project is socially desirable and worthwhile in the perspective of the national economy. The evaluation process does not consider the social costs-costs of external diseconomies (say, shifting of labour from one to another sector).

Examples:

The employment of one labourer by a commercial enterprise deprives society of the benefits it was receiving earlier from him engaged in other sectors of the economy (say, agriculture). Thus, the cost to the society (i.e., social costs) can be best defined by the benefits deprived through the use of any facility by an industrial sector.

Benefits can be defined by the goods and services contributed in real terms by such a sector. The real costs of scarce and surplus resources used in a project are opportunity cost and shadow price. So, the net benefit to society is the excess of benefits over costs (sum of input costs and social costs).

Purposes of SCB Analysis:

These are:-

(a) To determine and measure the expected future economic and social benefits that may be derived from an intended project or activity.

(b) To determine and measure the flow of future economic and social costs that would be incurred to accomplish the benefits.

(c) To ascertain the net benefits as a result of the above assessment.

(d) To decide as to which of the projects or activities will yield the maximum benefits about set economic standards and defined social goals for the national economy.

Basic Requirements (essentials) of SCB Analysis: Several elements are essential in undertaking an SCB Analysis.

These are as follows:

1. Identify and define the objectives of the project or intended activity.
2. Identify and measure the future benefits accruable -direct and indirect.
3. Identify and measure the relevant costs-direct and indirect (and imputed).
4. Ascertain the present value of net benefits including the choice of a discounting factor.

SCB Analysis Techniques:

About the analysis of projects for social profitability via SCB Analysis, the following techniques are available:

(i) UNIDO Methodology.

(ii) Little and Mirrlees approach.

(iii) Indian Planning Commission methodology.

The approaches advocated by the above are the same in the sense that they consider distortions in values of foreign exchange, savings, and unskilled labour and carry out corrections in a similar way.

UNIDO method uses the equivalent consumption at the critical consumption level. By an application of the DCF technique, the social IRR (internal rate of return) can be calculated as the yardstick for measurement.

L&M method uses the uncommitted social income in free foreign exchange at the hands of the Government. This can be improved by the DCF technique.

Indian Planning Commission’s Method uses the uncommitted social income at the hands of the Government but revalued at the shadow exchange rate.

To Sum Up:

Management audit is an emerging concept of auditing. Management audit is an act of evaluation with a view to provide appropriate suggestions to the management to help decision making process. It also refers to the existence of control system, compliance of rules and regulations etc.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Management auditor should have a thorough knowledge of _______ .
   (a) Financial Accounting.
   (b) Production techniques.
   (c) Costing systems.
   (d) All of the above.

2. A management auditor can recommend the most suitable system of flow of information _______ .
   (a) Internally.
   (b) Externally.
   (c) Internally and externally.
   (d) None of the above.

3. Management auditor should be well versed with _______ .
   (a) Management by exception.
   (b) Management by objectives.
   (c) Principles of delegation of authority.
   (d) All of the above.

4. Which of the following statements are true about management audit?
   (a) The management audit is made compulsory and statutory.
   (b) Management audit is a programme of one year.
   (c) Management audit cannot be conducted by an independent person.
   (d) No time limit can be fixed for submission of the report under management audit.

5. Cost audit is a verification of cost records to estimate the _______ efficiency of a business.
   (a) External.
   (b) Internal.
   (c) Both internal and external.
   (d) None of the above.

6. The management auditor's work begins ________ .
   (a) After the work of a statutory auditor ends.
   (b) Before the work of a statutory auditor begins.
   (c) Varies from firm to firm.
   (d) None of the above.

7. Management audit is useful for ________ .
   (a) Suggestion for targets.
   (b) Assistance to management.
   (c) Good staff relationship.
   (d) All of the above.

8. As per Leslie R. Howard, a Management audit is an investigation of a business from the ________ in order to ascertain whether sound management prevails throughout.
   (a) Highest level downwards.
   (b) Lowest level upwards.
   (c) Either (a) or (b).
   (d) None of the above.

9. Important point in corporate planning is ________ .
   (a) Time and Work Study
   (b) Imposing Control System
   (c) Forecasting and goal setting.
   (d) SWOT analysis.

10. Assurance engagements involve ________ .
    (a) Only Individual Parties
    (b) Three separate parties.
    (c) Contractor and Contractee
    (d) None of them

11. The consumer service audit critically examines:
    (a) Outstanding payment of consumers.
    (b) Price consumers are ready to pay for particular product/service

(c) An appraise management of business enterprise of responsibility towards consumers.

(d) Demand of a product by consumers.

12. Consumer Service Audit is part of _______ .

(a) Business Activity Audit

(b) Social Audit

(c) Service Audit

(d) None of Above

13. There are no fixed items of evidence to be checked by Management Auditor.

(a) The statement is true.

(b) The statement is false.

(c) The statement is partly true.

(d) The statement is partly false.

14. Management Audit Report Submitted to:

(a) Cost Audit Branch

(b) Audit Committee

(c) Central Government

(d) Management of Concern

15. There are no fixed items of evidence to be checked by Management Auditor. A Management Auditor has to rely more on _______ .

(a) his experience and acumen.

(b) Auditors Working Paper.

(c) Physical Verification Sheet.

(d) Information Provided by Management.

State True or False

1. Management auditor should be conversant with the nature of production activities in organisation.

2. Management auditing is a part of statutory auditing.

Essay Type Questions

1. As a Management Auditor of a large organisation, you have been asked to carry out the review of Marketing Policies as a part of Corporate Development. Prepare a questionnaire for carrying out such a review.

2. What is meant by "Corporate Services Audit"? Describe the areas of the "Corporate Services Audit", the scrutiny thereof and evaluation criteria used in the Audit.

3. You are appointed by Mr. K who wants to join M/s DEF & Co., partnership firm as an investigating accountant. List out the steps involved in conducting the same.

4. Evaluation of the personnel function of an organisation by management auditor is by no means an easy task.

   In your view what areas are to be covered and points to be kept in mind while assessing the personnel function of an organisation?

5. While performing an Information System Audit, the Management Auditor should make sure that various objectives are met. Briefly describe them.

6. M/s XYZ Ltd. engaged in manufacturing of engineering goods is consistently recording higher sales turnover, but declining net profits since the last 5 years. As a management consultant appointed to find out the reasons for the same, what are the points you would verify?

7. What do you understand by "Energy Audit"? Briefly state the functions of energy auditor.

8. What do you understand by Corporate Services Audit? Describe the areas of Corporate Services Audit, the scrutiny thereof and the evaluation criteria used in such audit.

9. "Management Audit and Operational Audit are complementary and supplementary to one another". Discuss in brief.

10. Mr. Ram, being a CMA, certifies a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client. Does Mr. Ram attract provision for professional misconduct?

11. State four objectives of operational audit.

12. While performing an Information System Audit, the Management Auditor should make sure that various objectives are met. Briefly describe them.

13. Write short note on - Probable format of environmental statement.

14. What points should you consider as a Management Auditor performing CSR Audit?

15. What do you understand by environment audit and productivity audit?

16. "Management Audit team should be multidimensional". Discuss.

17. Write short not on "Customer Costing in Service Sector".

18. What are the Management Audit Questionnaires?

19. "The Cost Audit Reports can be termed as propriety audit"- Discuss.

20. You have been appointed as a Management Auditor by SBI Bank. The Bank has recently launched a scheme of 'Gold Card' issuing credit card to all savings account holders with average of ₹50,000/- in the account. How will you evaluate the internal control system in the area of credit card operations of the bank?
21. Discuss the risks that can be covered by a CSR Audit programme. Described the area covered by Corporate Services Audit.
22. A management audit team should be multidimensional. discuss.
23. What is Energy Audit?
24. What is "Consumer Services" Audit?
25. What to you understand by Corporate Strategy?
26. Draft an internal control questionnaire for 'Account Receivables'.
27. Internal Audit is an independent appraisal activity within an organisation for review of operations as a service to management. Discuss.
28. You have been appointed as an internal auditor for M/s KBC Ltd which is a large manufacturing concern. You are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. draft a suitable audit programme for the above.

Answer:

Multiple Choice Questions (MCQ)

1.	(d) All of the above.
2.	(c) Internally and externally.
3.	(d) All of the above.
4.	(d) No time limit can be fixed for submission of the report under management audit.
5.	(b) Internal.
6.	(a) After the work of a statutory auditor ends.
7.	(d) All of the above.
8.	(a) Highest level downwards.
9.	(d) SWOT analysis: A SWOT - strengths, weaknesses, opportunities and threats analysis can help identify and understand key issues affecting the business.
10.	(b) Three separate parties: The parties are a public accountant in practice, a responsible party and intended users.

11.	(c) An appraise management of business enterprise of responsibility towards consumers: 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 by making available the products and services of the right qualities at the right time, in right quantity, at the right place and right price.
12.	(b) Social Audit: Consumer Service Audit is 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.
13.	(a) The statement is true: A Management Auditor has to rely more on his experience and acumen to identify areas of review.
14.	(d) Management of concern: Management audit undertakes examination of the effectiveness of management in controlling the total activities of the organisation in the accomplishment of the organisation objectives.
15.	(a) his experience and acumen: A Management Auditor has to rely more on his experience and acumen to identify areas of review. There are no fixed items of evidence to be checked by Management Auditor.

State True or False

1.	True
2.	False

Evaluation of Corporate Image 12

This Module includes:

Evaluation of Corporate Image

SLOB Mapped against the Module

To develop detail understanding about management reporting system to facilitate preparation of reliable reports which will ensure accurate data driven cost effective decisions and will build brand image. (CMLO 5b)

Module Learning Objectives:

A corporate image is, of course, the total of impressions of the mass on the company. In many instances, a brief, casual act by an employee can either lift or damage the corporate image in the eyes of a single customer but the overall image is a composite of many thousands of impressions and facts. After studying this module, the students will be able to –

- Know the benefits of Corporate Image in the Public towards the Organisations
- Understand the Reputation and performance of its brands ("brand equity") of the Organisation
- Analyse the manner in which External relations with customers, stockholders, and the community affects the Organisations
- Understand the importance of the ESG Audit in the Today's Business environment

Introduction

12.1

"Corporate Image" is the reflection of an organisation in the minds of stakeholders and society at large. referring to a company's reputation. The "Image" is what the public is supposed to see when the corporation is mentioned. A good corporate image is a genuine asset; it translates into money at the counter and a possible uptick in higher stock valuation.

The concept is usually associated with large corporations, but small businesses also have a corporate image even if neither their owners nor customers think of it that way. In the absence of active efforts, corporate image "simply happens": it is how a company is perceived.

Management, however, may actively attempt to shape the image of the entity by communications, brand selection and promotion, use of symbols, and publicizing its actions. Corporations trying to shape their image are analogous to individuals who will dress appropriately, cultivate courteous manners, and choose their words carefully to come across as competent, likable, and reliable. In the personal as in the corporate case, the image should match reality. When it does not, the consequence will be the opposite of the one intended.

The Elements of Corporate Image

A corporate image is, of course, the total of impressions left on the company's many publics. In many instances, a brief, casual act by an employee can either lift or damage the corporate image in the eyes of a single customer or caller on the phone, but the overall organisational image is a composite of many thousands of impressions and facts.

The major elements are:

1. The core business and financial performance of the company.
2. The reputation and performance of its brands ("brand equity").
3. Its reputation for innovation or technological prowess, usually based on concrete events.
4. Its policies toward its salaried employees and workers.
5. Its external relations with customers, stockholders, and the community.
6. The perceived trends in the markets in which it operates as seen by the public.
7. Promoter or leadership also acts in favour in building good corporate image. Sometimes a charismatic leader becomes so widely known as a personal luster to the company.

Image versus Images

Only in the best of cases does a corporation enjoy a single reputation. Different publics may have different views of the corporation depending on their different interests and experience with the organisation. A company's brand image may be very good but its reputation among suppliers is poor, because it bargains very hard, pays late, and shows no loyalty to vendors. A company may be highly regarded on Wall Street but may be disliked on the Main Street of cities where it has closed plants. A company may be valued for providing very low prices yet disliked for its employment practices or in different environmental performance. It is much more likely that a small business will have an all-around reputation for excellence than that a very large conglomerate will merit all-around praise. Smallness has its advantages.

At the Core: Business Performance

The single most important factor in the corporate image is a Company's core business performance reflected through financial performance. A growing, profitable corporation with a steady earnings history will, for these reasons alone please its customers, investors, and the community in which it operates. A profitable company that, nevertheless, exhibits huge gyrations in earnings will fare worse: its earnings and dividends will be unpredictable; it will have layoffs; its stock will fluctuate; its vendors will be more uneasy; its employees nervous. When a business fails in its core function, its reputation heads straight south. Enron Corp., an energy trader, had a stellar reputation as the 7th largest corporation measured in revenues. It fell into bankruptcy almost abruptly on December 2, 2001; the Justice Department began to investigate it for fraud. Suddenly every aspect of the company that had been admired and lauded, its audacity, energy, profitability, innovativeness, entrepreneurial spirit, and so on took on opposite and negative connotations. The core business had failed; Enron's reputation imploded. No amount of corporate image polishing could have saved Enron's reputation after that.

Measuring the Corporate Image

Corporations evaluate their image, much as politicians do, by the survey. They employ the methodology of marketing surveys used both in polling and in support of advertising. The investigators select appropriate samples of the public and interview them; telephone surveys are the most common. They use statistical methods of extrapolation to project from the sample what the public as a whole (or selected publics) think. Corporations, of course, also rely on the much "harder" measures such as sales and stock performance. Surveys of the corporate image are sometimes motivated by sagging sales and a miserable press.

The theory of the corporate image holds that all things equal, a well-informed public will help a company achieve higher sales and profits, whereas a forgetful or poorly informed public may come to hold negative impressions about the company and may ultimately shift more of its patronage toward competitors.

As reported by Jamie LaReau in Automotive News, "Toyota periodically surveys U.S. consumers' perceptions of the automaker. The surveys suggested that Americans' awareness of Toyota's U.S. presence had declined since 2000 even as the company was building and expanding plants."

Words and Actions

The example of Toyota is a case in which Toyota felt the need to communicate ("words") something about its investments ("action") in the United States. Ideally, words and actions are always closely linked in building or repairing the corporate image. Expert advisors to the corporate world, such as Roger Hayward's writing in Accountancy Age emphasize the need for consistent follow-through so that employees become "a vast army of goodwill ambassadors." Whether the objective is to make the most of a good thing or to turn around an adverse situation, good management practice will ensure that action is accomplished before the words are spoken.

Business and Corporate Image

Corporate image basically linked with 'Reputational Risk, reputation among its employees, customers, vendors, neighbours, society at large and the government agencies etc. goes a long way in favour of the Business.

The process continues in many ways:

- In the choice of brand names to be used.
- The company's Website design.
- The quality of its products or services.
- Its promptness in paying bills.
- Its effectiveness in mounting promotions; and so on.

Audit Checks of Different Managerial Functions

12.2

The functions of management uniquely describe managers' jobs. The most commonly cited functions of management are

- Planning,
- Organizing,
- Leading,
- Controlling etc.

Development of the Functional Approach to Management

Henri Fayol was the first person to identify elements or functions of management in his classic 1916 book 'Administration Industrielle et Generale'. Fayol was the managing director of a large French coal-mining firm and based his book largely on his experiences as a management practitioner.

Fayol defined five functions or elements of management:

- Planning,
- Organizing,
- Commanding,
- Coordinating, and
- Controlling.

Fayol argued that these functions were universal irrespective of the nature of business.

Fayol defined planning in terms of forecasting future conditions, setting objectives, and developing means to attain objectives. Fayol recognized that effective planning must also take into account unexpected contingencies that might arise and did not advocate rigid and inflexible plans. Fayol defined organizing as making provision for the structuring of activities and relationships within the firm and also the recruiting, evaluation, and training of personnel.

According to Fayol, commanding as a managerial function concerned the personal supervision of subordinates and involved inspiring them to put forth unified effort to achieve objectives. Fayol emphasized the importance of managers understanding the people who worked for them, setting a good example, treating subordinates in a manner consistent with firm policy, delegating, and communicating through meetings and conferences.

Fayol saw the function of coordination as harmonizing all of the various activities of the firm. Most later experts did not retain Fayol's coordination function as a separate function of management but regarded it as a necessary component of all the other management functions. Fayol defined the control function in terms of ensuring that everything occurs within the parameters of the plan and accompanying principles. The purpose of control was to identify deviations from objectives and plans and to take corrective action.

Fayol's work was not widely known outside Europe until 1949 when a translation of his work appeared in the United States. Nevertheless, his discussion of the practice of management as a process consisting of specific functions had a tremendous influence on early management texts that appeared in the 1950s.

Management pioneers such as George Terry, Harold Koontz, Cyril O'Donnell, and Ralph Davis all published management texts in the 1950s that defined management as a process consisting of a set of interdependent functions. Collectively, these and several other management experts became identified with what came to be known as the process school of management.

According to the process school, management is a distinct intellectual activity consisting of several functions. The process theorists believe that all managers, regardless of their industry, organisation, or level of management, engage in the functions of management. The process school of management became a dominant paradigm for studying management and the functions of management became the most common way of describing the nature of managerial work.

Criticism of the Functional Approach to Management

By the early 1970s, some experts suggested that the functions of management as described by Fayol and others of the process school of management were not an accurate description of the reality of managers' jobs. Chief among the critics of the functional approach was Henry Mintzberg.

Mintzberg argued that the functional or process school of management was "folklore" and that functions of management such as planning, organizing, leading, and controlling did not accurately depict the chaotic nature of managerial work. He felt that the functional approach to the managerial job falsely conveyed a sense that managers carefully and deliberately evaluated information before making management decisions.

Based upon an observational study of five executives, Mintzberg concluded that the work managers performed could best be represented by three sets of roles, or activities: interpersonal roles, informational roles, and decision-making roles. He described the interpersonal roles as consisting of figurehead, leader, and liaison. He identified three informational roles: monitor, disseminator, and spokesperson. Finally, he described four decision-making roles that included entrepreneur, disturbance handler, resource allocator, and negotiator.

Mintzberg's challenge to the usefulness of the functions of management and the process school attracted a tremendous amount of attention and generated several empirical studies designed to determine whether his or Fayol's description of the managerial job was most accurate. While this research did indicate that managers performed at least some of the roles Mintzberg identified, there was little in the findings that suggested that the functions of management were not a useful way of describing managerial work.

Scholars continue to debate this question. Research by David Lamond suggests that both approaches had some validity, with Fayol's approach describing the ideal management job and Mintzberg describing the day-to-day activities of managers. Thus, the general conclusion seems to be that while Mintzberg offered genuine insight into the daily activities of practicing managers, the functions of management still provide a very useful way of classifying the activities managers engage in as they attempt to achieve organisational goals.

Planning

Planning is the function of management that involves setting objectives and determining a course of action for achieving these objectives. Planning requires that managers be aware of environmental conditions facing their organisation and forecast future conditions. It also requires that managers be good decision-makers.

Planning is a process consisting of several steps. The process begins with environmental scanning, which simply means that planners must be aware of the critical contingencies facing their organisation in terms of economic conditions, their competitors, and their customers. Planners must then attempt to forecast future conditions. These forecasts form the basis for planning.

Planners must establish objectives, which are statements of what needs to be achieved and when. Planners must then identify alternative courses of action for achieving objectives. After evaluating the various alternatives, planners must make decisions about the best courses of action for achieving objectives. They must then formulate necessary steps and ensure the effective implementation of plans. Finally, planners must constantly evaluate the success of their plans and take corrective action when necessary.

There are many different types of plans and planning.

Strategic Planning

Strategic planning involves analyzing competitive opportunities and threats, as well as the strengths and weaknesses of the organisation, and then determining how to position the organisation to compete effectively in its environment. Strategic planning has a long-time frame, often three years or more. Strategic planning generally includes the entire organisation and includes the formulation of objectives. Strategic planning is often based on the organisation's mission, which is its fundamental reason for existence. An organisation's top management most often conducts strategic planning.

Operational Planning

Operational planning generally assumes the existence of objectives and specifies ways to achieve them. Operational planning is short-range planning that is designed to develop specific action steps that support strategic and tactical plans. Operational planning usually has a very short time horizon, from one week to one year.

Organizing

Organizing is the function of management that involves developing an organizational structure and allocating human resources to ensure the accomplishment of objectives. The structure of the organisation is the framework within which effort is coordinated. The structure is usually represented by an organisation chart, which provides a graphic representation of the chain of command within an organisation. Decisions made about the structure of an organisation are generally referred to as "organisational design" decisions.

Organizing also involves the design of individual jobs within the organisation. Decisions must be made about the duties and responsibilities of individual jobs as well as how the duties should be carried out. Decisions made about the nature of jobs within the organisation are generally called "job design" decisions.

Organizing at the level of the organisation involves deciding how best to departmentalize, or cluster jobs into departments to effectively coordinate the effort. There are many different ways to departmentalize, including organizing by function, product, geography, or customer. Many larger organisations utilize multiple methods of departmentalization. Organizing at the level of the job involves how best to design individual jobs to most effectively use human resources.

Traditionally, job design was based on principles of division of labour and specialization, which assumed that the more narrow the job content, the more proficient the individual performing the job could become. However, experience has shown that jobs can become too narrow and specialized. When this happens, negative outcomes result, including decreased job satisfaction and organisational commitment and increased absenteeism and turnover.

Recently many organisations have attempted to strike a balance between the need for worker specialization and the need for workers to have jobs that entail variety and autonomy. Many jobs are now designed based on such principles as job enrichment and teamwork.

Leading

Leading involves influencing others toward the attainment of organisational objectives. Effective leading requires the manager to motivate subordinates, communicate effectively, and effectively use power.

To become effective at leading, managers must first understand their subordinates' personalities, values, attitudes, and emotions. Therefore, the behavioural sciences have made many contributions to the understanding of this function of management. Personality research and studies of job attitudes provide important information as to how managers can most effectively lead subordinates.

Studies of motivation and motivation theory provide important information about how workers can be energized to put forth the productive effort. Studies of communication provide direction as to how managers can effectively and persuasively communicate. Studies of leadership and leadership style provide information regarding questions such as, "What makes a manager a good leader?" and "In what situations are certain leadership styles most appropriate and effective?"

Controlling

Controlling involves ensuring that performance does not deviate from standards. Controlling consists of three steps, which include establishing performance standards, comparing actual performance against standards, and taking corrective action when necessary. Performance standards are often stated in monetary terms such as revenue, costs, or profits, but may also be stated in other terms, such as units produced, number of defective products, or levels of customer service.

The managerial function of controlling should not be confused with control in the behavioural or manipulative sense. This function does not imply that managers should attempt to control or manipulate the personalities, values, attitudes, or emotions of their subordinates. Instead, this function of management concerns the manager's role in taking necessary actions to ensure that the work-related activities of subordinates are consistent with and contribute toward the accomplishment of organisational and departmental objectives.

Effective controlling requires the existence of plans since planning provides the necessary performance standards or objectives. Controlling also requires a clear understanding of where responsibility for deviations from standards lies. Two traditional control techniques are the budget and the performance audit. Although controlling is often thought of in terms of financial criteria, managers must also control production/operations processes, procedures for delivery of services, compliance with company policies, and many other activities within the organisation.

Management Functions Audit

Management Audit helps management in setting sound and effective targets. It is the method of evaluating the total efficiency of the management from the top level to the lowest level. It was originally developed as a tool for investment appraisal.

Management audit is a difficult and complex task. It performs the following functions:

1. Management audit identifies the objectives of an organisation.
2. It reviews or provides guidance in the preparation of complete statements of the performance standards and yardsticks for measurement applicable to each major decision or performance area.
3. It reviews the structure of the organisation and assets of the organisation and decides whether goals can be achieved or not. It critically examines and refines the units of measurement commonly applied in each major performance or decision area.

4. It examines all the scope of work and liability centers. In this regard, the auditor should help management in pinning down and inter-relating the performance standards and measurements with the operating responsibilities of each person affected.
5. It evaluates whether the management team is working in the interests of shareholders, and other stakeholders.

The management audit covers the following areas:

1. Examination of organisation structure in full or part thereof.
2. Checking the operations of management and its effectiveness.
3. A critical appraisal of activities of management executives.
4. Examination is to be carried on independently by experts.
5. Evaluation of the functioning of the management board.
6. Analyze goals, plans, policies, and activities of the management.
7. Evaluation of the earning capacity of the management.
8. Making management face or tackle any problem effectively in the future.

Management Audit and its Scope

1. Studying the organisation:

Reviewing the formal organisation structure, policies, procedures, information systems and flows, and decision centers to determine adequacy of arrangements made for running an entity

2. Searching for-performance shortcoming:

Since the concept of management audit requires the appraisal and assessment of total organisational performance; examines in depth the functioning of the system and its performance, its scope is synonymous with the appraisal areas identified by the American Institute of Management.

These are as follows:

1. Economic function vis-a-vis social responsibility:

This involves appraising the public esteem value of the company about different interests like shareholders, employees, creditors, distributors, consumers, and the community in which it operates.

2. Corporate structure:

The appraisal is made as to flow of information, span of supervision, authority relations, Organisation structure and reporting lines viz. centralization /de-centralization of authority etc.

3. Earning growth and business prosperity:

This requires appraising the extent to which the resources have realized the profit in real and tangible terms. The potential earnings, opportunities and actuals on Year-on-Year basis indicates improvement.

4. Service to shareholders:

The assessment is made mainly on three basic criteria:

(a) Risk minimization of their investment.

(b) Reasonable return on investment, and

(c) Reasonable appreciation of capital over a period.

5. Research and development:

This is applicable for manufacturing entities and big ticket item for Pharma, Drug discovery, electric vehicle and battery, robotic application etc. Business opportunity may out weight the new Investment and research & development cost.

6. Constitution of Board Of Directors:

The assessment on four fundamental elements, viz.:

(a) Quality of each Director and his contribution

(b) Role as influencer

(c) Team work and

(d) Trusteeship role.

7. Fiscal and financial policies:

The evolution of the capital management system, dividend policy, fiscal policy and controls and their application in different areas of corporate activity.

8. Operational effectiveness:

The evaluation of the management performance (betterment) in each relevant operational areas (sourcing, labour, waste control, uninterrupted flow of product, maximize throughput, sales volume and revenue growth, machinery up-time etc.) against the target set; indicates management capability to move towards next level of success.

Management Audit – Objectives:

The basic objectives of management audit are given below:

1. To identify the level of achievement of the objectives of the organisation.
2. To identify the shortcomings and barriers to achievement.
3. Putting appropriate control mechanism to pre-empt possibility of leakage or sabotage.
4. To help the management to conduct efficient administration of the operations.
5. To help the management executives in the effective discharge of their responsibilities.
6. To suggest to the management the ways and means available to achieve the objectives.
7. To guide towards improved performance.
8. To improve operations and achieve operational excellency.
9. To ensure the fullest extent of the management efficiency.
10. To help the management executives in the effective discharge of their duties.
11. To come-up with innovative ideas, solutions to improve efficiency and performance.
12. To ensure openness and proper, honest feedback mechanism.
13. To identify the deviations against the set standards or the benchmarks of the industry.
14. To help the management in improving the communication w.r.t execution aspect of policies, objectives, etc.

Management Audit – Need and Importance:

Management Audit has become necessary on account of the following reasons:

1. Management audit examines whether appropriate policies are laid down by the company management and he same being adhered through spirit and action.
2. It helps in the improvement of the performance of management as a Team.
3. Management audit suggests eliminating wastage and/or achievement of maximum with minimum.
4. Independent appraisal of performance.
5. SWOT (Strength, Weakness, Opportunity and Threats) are analyzed for timely management intervention.
6. Review of effectiveness w.r.t decision making process.
7. Ensure good governance practice in every sphere of managerial activities.

Importance of Management Audit:

Management audit plays a pivotal role in making the company efficient due to the following reasons:

1. Management Audit sets the policies and objectives right given changing environment, competitors' strategies, changes in technology, consumers' preferences, etc.
2. It helps the management in improving its systems given developments or creations in management principles, techniques, and approaches.
3. It helps the management in improving its performance in the execution of policies and in utilizing resources.
4. It sets the direction of objectives policies and business definition.
5. Provide a roadmap w.r.t overall organisational improvement.

Management Audit – Process Adopted for the Implementation of Management Audit:

(1) Objectives for Introducing Management Audit System:

Progressive management wants proper and independent evaluation of its activities including decision making process. To achieve the said purpose, management auditor is appointed. Management Audit function can be outsourced and/or through internal resources.

(2) Critical Appraisal:

Role of management audit is to critically appraise the activities from all possible angels including technical and provides independent feedback with suggestion for improvement.

Management Audit Approaches:

A structured approach is the basic pre-requisite of the management auditor. Knowledge of organisational structure, processes and sub-processes guides the auditor to frame appropriately the scope and program before starting a management audit. The scope to include-

1. Effectiveness of the formal organisation structure and organisation charts.
2. Apprising decision making process effectiveness and hierarchy.
3. He should appraise the management information system, its worth by way of accuracy and timeliness of reporting.
4. Various policies and status of deployment including further requirement to strengthen the activities.
5. Adherence to statutory regulations for running the business.

Audit Checks of Various Corporate Divisions / Departments

12.3

The need for auditing a company's business activities and operations hovers around mitigation of business risks, improve governance processes, ensure accomplishment of organisational goals and objectives.

The checklist aims to help the auditor in course of review in performing the task in a structured manner and also ensures completeness against the planned objective of accomplishment.

1. Strategic Business Planning

Auditing strategic business planning can be described as taking a series of steps to assess the company's objectives, the business plan, and the SWOT for accomplishment of the goals.

The following questions are to be raised by the Management Auditors with the concerned Corporate Divisions/ Departments during the Audit Process:

- Whether the entity having a Mission, Vision statement aligned with Corporate Goals and departmental goals?
- Whether SMART (Specific, Measurable, Achievable, Relevant, and Timeframe) set of Goals are in place and cascaded down function-wise for accomplishment?
- Whether company strategies to address target market, acquisitions, entering new geography, market penetration, counteract competition etc. are in place and effectively perused?
- Whether outcomes are compared with target for corrective actions, if any, required?

2. Organizational Structure:

- Whether a lean but adequate structure in the Organisation exist to address business requirement?
- Whether hierarchical structure supports the smooth decision making process with appropriate and adequate information movement from the approved requisite sources?
- Whether appropriate communication for clarity on organisation operating model in place to help conduct / perform the designated role?
- Whether the employees are clear about their roles, responsibility and accountability?
- Whether JD (Job Description) aptly documented with required details available to all job holders?
- Whether delegation of authority (DOA) captures clearly the authority and responsibility of assigned role?
- Whether review of structure is carried out from time to time to cope-up with changes in business scenario and/ or new requirements?

3. Finance & Accounting:

- Whether Finance and Accounting function manned with qualified accountants in sufficient number to handle the criticality of business operations?
- Whether Company's accounting activities are carried out through accounting software duly modified to support the business requirement?
- Whether accounting function, recording, supervision, approval, report generation etc. authority is password driven to cater the requirement of roles and responsibilities?
- Whether appropriate review mechanism is in place over the accounting activities carried out?
- Whether accounting results, cost datum etc. are published and shared with reviewers at appropriate level?

5. Tax:

- Whether a tax calendar to monitor deposit, return dates against each of the applicable tax legislation?
- Whether Tax law/rules-wise responsibility fixed to ensure compliances?
- Whether tax department employees are knowledgeable w.r.t tax provisions to ensure compliance?
- Whether contingent issues are appropriately decided to contest against any query from appropriate revenue exchequer?
- Whether books of account is updated with return status (refund, penalty, claims), tax deposits etc. and reviewed periodically w.r.t Tax Demand letters, assessment order etc.?

6. Budgeting:

- Whether budgeting exercise carried out for all the major activities e.g sales, purchases, advertisement, HR, Marketing, Training etc.?
- Whether approval obtained for such budgets?
- Whether any course correction of Budget takes place based on the dynamic business scenario with due approval mechanism?
- Whether the budget developed in terms of periods and performance standards, growth prospects etc.?
- Whether spent against each of budget heads are monitored periodically?

7. Cash Management:

- Whether Treasury Dept. having a Budget of inflow and outflow of Cash for business requirement on period basis?
- Whether Capex and Opex related lows are monitored against sanctions to oversee best utilization?
- Whether transactions are carried out based on approvals of appropriate designated authority?
- Whether there exist a auto transfer facility for surplus cash to Overdraft Account to make cash at bank position as 'zero'?
- Whether cash at hand are kept with custodian with adequate recording for cash at hand?
- Whether surplus funds are invested /deployed efficiently?
- Whether all collections are banked immediately and exceptions reported?
- Whether opportunity of using lines of credit to reduce the demand for cash being carried out?

8. Pricing and cost-saving:

- Whether the entity having a flexible pricing policy to address the market dynamics of demand, supply, competition, aggressive players' strategy and quality etc.
- Whether the entity having a market penetration strategy to reach newer geography, new communities etc.?
- Whether the entity having a product and/or price leadership position?
- Whether R & D facility being deployed to cost rationalization effort for balancing margin even in case of price erosion?
- Whether market forces are regularly monitored for reaping most advantageous price proposition?
- Whether economies of scale factored for enabling best obtaining pricing?
- Whether 'make or buy' decisions are explored to gain advantages in rising plant cost scenario?
- Whether marketing plans of discount, higher credit days are factored into cost to fix sales price?

9. Purchasing:

- Whether a well defined authority structure for purchase decisions is in place?
- Whether Requirements are raised after considering stock at hand and production Plan in sync with Sales Forecast?
- Whether process of regular communication exists with Costing Team, sales and manufacturing Team for price/ rate change of items procured/planned for procurement?
- Whether quality monitoring forms part Vendor selection and price negotiation?
- Whether a pre-defined Vendor rating system exists and Vendors rated accordingly?
- Whether sufficient stock at ensured through monitoring delivery dates and supplies made?
- Whether a Vendor Development process in place to introduce new sourcing?
- Whether Share Of Business (SOB) of Vendors monitored to avoid dependency on Vendors?
- Whether the purchases are made at the best available price?
- Whether purchases are made mostly from direct manufacturers, instead of dealer, agents and brokers?

10. Marketing:

- Whether entity having a sales organisation with defined goals /targets?
- Whether the entity's products are best in class w.r.t quality, pricing and performance to claim 'top ranked'?
- Whether the products/services have a good reputation in the minds of the target audience?
- Whether the entity regularly reviews the market scenario to make its strategy, promotion activities and thwart competition?
- Whether the entity having authentic source for collection of market data and utilize the same for best possible decision?
- Whether Customer loyalty program, 'Loss value analysis' etc. tools are used to assess product leadership depth of market for the product?

11. Risk & Insurance:

- Whether risk identification, managing and mitigation process is in place?
- Whether business risks analyzed and responded and opportunities explored?
- Whether the entity opts for insurance cover against the insurable perils?
- Whether appropriate policies are chosen to mitigate the risk of insurable perils and?
- Whether non-transferable risks are reviewed regularly for appropriate cost-effective mitigation plan

1. Evaluation of Purchase Management
2. Evaluation of Personnel Management
3. Evaluation of Production Management
4. Evaluation of Research and Development Activities
5. Marketing Audit
   (i) Evaluation of Sales Management
   (ii) Evaluation of Distribution Function

Annexure-I

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 a reasonable cost at the right time. A management accountant may make a model questionnaire for evaluation of purchase management:

(a) Whether a separate Organisation structure with authority level exist to handle procurement function?

(b) Whether the purchase policy is available and reviewed from time to time?

(c) Whether the purchase requirements are based on material planning w.r.t production and sales requirement, Inventory holding volume?

(d) Whether supplier selection process is laid down and negotiation takes place for the best offer?

(e) Whether specific quality, Cycle time etc. factors are considered before finalizing deal with the Vendor? regular and dependable suppliers are ensured?

(f) Whether best available rate agreed upon after comparing with market rates?

(g) Whether follow-ups made for ensuring timely supplies?

(h) Whether Vendor rating process is in place?

(i) Whether a robust Vendor registration process is in place?

(j) Whether new Vendors are introduced to reduce the role of existing Vendors?

(k) Whether SOB (Share Of Business) monitored by the Dept. to pre-empt possibility of excessive dependency?

2. Evaluation of Personnel Management

The main objective of personnel function is to create such conditions in the organisation that the employees can put to their best performances. The personnel manager has to assess manpower requirement, selection, recruitment, training and development of individuals to get best out of the employee, and also to ensure favourableindustrial relations, grievance redressal, discipline, wage settlements etc. The performance of the personnel function may broadly be evaluated in the following way:

(a) Whether the HR is vibrant in the organisation through constant touch with employee/workmen?

(b) Whether the designated HR Representative function-wise monitoring performance of the Dept. and of the staff?

(c) Whether HR is in constant touch with the decision makers within the Organisation?

(d) Whether HR Policies are available for employee entitlements and the same adhered by employees?

(e) Whether goal setting and performance monitoring exercise taken-up with functional heads?

(f) Whether training needs re identified and imparted as per requirement?

(g) Whether periodical 'Job Evaluation' process carried out for the purpose of employee movement, considering promotion etc.?

(h) Whether manpower requisitions, budgeting of cost and manpower etc. monitored and approval obtained for recruitment?

(i) Whether appropriate attendance capturing and monitoring in place?

(j) Whether salary, wages, reward etc. billed after due consideration of approvals?

(k) Whether appropriate initiative timely taken for employee grievance redressal?

(l) Whether regular communication (town hall etc.) conducted for maintain industrial harmony?

(m) Whether employee turnover is below the industry average?

(n) Whether appropriate regulations are adhered for 'contractual deployments' ?

(o) Whether 'labour welfare schemes' are announced keeping in view of larger interest of the rank and file?

(p) Whether legitimate unionism encouraged?

(q) Whether safety needs are appraised and strict vigil maintained for accident free operations?

(r) Whether 'job rotation' process resorted to for preparing pipeline of able employees?

(s) Whether monetary and non-monetary benefits are balanced in CTC (Cost To Company)?

3. Evaluation of Production Management

The main objective of production management is to turn out finished goods of requisite quality by making optimum use of men, machines, and methods. The productivity of such factors must satisfy the standards or norms set for the industry. The following checklist will help the management auditor in evaluating production management:-

(a) Whether production planning cognizes market demand, plant capacity, raw materials availability, availability of power, etc.?

(b) Whether quality concerns are addressed appropriately?

(c) Whether cost minimization efforts are taken to ensure competitive selling price?

(d) Whether actual consumption and BOM (Bill Of Material) is in tandem and variance, if any, analyzed at the end of each run?

(e) Whether actual capacity is in line with expected production target?

(f) Whether appropriate safety measures are in place to preempt possibility of accidents?

(g) Whether Production system is connected with incentives for achievement?

(i) Whether maintenance plans are in place to ensure higher availability of equipment for production run?

4. Evaluation of Research and Development Activities

A management auditor of a company can appraise and evaluate activities of research and development based on the following checklist:

(a) Whether R & D is a continuous process used for betterment of product quality, cost reduction, change in process of production, new product discovery etc.?

(b) Whether the entity having a vision to achieve the above through R &D?

(e) Whether a budget prepared for R & D spent?

(d) Whether achievements are made as expected?

(e) Whether appropriate Quality of people manned in R & D?

(f) Whether the Board of Directors identify or endorse the broad "types of research" to be undertaken to order oensure that the efforts are concentrated in line with the defined goals?

(h) Whether the R&D considered an independent department in the company?

(i) Whether the R&D results are properly recorded, classified and analysed?

(j) Whether on implementation of R & D suggestions, benefits outweigh the costs incurred?

5. Marketing Audit

A marketing audit is an independent review 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 what is being done, and recommending what should be done in future.

Marketing audits may be horizontal or vertical. A horizontal audit (also known as a system-level audit) covers a major part of a marketing audit and evaluates a total appraisal of the marketing efforts of a company. The marketing audit encompasses the following areas:

1. Objectives: Target setting and methods for accomplishment of objectives in detail.
2. Programme: Appraising efficacy of marketing programs for achieving the objectives.
3. Organisation: Structure, roles of marketing department.

5.1. Evaluation of Sales Management

The main objective of the function of sales management is to create and develop market (customers) and take the 'pole position'.

The following questionnaire will help in evaluating sales management:

(a) Whether Organisation structure with role clarity exists?

(b) Whether SWOT for different geographical or Customer segment is carried out for planning the marketing effort?

(c) Whether market share (product-wise, Customer base etc.) and enhancement of billing value indicating any uptick?

(d) Whether growth is sustainable?

(e) Whether the system of appraising the performance of sales division and salesmen objectives fair?

(f) Whether the salesmen's performance/efforts linked with rewards?

(g) Whether the budget is realistic and achievable without additional pass on to Customers?

(h) Whether quality of product justifies 'price' and returns are bare minimum?

(i) Whether market strategies are developed after in-depth study of market condition supported by database?

(j) Whether Order revies are carried out at periodic intervals and un-catered (able)ones are 'dropped'?

(k) Whether supply pipeline and logistics are reckoned while booking order?

(l) Whether market campaign, advertisement, sales promotion effort etc. are linked with market achievement and budgeted?

(o) Whether a defined 'credit policy' exists? And over ridings are duly approved as per delegation of authority?

(p) Whether 'overdue' are monitored and sales teams' responsibility for collection clearly specified?

(q) Whether customer complaints are monitored for resolution?

5.2. Evaluation of Distribution Function

For evaluation of distribution function, a management auditor should consider the following points:

A. Distribution Function

(a) Whether the entity having an established network of distribution?

(b) Whether network/channel-wise operating plans are in place?

(c) Whether actual performance measured against plan?

(d) Whether appropriate logistic arrangements are in place for stock replenishment and delivery?

(e) Whether competition channels are enquired for performance and compared with own?

B. Capacity configuration

(a) Whether the production, marketing and distribution capacities provide an economical means of meeting the necessary customer service criteria?

(b) Whether adequate inventory levels are maintained for smooth operational flow?

(c) Whether any ramp-up required for smooth operations?

C. Staging of inventory

(a) Whether past order trends are perused for inventory holding in each of the distribution channel?

(b) Whether the flow of finished goods inventory through the distribution process reasonable within the acceptable service limits?

(c) Whether regular reviews of inventory physical condition checked and segregation, if required, carried out to avoid any erosion?

D. Transportation mode mix

(a) Whether a transporter Registration process exists?

(b) Whether route, distance and vehicle availability factored into fixing freight?

(c) Whether delivery times are tracked for transport efficiency measurement?

(d) Whether multimodal arrangements are there? If so, safe handover ensured at each point?

(e) Whether the present model has been selected considering cost and service capabilities?

ESG Audit

12.4

India has introduced new environment, social, and governance (ESG) reporting requirements for the top 1,000 listed companies by market capitalization. The Securities and Exchange Board of India (SEBI) stipulates that the disclosure must be made through a new format, namely the Business Responsibility and Sustainability Report (BRSR). BRSR reporting will be mandatory from F.Y. 22-23.

Sustainability is fast becoming a key priority for corporates around the world. Businesses today are expected to be more ethical and duty bound towards society. There has been a corresponding shift in the mindset of investors, with priorities expanding to include sustainable growth along with the primary goal of wealth creation. Boardrooms have taken note of this and have started embedding practices to ensure that these requirements are met.

Companies and organisations have started preparing sustainability reports disclosing their performance on environmental, social, governance parameters as a part of reporting non-financial performance metrics. While the Indian government has not mandated all companies to prepare these reports, it is strongly encouraged as such monitoring and accountability provide clarity to investors and other stakeholders about the company's responsible conduct of activities.

How does India view ESG compliance?

In 2013, India became the first country to mandate corporate social responsibility with the Companies Act of 2013. This tenet was previously suggested in the National Voluntary Guidelines (NVGs) on Social, Environmental, and Economic Responsibilities of Business released in 2011 before being included in the Companies Act 2013.

Additionally, the top 500 listed firms in India by market-cap were instructed by SEBI to disclose indicators of business responsibility and sustainability through Business Responsibility Reporting (BRR).

SEBI in India plays the role of the market regulator, regulating securities, and protecting the interests of the stakeholders in the market. SEBI is also responsible for the implementation of an efficient ESG policy mechanism.

In 2021, SEBI issued a circular containing details of new sustainability-related reporting requirements called the Business Responsibility and Sustainability Report (BRSR), which brings India's sustainability reporting to global reporting standards. BRSR is a departure from the BRR format.

What are the disclosure requirements under India's new ESG policy?

On May 10, 2021, SEBI issued a circular introducing the Business Responsibility and Sustainability Report (BRSR), which will replace the Business Responsibility Reporting (BRR). The new reporting format outlines mandatory ESG policies and requirements for the top 1000 listed companies by market capitalization. The format is based on the nine principles stipulated in the "National Guidelines on Responsible Business Conduct" (RBC Guidelines).

The RBC Guidelines are influenced by leading international standards, including the UN Guiding Principles on Business and Human Rights, UN Sustainable Development Goals, Paris Agreement, and International Labour Organisation (ILO) Core Conventions. The RBC Guidelines addresses key sustainability matters, such as business ethics and transparency, human rights, environmental safety, and fair labour practices.

The reporting format is mandatory from FY 2022-23 but is voluntary for FY 2021-22. This is to provide companies with sufficient time to adapt to the new reporting compliance. Companies are encouraged, however, to adopt the BRSR early.

The BRSR is aimed at securing transparent and standardized disclosures by companies on their ESG parameters and sustainability-related risks. This approach is expected to help companies better demonstrate their sustainability objectives, position, and performance to the market, resulting in long-term value creation and increasing the ability of investors to make informed ESG-related decisions.

Business Responsibility and Sustainability Reporting in India:

Aspects	Disclosure requirements	Principles
General	a) Overview of the company's material environmental, social , and corporate governance risks and opportunities and approach to mitigate or adapt to these ESG risks as well as relevant financial implications b) Sustainability related goals and targets and related performance c) Management structures, policies, and processes related to sustainability	General management and process disclosures

Aspects	Disclosure requirements	Principles
Environment	a) Resource usage (energy and water) and intensity metrics b) Air pollutant emissions c) Greenhouse gas emissions (Scope 1, Scope 2, and Scope 3) d) Waste generated and waste management practices e) Impact on biodiversity	Principle 6: Businesses should respect and make efforts to protect and restore the environment.

Social	**Employees:** a) Gender and social diversity, including measures for differently-abled employees b) Turnover rates c) Median wages d) Welfare benefits to permanent and contractual employees e) Occupational health and safety f) Trainings	Principle 3: Businesses should respect and promote the well-being of all employees, including those in their value chains. Principle 5: Businesses should respect and promote human rights.
	Communities: a) Social impact assessments b) Rehabilitation and resettlement c) Corporate social responsibility	Principle 8: Businesses should promote inclusive growth and equitable development.
	Consumers: a) Product labeling b) Product recall c) Consumer complaints concerning data privacy, cyber security, etc.	Principle 9: Businesses should engage with and provide value to their consumers in a responsible manner.
Governance	a) Training on the principles stipulated in the "National Guidelines on Responsible Business Conduct" (RBC Guidelines) for members of the Board, senior managers, and employees b) Anti-corruption and anti-bribery policies c) Awareness programs conducted for value chain partners on the principles in the RBC Guidelines	Principle 1: Businesses should conduct and govern themselves with integrity, and in a manner that is ethical, transparent, and accountable.

Source: Mayer Brown

How big Indian companies are adapting to the ESG pivot:

Many leading companies in India have begun to include environmental, social, and governance targets as a part of key result areas (KRAs) for Top Management.

The move is influenced by an increasing push from investors to allocate capital that not only generates financial returns but is also invested in social good. Overall, non-financial factors increasingly become a marker of material risks and growth opportunities for investors.

The pandemic and increasingly evident costs of climate change have elevated the importance of these discussions, with many boards devoting significant time in their strategy meetings to discuss ESG issues.

ESG consciousness among corporates in India: Leading examples

For consumer goods maker Marico, ESG now becomes a part of top management KRAs.

Diversified miner Vedanta is currently planning to embed ESG into every aspect of the company's decision-making and performance evaluation.

Tata Group companies, such as Tata Steel, Tata Motors, Tata Consumer, Tata Power, and Tata Consultancy Services (TCS) look at ESG as a priority. Their top management claims that sustainability is among the top four business objectives for the organisation.

Early-stage venture capital investors are keen to support start-ups that actively facilitate ESG goals.

Textile major, Welspun, has also embarked on a journey to enable a sustainable approach in all its operations. Environmental and social concerns are making modern consumers more cautious of their fashion and textile choices leading brands to be more conscious of whether their ESG parameters are being optimally met.

Prominent Indian companies like Tech Mahindra, Infosys, and Wipro are part of the Dow Jones Sustainability Index (DJSI), which assesses the ESG performance of companies globally. Historically, the companies that are part of the DJSI follow ESG best practices and have fared well on the Indian bourses. This may be attributed to the fact that investors, both institutional and retail, wish to invest in companies seen to be more socially responsible.

Blue-chips stock, such as TCS and Reliance Industries, recently announced roadmaps towards reduction in greenhouse gas emissions towards zero. Investors seem to have an appetite for innovative instruments to finance environmental and social initiatives.

How India compares with other countries:

Being the first country to have mandated corporate social responsibility, India has for some time taken the lead in demanding ethical commitments from businesses. However, different countries have different approaches and beliefs when it comes to ensuring responsible business activity.

The United Kingdom:

In the UK, quoted companies are mandated to provide a report disclosing annual greenhouse gas emissions, diversity, and human rights under the Companies Act 2006 (Strategic and Director's Report) Regulations, 2013. Companies with a premium listing of equity shares in the UK also need to report on how they apply the main principles of the Corporate Governance Code, 2012.

European Union:

The European Commission (EC) Directive on Disclosure of Non-Financial and Diversity Information (2013) is considered a major reporting instrument of the EU. It requires certain large companies and public-interest companies to disclose material environmental, social, and employee-related matters.

United States:

According to the Regulation issued by the US Securities and Exchange Commission (SEC), all listed companies should disclose their environmental compliance expenses. Another sustainability reporting instrument by the New York Stock Exchange (NYSE) mandates that listed companies adopt and disclose a code of business conduct and ethics.

China:

Overall, China has seven regulations that act as instruments of mandatory disclosure on sustainability matters. The Environmental Information Disclosure Act, 2008 mandates corporations to disclose environmental information. Annual resource utilization, pollution levels, waste generation, disposal method, and some other aspects can be disclosed voluntarily to gain more rights to grants and public support. A separate report with an environmental disclosure is also requested from large companies listed on the Shanghai Stock Exchange.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. What is the main factor to maintain corporate image?
   (a) Industry Goodwill.
   (b) Employee loyalty.
   (c) Shareholder's trust.
   (d) All of these
2. Which media relation norm enlists that actual and factual data should be reported?
   (a) Accuracy.
   (b) Honesty.
   (c) Integrity.
   (d) Depends upon the media.
3. Who is starting point of bottom–up communication?
   (a) Employees.
   (b) Customers.
   (c) Management.
   (d) Depends upon the media.
4. What is the business case for CSR?
   (a) Better motivated staff reduce operating costs.
   (b) Increased brand value and reputation.
   (c) None of the above.
   (d) All of these
5. What is the crucial function of a PR agency?
   (a) Strategic planning.
   (b) Key messaging.
   (c) Media relations.
   (d) All of the above.
6. What is the main objective of investor relations?
   (a) Create understanding between the investors, financial community, and the company.
   (b) Create interest of the prospective investor in the company's stocks.
   (c) Build corporate image of the organisation.
   (d) All of these.

7. What refers to the act of offense of saying something false or malicious that damages somebody's reputation?
   (a) Libel.
   (b) Slander.
   (c) Defamation.
   (d) IPR violation.
8. What is the essential trait of a PRO?
   (a) Have high standard of integrity.
   (b) Should be a learned.
   (c) Should gain the people's confidence easily.
   (d) All of these.
9. Which type of advertising focuses on the basis of experience that customers have with a company?
   (a) Corporate Image.
   (b) Institutional.
   (c) Perception Oriented.
   (d) Identity.
10. Which strategy influences internal communications?
   (a) Organisation's strategy.
   (b) A strategy of its own.
   (c) Both of above
   (d) Depends upon the media.
11. Which of this is true for corporate image of an organisation?
   (a) Image is static and does not evolve over years.
   (b) Image should change every year.
   (c) Image should change with launch of every new product.
   (d) Image should be built over years and then maintained.
12. Mass communication is the process of ________by spreading a message to the desired public.
   (a) Mass persuasion.
   (b) Mass awareness.
   (c) Mass enlightenment.
   (d) Mass prelude.
13. Which type of advertising focuses on the basis of experience that customers have with a company?
   (a) Corporate Image.
   (b) Institutional.
   (c) Perception Oriented.
   (d) Identity.

State True or False

1. A firm's image is based on the feeling consumers and businesses have about the overall organisation and its individual brands.
2. Effective marketing communications are based on a clearly defined corporate image.
3. What a firm's employees believe about the company's image is far more important than what consumers think.
4. Changing a corporation's image requires both internal programs and external promotions.
5. An overt corporate name reveals what the company does.
6. A conceptual corporate name captures the essence of what a company offers, but does not reveal it directly.
7. An implied corporate name contains recognizable words or word parts that suggest what the company does.
8. Google is an example of an implied corporate name.
9. A conceptual corporate name seeks to capture the essence of the idea behind the brand or a vision of what the company does.
10. "Federal Express" is an example of a conceptual corporate name seeking to suggest the idea of express delivery.

Essay Type Questions

1 What is ESG?

2. What is the Difference Between CSR and ESG?
3. How ESG is measured by the Organisation? – The Value of Data.
4. How ESG is Reported by the Organisation?
5. How does ESG create value for the Organisation?
6. How does the board of directors of the company need to evolve to oversee, enable and support the delivery of our ESG and sustainability strategy?
7. What are the importance and limitations of Planning as a Function of Management?
8. What are the functions of managers? What are the basic activities within the management process?
9. What are the different levels of management?
10. Mention the different roles managers have to play in modem organisations.
11. How are management skills acquired?
12. What is the scope of management?
13. How to enrich or improve company image?
14. Briefly explain the company's mission, vision, and values.
15. If new product or service launched, explain the measures to fit with existing brand.

16. What are the fundamental components for a successful brand?

17. How to spin-off a company without losing market share or profit?

18. How to increase brand recognition?

19. A full research or discovery is required before kick-starting a re-brand of the Company Product. Explain.

Answer:

Multiple Choice Questions

1.	(d) All of these
2.	(a) Accuracy
3.	(a) Employees
4.	(d) All of these
5.	(d) All of the above
6.	(d) All of these
7.	(b) Slander
8.	(d) All of these.
9.	(c) Perception Oriented.
10.	(c) Both of above
11.	(d) Image should be built over years and then maintained
12.	(a) Mass persuasion
13.	(c) Perception Oriented

True / False

1.	True	2.	True	3.	Fasle	4.	True	5.	True
6.	False	7.	True	8.	False	9.	True	10.	False

Information Systems Security Audit

13

This Module includes:

Information Systems Security Audit

SLOB Mapped against the Module

To develop adequate knowledge on information system, its security framework to evaluate whether information systems are safeguarding corporate assets, and maintaining the integrity of stored and communicated data. (CMLO 3c)

Module Learning Objectives:

An IT security audit is a comprehensive examination and assessment of an enterprise's information security system. Conducting regular audits can help identify weak spots and vulnerabilities in IT infrastructure, verify security controls, ensure regulatory compliance, and more. After studying this module, the students will be able to –

- Identify the need for IS Audit in the Business Organisations
- Learn the various compliance and security frameworks of the organisation in an IT Environment
- Differentiate between Cyber Security and Cyber Forensics

Introduction

13

The advancement of information systems and technology offers a vital benefit for businesses. However, it also brings ever-increasing challenges due to the existence of hackers, malware, viruses, cyber crimes, etc. Therefore, frequent and strong follow-up is required via regular information systems security audits.

An information systems security audit (ISSA) is an independent review and examination of system records, activities, and related documents. These audits are intended to improve the level of information security, avoid improper information security designs, and optimize the efficiency of the security safeguards and security processes. The term "security framework" has been used in a variety of ways in security literature over the years, but in 2006, it came to be used as an aggregate term for the various documents, some pieces of software, and the variety of sources that advise on topics related to information systems security, in particular, about the planning, managing or auditing of overall information security practices for a given institution.

Although security is a never-ending process that requires continued follow-up, it is still in its infancy. Also, a security audit is an unexplored area and requires a simple framework to guide the process.

Overview

13.1

An IT security audit is a comprehensive examination and assessment of an enterprise's information security system. Conducting regular audits can help identify weak spots and vulnerabilities in IT infrastructure, verify security controls, ensure regulatory compliance, and more.

IT security audits involve how they can help the organisation achieve its security and compliance goals.

First and foremost, a comprehensive IT security audit enables to verification of the security status of the company's infrastructure: hardware, software, services, networks, and data centers.

An audit can help to answer the following critical questions:

Are there any weak spots and vulnerabilities in current security?

Are there any extraneous tools or processes that don't perform a useful security function?

Are equipped to fend off security threats and recover business capabilities in the event of a system outage or data breach?

If discovered security flaws, what concrete actions can take to address them?

A thorough audit can also help remain in compliance with data security laws. Many national and international regulations, require an IT security audit to ensure that information systems meet their standards for the collection, usage, retention, and destruction of sensitive or personal data.

A Compliance Audit is typically conducted by a certified security auditor from either the applicable regulatory agency or an independent third-party vendor. In some cases, though, personnel within the company may perform an internal audit to check the company's regulatory compliance or overall security posture.

If an organisation performing an audit for either general cyber security or regulatory compliance purposes, follow these steps and best practices to ensure an efficient, effective process.

The Steps in an IT Security Audit

A cyber security audit consists of five steps:

- Define the objectives.
- Plan the audit.
- Perform the auditing work.
- Report the results.
- Take necessary action for the deficiencies.

Define the Objectives:

Layout the goals that the auditing team aims to achieve by conducting the IT security audit. Make sure to clarify the business value of each objective so that specific goals of the audit align with the larger goals of the company.

List of questions as a starting point for brainstorming and refining of objectives for the audit.

- Which systems and services do want to test and evaluate?
- Do audit digital IT infrastructure, physical equipment, and facilities, or both?
- Is disaster recovery on the list of concerns? What specific risks are involved?
- Does the audit need to be geared towards proving compliance with a particular regulation?

Plan the Audit:

A thoughtful and well-organized plan is crucial to success in an IT security audit.

Define the roles and responsibilities of the management team and the IT system administrators assigned to perform the auditing tasks, as well as the schedule and methodology for the process. Identify, monitor, report, and data classification tools that the team will use and any logistical issues they may face, like taking equipment offline for evaluation.

Once decided on all the details, document and circulate the plan to ensure that all staff members have a common understanding of the process before the audit begins.

Perform the Auditing Work:

The auditing team should conduct the audit according to the plan and methodologies agreed upon during the planning phase. This will typically include running scans on IT resources like file-sharing services, database servers, and SaaS applications like Office 365 to assess network security, data access levels, user access rights, and other system configurations. Also physically inspect the data center for resilience to fires, floods, and power surges as part of a disaster recovery evaluation.

During this process, interview employees outside the IT team to assess their knowledge of security concerns and adherence to company security policy, so any holes in the company's security procedures can be addressed moving forward.

Report the Results:

Compile audit-related documentation into a formal report that can be given to management stakeholders or the regulatory agency. The report should include a list of any security risks and vulnerabilities detected in IT systems, as well as actions that IT staff recommend to mitigate them.

Take Necessary Action:

Follow through with the recommendations outlined in the audit report. Examples of security-enhancement actions can include:

- Performing remediation procedures to fix a specific security flaw or weak spot/s.
- Training employees in data security compliance and security awareness.
- Adopting additional best practices for handling sensitive data and recognizing signs of malware and phishing attacks.
- Acquiring new technologies to strengthen existing systems and regularly monitor infrastructure for security risk.

Difference Between a Security Audit and a Risk Assessment

A security audit and a risk assessment each involve a process of examining and evaluating security risks for an organisation. The differences between them have to do with their timing and scope.

A risk assessment is often performed at the start of an IT initiative before tools and technologies have been deployed. It's also performed every time the internal or external threat landscape changes-for example when there is a sudden rise of ransomware attacks or a massive shift to remote working. In organisations with mature security processes, risk assessment is performed regularly to assess new risks and re-evaluate risks that were previously identified. The goal of a risk assessment is to determine how best to build IT infrastructure to address known security risks. Hence, this activity is focused on outward factors and how they affect infrastructure.

A security audit, on the other hand, is performed on an existing IT infrastructure to test and evaluate the security of current systems and operations. As a best practice, schedule security audits to be performed at regular intervals so that overall security posture is on an ongoing basis.

To make sure that security audit is effective in identifying flaws and weaknesses in the IT system, follow these best practices.

Establish Clear Objectives

Clearly defining goals and scope keeps the audit on track to be measurable, actionable, and successful. And when all members of the auditing team stick to the defined objectives, they can stay focused on critical tasks and avoid wasting valuable time and resources on irrelevant or unnecessary issues.

Obtain Buy-in from Key Stakeholders

For an infrastructural initiative like a security audit to be successful, there is a need for support and advocacy from the top levels of the organisation, including the chief security officer and chief information officer. Management sponsorship will help ensure that the audit gets the time and resources that are required.

Define Clear Action Items Based on the Audit Results

It's not enough just to publish a report of findings. The audit should contribute to the security of the organisation by providing clear and practical guidelines for making cybersecurity improvements. If there's a system vulnerability, create a plan for how to remediate it. If a file or data system is out of regulatory compliance, take the necessary measures to bring it into compliance.

Security Audit Solutions

IT security auditing is most useful and effective when conducted regularly. Create a schedule to periodically audit the entire system portfolio to assess compliance with data regulations and maintain operational readiness for cyber attacks.

Compliance and Security Framework

13.2

Since the entire banking heavily relies on electronic platforms and online transactions, cyber security is imperative. Hence, RBI expects banks to assess their Cyber Security preparedness. RBI mandates that a Top to Down approach in information security governance must be followed which starts from the Bank's operating board to IT and IS committee, and to level further down in the hierarchy. RBI also expects the Banks to report to the Cyber Security and Information Technology Examination (CSITE) Cell of the Department of Banking Supervision, with the following details.

- Gap analysis against the published Cyber Security / Resilience Framework.
- Information security controls.
- Effectiveness of the implemented controls.
- Plan of action to mitigate risks.
- Role of Chief Information Security Officer (CISO).

How RBI Audit is performed for a bank?

- The audit is conducted as an in-depth technical assessment.
- Includes information security process audit.
- Includes applicability of cyber security controls.
- By checking evidence and logs on servers.
- Includes checking all norms of technical requirements as per RBI.

RBI Audit Report

- A detailed gap analysis report.
- The report will provide who needs to do what activities to be compliant with RBI.
- Wherever possible, the report will include details on what exactly needs to be done and by which team or person.

RBI Cyber Security Framework Domains

RBI has provided clear guidelines for controls implementation, for the baseline cyber security and resilience framework. Following are the Baseline controls:

- Inventory Management of Business.

- IT Assets Preventing execution of unauthorized software.
- Application Security Life Cycle (ASLC).
- Patch/Vulnerability & Change Management.
- Vendor Risk Management.
- Removable Media.
- Maintenance, Monitoring, and Analysis of Audit Logs.
- Audit Log settings.
- Metrics.
- Forensics.
- Environmental Controls.
- Network Management and Security.
- User Access Control / Management.
- Authentication Framework for Customers.
- Advanced Real-time Threat Defense and Management.
- Anti-Phishing.
- Vulnerability Assessment and Penetration Test.
- Red Team Exercises.
- Incident Response & Management.
- User / Employee/ Management Awareness.
- Customer Education and Awareness.
- Secure Configuration.
- Secure mail and messaging systems.
- Data Leak prevention strategy.
- Risk-based transaction monitoring.

Besides these controls, the Banks are mandated to implement controls based on their level as decided by RBI. Those controls are as below:

Level 1 Banks Cyber Security

- Baseline Cyber Security and Resilience Requirement.
- Vendor/Outsourcing Risk Management.

Level 2 Banks Cyber Security

- Network Management and Security.
- Secure Configuration.

- Application Security Life Cycle (ASLC).
- Change Management.
- Periodic Testing.
- User Access Control / Management.
- Authentication Framework for Customers.
- Anti-Phishing.
- Data Leak Prevention Strategy.
- Audit Logs.
- Incident Response and Management.

Level 3 Banks Cyber Security

- Network Management and Security.
- Secure Configuration.
- Application Security Life Cycle (ASLC).
- User Access Control.
- Advanced Real-time Threat Defense and Management.
- Maintenance, Monitoring, and Analysis of Audit Logs.
- Incident Response and Management.
- User / Employee/ Management Awareness.
- Risk-based transaction monitoring.

Level 4 Banks Cyber Security

- Arrangement for continuous surveillance-Setting up of Cyber Security Operation Centre (C-SOC).
- Participation in Cyber Drills.
- Incident Response and Management.
- Forensics and Metrics.
- IT Strategy and Policy.
- IT and IS Governance Framework.
- Chief Information Security Officer (CISO).
- Information Security Committee.
- Audit Committee of Board (ACB).

Cyber Security and Cyber Forensics

13.3

At first glance, computer forensics and cyber security may seem similar, but there are key differences between the two professions. Computer forensics focuses on uncovering and preserving encrypted or lost data, while cyber security is about preventing data loss or cybercrimes from occurring. In short, one is reactionary while the other is preventative.

What is Cyber Security?

Cyber security is a professional discipline that is about creating defensive measures to protect against cyber attacks. People working in this industry may have a wide range of information technology (IT) skills including programming, operating systems, and networking. The primary goal of any cyber security professional is to create a network or system that is impossible to breach, thereby protecting the information within the network.

One important note about cyber security is that it is almost entirely about prevention. Even more niche positions, like ethical hackers, only use their offensive skills to test networks and improve them.

Cyber security encompasses many protocols that are used in the real world. Things like setting user permissions, establishing file transfer protocols (FTP), and requiring secure, frequently changing passwords are all vital elements of cyber security. It's not just up to one individual, everyone in an organisation needs to practice safe computer usage for security to be maintained.

What is Computer Forensics?

Computer forensics is the practice of recovering data from a device, often to uncover evidence of criminal activity. The practice itself is reactionary, meaning that it only takes place after an incident has occurred and is not concerned with preventing the incident itself.

Computer forensics jobs typically serve one of two purposes. They either assist with an investigation or help people and companies recover data that has been lost. In the first instance, a computer forensics specialist will be given access to a suspect's device, such as a laptop, desktop, or smartphone. Once they have the device, they begin using a variety of skills, such as programming, hardware knowledge, and software knowledge, to locate valuable data. In a law enforcement case, they will ideally uncover data that is of value to the prosecution and can be presented in a court of law. To do this, the data must be recovered in a very particular manner that does not violate the suspect's rights.

Sometimes, computer forensics specialists are called in to help a company recover lost data. While the purpose of the assignment differs greatly from uncovering evidence of criminal activities, the processes used to recover the lost data are very similar. The main difference in the execution of these tasks is that the particular processes required to create court-admissible evidence do not need to be followed in this case. In some cases, if the data is lost as a result of cybercrime, the computer forensics expert may be tasked with recovering the data and identifying the perpetrator of the crime.

Cyber Security vs. Computer Forensics

In short, cyber security is focused on prevention while computer forensics is about recovery and reaction. Despite their differences, both are meant to protect data, programs, networks, and other digital assets. Cyber security helps to prevent cyber crimes from happening, while computer forensics helps recover data when an attack does occur and also helps identify the culprit behind the crime.

It helps to think of cyber security professionals as a security company, and to think of computer forensics experts as investigators.

What Specializations are Available in Cyber Security and Computer Forensics?

Cyber security and computer forensics both have a few specializations that focus on specific areas of the practice. Cyber security has far more specializations, such as systems architecture, software security, access management, ethical hacking, and vulnerability assessment.

Computer forensics specializations tend to be related to the reason why the data is being recovered. The main specializations are criminal investigations, in which the expert is tasked with uncovering data that is relevant to a crime, and data recovery.

Data recovery specialists are mostly concerned with getting data back in the hands of its rightful owner, though they may also perform an audit to find evidence of a data breach if the data was stolen rather than lost through a technical issue.

IT Audit in Banking Sector

13.4

The objectives of IS audit are to identify the risks that an organisation is exposed to in the computerized environment. IS audit evaluates the adequacy of the security controls and informs the Management with suitable conclusions and recommendations. IS audit is an independent subset of the normal audit exercise in an organisation. The overall objectives of the normal audit exercise do not change, when applied to the computerized environment. The major objectives of IS audit include, among others, the following:

(a) Safeguarding of Information System Assets/Resources.

(b) Maintenance of Data Integrity.

(c) Maintenance of System Effectiveness.

(d) Ensuring System Efficiency.

Safeguarding of Information System Assets/Resources

The Information System Assets of the organisation must be protected by a system of internal controls. It includes the protection of hardware, software, facilities, people (knowledge), data files, system documentation, and supplies. This is because hardware can be damaged maliciously, software and data files can be stolen, deleted, or altered and supplies of negotiable forms can be used for unauthorized purposes. Safeguarding of the Information System Assets is a very important function of each organisation.

The term IT infrastructure is a generic one used to describe the physical computer installations, the system software, and the Information Systems process that support them. The IS auditor will require to review the physical security over the facilities, the security over the systems software, and the adequacy of the internal controls. The IT facilities must be protected against all hazards. The hazards can be accidental hazards or intentional hazards.

Accidental hazards include fire, flood, power failure, etc. Fire starts accidentally or is the result of a deliberate attack. All computer installations should take adequate precautions to ensure that fire can be prevented, detected, and extinguished. Flooding can cause extensive damage to computer systems. The power supply for the computer installation is a vital service need and the uninterrupted availability thereof has to be ensured to facilitate continuity in processing.

Maintenance of Data Integrity

Data Integrity includes the safeguarding of the information against unauthorized addition, deletion, modification, or alteration. This includes items such as accounting records, backup, documentation, etc. Information Systems are used to capture, store, process, retrieve and transmit the data securely and efficiently. The emphasis is on the accuracy of the data and its transmission in a secured manner. Data Integrity also implies that during the various phases of electronic processing, various features of the data viz. Accuracy, Confidentiality, Completeness, Up-to-date status, Reliability, Availability, Timeliness, and Effectiveness are not compromised. In other words, data should remain accurate during electronic processing.

The desired features of the data are described hereunder:

(a) **Accuracy:** Data should be accurate. Inaccurate data may lead to wrong decisions and thereby, hindering the business development process.

(b) **Confidentiality:** Information should not lose its confidentiality. It should be protected from being read or copied by anyone who is not authorized to do so. It also includes protecting the individual pieces of information that may seem harmless by the owner but can be used to infer other confidential information.

(c) **Completeness:** Data should be complete. Incomplete data loses its significance and importance.

(d) **Up-to-date Status:** Data should be updated regularly. If the information is not up-to-date, it presents a false picture of the organisation.

(e) **Reliability:** Data should be reliable because all business decisions are taken based on the current database.

(f) **Availability:** Data should be available when an authorized user needs it. It should be ensured that the information services are unavailable to unauthorized users.

(g) **Timeliness:** Timeliness of the data is very important because if data is not available when required, the very purpose of maintaining the database gets defeated.

(h) **Effectiveness:** Information should be effective so that it helps in the process of business development and expansion.

If data integrity is not maintained, an organisation loses its true representation. Poor data integrity could lead to the loss of competitive advantage. The corruption of data would affect many users in a networked environment. If the data is valuable to a competitor, its loss may undermine an organisation's competitive position.

Maintenance of System Effectiveness

An effective Information System significantly contributes to the achievement of the goals of an organisation. Therefore, one of the objectives of IS audit is to verify system effectiveness. It provides input to decide when what and how the system should be improved so that its utility to the management is maximum.

The main objective of introducing computerization in organisations in the banking and financial sector is to achieve the goals effectively and efficiently. The IS auditor's responsibility is to examine how the Information Systems assist in the achievement of each organisation's goals. System Effectiveness is a ratio of the actual output to the standard (budgeted) output. If it is more than 100%, effectiveness is achieved; or else, it shall be deemed that ineffectiveness has been introduced in the business process. Major goals and criteria of computerization are:

(a) **Improved Task Accomplishments**: The Information Systems should improve the task accomplishment capacity of its users by enabling them to become more productive.

(b) **Improved Quality**: It should improve the overall quality of work and services by increasing the accuracy of information. It should also reduce the time required for the retrieval of information.

(c) **Operational Effectiveness**: The Information System should be operationally effective and easy to use. It should be frequently used and users must be satisfied with its performance.

(d) **Technical Effectiveness**: The Information System should be equipped and upgraded with appropriate hardware and software from time to time.

(e) **Economic Effectiveness**: The Information System should be fully utilized. Benefits derived should exceed the cost of procurement, implementation, operation, and maintenance.

Ensuring System Efficiency

The resources used by the Information Systems such as the machines, computer peripherals, software, etc. are scarce and costly. Efficient Information Systems use minimum resources to achieve the desired objectives. When a computer no longer has excess capacity, system efficiency becomes important. It becomes necessary to know whether the available capacity has been exhausted or the existing allocation of the computer resources is causing the bottlenecks.

The ratio of the output to the input is known as efficiency. If the output is more with the same or less actual input, system efficiency is achieved; or else, the system is inefficient. If computerization results in the degradation of efficiency, the effort for making the process automated stands defeated. Hence, the assessment of the capabilities of the hardware and software against the workload of the environment is very essential. The IS auditors are responsible to examine how efficient the application software is about the users and the workload of the environment. The system should assist in management planning and efficient execution thereof. The organisation should get maximum output using minimum resources. In this context, the efficient use of the hardware resources and their upgradation, as per requirements, is very essential. Automation should deliver the planned results with less consumption of computer hardware, software, computerized operations, and computer personnel.

Other Objectives

The following could be, among others, considered the other objectives of IS audit:

(a) Identify the risks that the organisation is exposed to in the existing computerized environment and prioritize such risks for remedial action.

(b) The implementation of Information Technology in the organisation is as per the parameters laid down in the Security Policy, as approved by the Board of Directors of the organisation.

(c) Verify whether the Information System procedures and policies have been devised for the entire organisation and that the organisation's systems, procedures, and practices are adhered to and that due prudence is exercised at all times by the circulars and instructions for a computerized environment, issued by the management of the organisation.

(d) Verify whether proper security policies/procedures have been formulated and implemented regarding the duties of the system administrators, system maintainers, and persons operating the system for daily operations.

(e) Contribute effectively towards the minimization of computer abuses/ crimes by suggesting steps for removing any laxity observed in the physical and logical controls.

(f) Suggest improvements in the security controls for the Information Systems.

(g) Act as an advisor to the management of the organisation for improving security and IT implementation standards.

(h) Adhere to the established norms of ethics and professional standards to ensure the quality and consistency of audit work.

Scope of IS Audit

The IS audit should cover all the computerized departments/offices of the organisation. The scope of IS audit should include the collection and evaluation of evidence/information to determine whether the Information Systems in use safeguard the assets, maintain data security, integrity, and availability, achieve the organisational goals effectively, and utilize the resources efficiently. The scope of IS audit should also include the processes for the planning and organisation of the Information Systems activity, the processes for the monitoring of such activity, and the examination of the adequacy of the organisation and management of the IS specialist staff and the non-specialists with IS responsibilities to address the exposures of the organisation.

Information Systems Audit Approaches

There are three approaches for conducting Information Systems Audit viz. auditing around the computer, auditing through the computer, and auditing with the computer.

Auditing around the Computer

Under this approach, the emphasis is on checking the correctness of the output data/documents concerning the input of a process without going into the details of the processing involved. This approach is preferred, where auditors themselves do not have the desired level of technical skills to adopt the other approaches. This is also preferred, when high reliance is placed on the users rather than the computer controls to safeguard the assets, maintain data integrity and attain effectiveness and efficiency objectives. The focus is on procedural controls rather than computer controls. This approach can be used in the following circumstances:

When an application system is simple, logic is straightforward, and a clear audit trail exists, this approach can be adopted. The process generates the audit trails such as the generation of exception reports along with the main reports. Such systems have very low inherent risk i.e., they are unlikely to be susceptible to material errors or irregularities or to be associated with significant ineffectiveness or inefficiencies in operations. Input transactions in such systems are in batch mode and control is maintained using traditional methods like the separation of duties and management supervision. Further, the task environment in such systems is relatively constant and the system itself is rarely modified.

This approach may be used when an application system uses a generalized package that is well tested and used by many users as its software platform. If the package has been provided by a reputed vendor, has received widespread use, and appears error-free, the auditors may decide to adopt this approach. Auditors should ensure that the organisation has not modified the package and adequate controls exist over the source code and documentation to prevent unauthorized modification of the package.

When high reliance is placed on the users rather than the computer controls to safeguard the assets, maintain data integrity and attain effectiveness and efficiency objectives, this approach can be adopted.

Auditing around the computer is a simple approach. It does not provide any information about the system's ability to cope with the changes. Systems can be designed and programs can be written in certain ways to inhibit their degradation when user requirements change. Further, this method cannot be used for complex systems. Otherwise, the auditors might fail to understand some aspects of a system that could have a significant effect on the audit approach.

Auditing through the Computer

Auditing through the computer requires a fair knowledge of the operating system, hardware being used, and certain technical expertise in systems development. Under this approach, the computer programs and the data constitute the target of IS audit. Compliance and substantive tests are performed on the computer system, its software (both operating system and application system), and the data. IS auditors can test the application system effectively using this approach. The IS auditors can use a computer to test logic and controls existing within the system and also records produced by the system. This approach increases the IS auditor's confidence in the reliability and applicability of the evidence/information collected and evaluated. This approach is time-consuming, as it needs an understanding of the internal working of an application system. It also needs some technical expertise.

Auditing with the Computer

Under this approach, the computer system and its programs are used as tools in the audit process. The objective is to perform substantive tests using the computers and their programs. The data from the auditee's computer system are retrieved in an independent environment. Audit interrogation and the query are carried out on such data, using special programs designed for the purpose. This method is used where:

(a) Application system consists of a large volume of inputs, producing a large volume of outputs and where the direct examination of the inputs/outputs is difficult.

(b) Logic of the system is complex.

(c) There are substantial gaps in the visible trails.

Computers are quite useful in the testing of transactions. Some of the software tools used for this purpose are briefly described hereunder:

Computer Assisted Audit Tools (CAATs) are efficient and effective ways to audit system-generated files, records, and documents and to evaluate internal controls of an accounting system in many Information Systems. Computer Assisted Audit Tools are a practical means for conducting an audit, wherever the information is available on the magnetic media alone. The technical papers relating to the use of the CAATs should be kept separate from the other audit working papers. The IS audit documentation should contain the description of the CAAT application.

Audit Software: It is a program, used by the auditors, to process data of audit significance from the auditee's accounting system. There are three types of such programs as under:

(a) Package programs are designed to perform processing functions, creating data files and reports in a format specified by the auditor.

(b) Special Purpose Programs are used to perform the audit tasks in specific circumstances and are prepared by the auditors or an outside programmer, engaged by the auditor.

(c) Utility Programs are used to perform common data processing functions such as sorting, creating, and printing files.

Test Data Techniques: A sample of data transactions is entered into the auditee's computer system and the results are compared with the predetermined results. CAATs are used to test the details of the sample transactions, the balances of the accounts, to identify unusual fluctuations if any, and general EDP controls like accessing the program libraries.

General Audit Software: It is the most widely used technique in conducting IS audits. Its use is limited by the skills of the personnel conducting the audit. Audit Command Language (ACL) is one such software. It is a tool for data analysis. It has the capabilities for Compliance and Substantive testing.

ACL is used to access, analyse, summarize or report data. Advantages of the ACL are as under:

(a) It creates flexible reports and documents.

(b) Auditors are independent of the technical experts for the data, access, and process.

(c) It increases audit coverage.

(d) It saves time, money, and effort.

(e) It helps gain control over and confidence in the audit results.

(f) General Audit Software is not useful at the application level.

Any Computer Assisted Audit Tool (CAAT) is as good as a data mining tool, which is used for extracting data from a data warehouse for MIS / Audit purposes.

Information Systems Audit Methodology

Audit Methodology:

The IS audit work includes manual procedures, computer-assisted procedures, and fully automated procedures, depending on whether it is around, though, with, or a combination of all these types of audits. In many cases, a combination of these techniques is required. The IS auditors may utilize the manual procedures when they are more effective than the other alternatives or when these procedures cannot be partially or fully automated. He/she should also use computer-assisted procedures known as Computer Assisted Audit Tools (CAATs) because they permit the IS auditors to switch from the procedures based on limited, random, and statistical samples of records in a file to a procedure that includes every record in a file.

Audit activity is broadly divided into 5 major steps for the convenience and effective conduct of the audit.

(a) Planning IS Audit.

(b) Tests of Controls.

(c) Tests of Transactions.

(d) Tests of Balances.

(e) Completion of Audit.

(a) Planning IS audit:

Planning is the first step of the IS audit. IS auditors should plan the audit work in a manner appropriate for meeting the audit objectives. As a part of the planning process, IS auditors should obtain an understanding of the auditee department/ office/organisation and its processes. It includes an understanding of the objectives to be accomplished in the audit, collecting background information, assigning appropriate staff keeping in mind skills, aptitude, etc., and identifying the areas of risk. Risk analysis of the operating system is carried out to identify the system with the highest risks, considering the critical nature of the information processed through such system as well as the number and the value of the transactions processed. This is to identify the systems having the highest risk and to decide on the extent of the detailed analysis and testing to be conducted on those systems.

In this phase, IS auditors are required to understand the internal controls used within an organisation. Various techniques can be used to understand the internal controls viz. review of previous audit reports/papers, interview/ interaction with the management and Information Systems personnel, observation of activities carried out within the Information Systems function, and review of Information Systems documentation.

(b) Tests of Controls:

During this phase of IS audit, Internal Controls are tested to evaluate whether they operate effectively. This includes testing of management controls and application controls. The objective is to evaluate the reliability of the controls and find out weaknesses of the controls for meeting the IS audit objectives. IS auditor is required to make recommendations to rectify the weaknesses, observed during an IS audit.

While carrying out tests of controls, the IS auditors should satisfy themselves regarding the following aspects of controls.

- **Identification:** Organisation should identify the controls to minimize the occurrence of unlawful events.
- **Implementation:** Identified controls should be implemented.
- **Existence:** Sometimes it happens that controls have been implemented, but in reality, they do not exist due to various reasons. For example, the organisation may have stipulated that the users should change their passwords every week. But, in reality, this may not be happening. The physical existence of the controls is equally important.

- **Adequacy:** IS auditors should examine the adequacy of the controls. They should see that the controls are adequate to cover all possible threats.
- **Documentation:** All controls should be documented to make them effective.
- **Maintenance:** Controls should be maintained intact continuously. For example, only the provision and installation of the fire extinguishers, smoke detectors, UPS, etc. do not solve the problem. These instruments should be properly maintained, so that they serve the purpose, as and when needed.
- **Monitoring:** Controls should be monitored using strict supervision, surprise checks, periodic inspection, etc.

(c) Tests of Transactions:

Tests of Transactions are used to evaluate whether erroneous transactions have led to a material misstatement of the financial information and whether the transactions have been handled effectively and efficiently. The objective is to evaluate data integrity. Some of such tests include the tracing of journal entries to their source documents, the examination of the price files, the testing of computational accuracy, the study of the transaction log, etc. These tests are used to indicate the database system's effectiveness. CAATs are quite useful to perform these tests.

(d) Tests of Balances:

During this phase of IS audit, final judgment is made on the extent of the losses or account misstatement that occur when Information Systems fail to safeguard assets, maintain data integrity and achieve system effectiveness and efficiency goals. As regards the safeguarding of assets and data integrity objectives, the typical substantive tests used are confirmation of the receivables, physical verification of inventory, and recalculation of depreciation on the fixed assets. Regarding the system effectiveness and system efficiency objectives, the tests to be conducted are in the process of evolution. For example, the shortcomings in the Information Systems Planning may have resulted in the purchase of inappropriate hardware. The system may provide outputs, but not of the required standards to make high-quality decisions. During this phase of the IS audit, computer support is often required. General Audit Software can be used to select and print confirmations; expert systems can be used to estimate the likely bad debts and so on.

(e) Completion of Audit:

This is the final stage of IS audit. Auditors are required to form their opinion, clearly indicating their findings, analysis, and recommendations. Potential IS audit findings should be discussed with the appropriate/authorized personnel throughout IS auditing. Preliminary conclusions and the audit findings should be presented to the auditee during an exit conference. All potential findings with sufficient merits and preliminary audit recommendations should be included for discussion in the exit conference. The exit meeting should document and include the auditee's comments and questions concerning the preliminary IS audit recommendations. The draft audit report should be the natural extension of the exit conference materials along with the discussions that took place during the exit meeting. Once the auditee's responses have been received, the final audit report should be prepared and submitted to the designated authority/ management of the organisation.

Work papers used in the auditing should be well organized, clearly written, and address all the areas included in IS audit. IS audit work papers should contain sufficient evidence/information of the tasks performed and the conclusions reached, including the results achieved, issues identified, and authorized signatures approving the final opinion.

A typical audit report will include, among others, an introduction to the audit objectives, scope, general approach employed, a summary of the critical findings, the data to support the critical findings, potential consequences of the weaknesses, auditee's responses, and recommendations to rectify the weaknesses.

Sub-system Factoring

IS audit being generally an exercise dealing with complex Information Systems. To understand the complex system, it is always advisable to break the system into sub-systems. A sub-system is a component of a system that performs some basic functions needed by the overall system to attain its basic objectives. The process of breaking a system into sub-systems is called factoring. The process of factoring terminates when it is felt that the system has been broken into sub-systems, small enough to be understood and evaluated. Thus, a complicated system is divided into small sub-systems until it becomes easily understandable.

Once the system has been factored into several easily understandable subsystems, the task of the IS auditors is:

(a) To evaluate the effectiveness of the controls in each sub-system.

(b) To determine the implications of each sub-system's reliability vis-a-vis the overall reliability/effectiveness of the system.

There are two main sets of systems, which require to be further factored into sub-systems for conducting IS audit.

Management Systems

Management Systems provide stable and basic infrastructure facilities on which the Information Systems can be built and operated on a day-to-day basis. Management Systems can be factored into sub-systems that perform Top-level Management, Information Systems Management, Systems Development Management, Programming Management, Data Administration, Quality Assurance Management, Security Administration, and Operations Management.

Top-level Management is responsible for long-term policy decisions on the use of Information Systems in the organisation.

Information Systems Management is responsible for planning and controlling the Information Systems activities in the organisation. It assists the top management in making long-term policies and translates the long-term policies into short-term goals and objectives.

Systems Development Management designs, implements and maintains the application systems.

Programming Management prepares programs for new systems, maintains old systems, and provides general systems support software.

Data Administration addresses the planning and control issues about the use of the database.

Quality Assurance Management ensures that the Information Systems development, implementation, operations, and maintenance conform to the established quality standards.

Security Administration is responsible for access control and physical security over the Information Systems.
Operations Management plans and controls the day-to-day operations of the Information Systems.

Application Systems

Application Systems undertake basic transactions processing, management reporting, and decision support. They can be broken into sub-systems that perform boundary, input, communication, processing, database, and output functions.

The boundary sub-system consists of the components that establish an interface between the user and the system. Input sub-system comprises the components that capture, prepare and enter commands and data into the system. The Communications sub-system consists of the components that transmit data among the sub-systems and systems. The processing sub-system includes the components that perform decision making, computation, classification, ordering, and summarization of the data in the system.

Database Sub-system comprises the components that define, add, access, modify and delete data in the system Output Sub-system consists of the components that retrieve and present data to the users of the system.

Broad Framework for Conducting IS Audit

A broad framework can be formed from the basic objectives of IS audit. In addition to this, IS audit evaluates the organisational setup and quality of administration. It should be noted that IS audit is not limited by laid down procedures. It is also important to keep one's eyes and ears open. The IS auditors should, therefore, analyse what they observe and hear. The main issue involved in IS audit is the confidentiality of programs, files, access rights to files and focus on software application packages. The major concerns of the IS audit, as derived from its objectives, are as under:

A. Safeguarding Assets:

One of the prime objectives of any audit is to ensure that the assets of the organisation are safeguarded. In the computerized environment, the assets to be safeguarded are hardware, software, data, and users. The yardstick to measure the importance of this objective is the expected loss that may be sustained by the organisation if the asset is destroyed, stolen, lying unutilized, service denied, or used for unauthorized purposes. The IS auditors should verify that the assets are put to effective use in a secured environment. To determine whether the assets of the organisation are duly safeguarded, the IS auditors should inspect, among others, the following areas:

Environmental Security: It is very important for the effectiveness of all other protective measures stipulated or installed at the sites. The server room houses the all-important hardware. Its location should be a strategic one and not easily accessible. The server room should be exclusively for the server itself and the other items, equipment, etc. should not be kept there.

Uninterrupted Power Supply: The uninterrupted power systems are meant for supplying conditioned and stabilized power to computer equipment at all times. It also provides stabilized power from battery storage when electricity fails. The UPS must function properly when electricity fails. The UPS should be maintained regularly.

Electrical Lines: Electrical cabling and wiring constitute the basic components. Faulty electrical cabling and wiring are responsible for operational failures. There should be separate and proper earthing for the dedicated electrical line.

Data Cabling: Information Technology experts estimate that 90 percent of the network problems are cable-related. Hence, all possibilities of routing cables, locations of cable closets, sites of Switch, Router installation, etc. should be explored before finalizing the plan. A detailed map of the cable layout including Switches, Routers is very important to guide the hardware service engineer in the event of a LAN cable fault. Further, electrical cable and data cable should not cross each other to avoid possible disturbance during data transfer.

Fire Protection: Fire alarm systems, smoke detectors, and fire extinguishers are very important to deal with the event of a fire breaking out. Fire extinguishers are commonly filled with water, carbon dioxide, or Halon. Little care is required while operating gas-based extinguishers because they replace oxygen and thereby, extinguish the fire. Water is effective, but it is dangerous to use in proximity to live equipment. Dry powder or foam-type extinguishers are not advisable because they leave deposits on the equipment.

Insurance: All critical computer equipment is required to be insured with a reputed insurance firm/s to secure the Information System resources/assets of the organisation.

Annual Maintenance Contract: Periodic maintenance of the computers, network, etc. is essential to ensure trouble-free operations of the equipment. For this purpose, it is required that the annual maintenance contract be awarded and renewed in time. At the same time, it is also essential that the maintenance staff is available on time. There should be a proper record of the activities carried out during maintenance.

Logical Security: It restricts access to the system if the user fails to identify himself/herself to the system correctly. Login name/user ID and password are controls for this security. It is exercised at the operating system level and the application system level. Logical security at the operating system level ensures access to the computer system when it is successfully powered on after its boot operation is completed. Logical security at the application system level gives access rights to specific application software depending on the responsibility and authority of the user. IS auditors should verify the effectiveness of the logical security in place by evaluating its controls. Secrecy and security of the user ID and password, different levels of access rights and their allocation to the users, creation of users, its records, users created for maintenance purpose and their termination on completion of the work, a user log in the status report, presence of dummy user ID in the system, etc. are some of the points which require consideration of the IS auditors.

B. Data Integrity:

Data is the most important resource in a computerized environment, which needs to be accurate, complete, consistent, up-to-date, and authentic. The IS auditors are concerned with the possibility of deviation from the standards. They are required to verify how well data integrity is maintained and find out any laxity therein.

The examination of the following points is very important in respect of data integrity:

Data Input Controls: The largest number of controls is available at the time of data entry in the system. Data Input Controls are error-prone because the activities involved in data entry are of a routine and monotonous nature. Data entry is also a major area for intentional fraudulent activity. It involves the addition, deletion, modification, or alteration of the input transactions or data. Hence, the IS auditors should minutely evaluate the effectiveness of the data input controls. The use of the scanner and inputs to the system through floppy should be monitored and controlled.

Data Processing Controls: The application system processes the data online on a day-to-day basis. The IS auditors are concerned about the Data Processing Controls. They should examine that only designated/authorized officers perform the start-of-day operation. The day-end process should be completed with the generation of the prescribed reports. It is also required that proper record is maintained in respect of the corrections made in the database under authentication.

Patch Program: It uses the file structure of the existing database files and is capable of effecting changes in a data file. It bypasses the proper menu access controls provided by the application software system and does not leave an audit trail. It can add, modify, alter and delete the data. The behaviour of the approved programs is known and certified, but it is uncertain in the case of such patch programs. They usually bypass all the safeguards available to the system programs. They conveniently flout all norms to achieve results at any cost. Therefore, the IS auditors should verify that only approved programs are loaded in the system and the application programs are identical with the list of the approved programs in respect of file name, file size, date, and time of compilation. It is also necessary that a record be maintained regarding the patch programs used indicating the reasons under authentication.

Purging of Data Files: It is pruning of the data files of the identified past period for which it is no more necessary to store the data in the current system. Before undertaking the purging activity, it is necessary to take a backup of the full data directory. The purging of the static data or master particulars is never taken. The IS auditors should examine that the purged data backup media is stacked in chronological order for easy tracing and also is in safe custody. A manual record of purging activity should also be maintained. Access to the purged data should be restricted and controlled to ensure the integrity of the purged data.

Data Backup: Data backup is an essential aspect of all computer operations. Some commonly used computer media include hard disks, floppy disks, tape cartridges, CD-ROMs, DVD ROMs, etc. Off-site back-ups are taken on floppies or tape cartridges, while on-site back-up is taken on hard disks. Back-up is one of the measures of business continuity planning and is also required for archiving old records. The backups must be taken regularly. One set of backups requires to be stored off-site. The backups have to be tested periodically by restoring the data therefrom. The backup media have to be verified periodically for readability. Backup media should be properly labelled and numbered. This is a very important area and requires proper attention.

Restoration of Data: It is defined as downloading of data afresh from magnetic media, in case of a crash of the system, irrecoverable corruption, or loss of data, for going back online. Backup is taken at a particular point of time like the beginning of day operations, end of day operations, etc. Thus, the restoration of data is dependent on the magnetic media and the data stored thereon. Restoration of the data is required in the event of major corruption of data. In the event of a virus attack or destruction of a server or the computer site, the only option is to fall back upon the restoration option. Restoration of data helps to obtain a position of data as of a particular date, to establish whether any data tampering has taken place. It assists in conducting system audits as of the previous date and generates ledgers of previous years. Transactions of the purged period can also be retrieved.

C. Business Continuity Planning:

Disruption of operations can occur because of two types of problems. First, some minor problems like power failure, UPS failure, server failure, inability to read/restore backups, cable fault, etc. can disrupt the operations. The second type of disruption can occur on account of natural calamities like fire, flood, building collapse, or man-made calamities like a bomb blast, radiation, virus attack, induced data loss, etc. Business Continuity Plan is prepared to recover from such kinds of interruptions. It relates to a higher level of failure. It is all about anticipating any disastrous event and planning adequately for the business to live through it. The IS auditors should verify the existence and operability of the Business Continuity Plan. They should also examine the awareness of the staff regarding the execution of the plan in a genuine emergency and comment upon its effectiveness. Business Continuity Plan should be documented and tested at regular intervals to assess its effectiveness.

BCP is required to satisfy short, medium, and long-term recovery. In the short term, the essential systems and services are restored. Medium-term plans are for recovering the organisation's systems and services temporarily. Long-term plans are for a total recovery of the processing environment.

There are three methods of recovery namely cold, warm and hot backup sites. A cold site is where a computer room is provided in which equipment can be installed when needed. A warm site is a computer room filled with all the required equipment, but onto which all the software and applications must be loaded when it is needed. A hot site is one where the original installation is duplicated and ready to use when a disaster occurs.

BCP should outline the responsibilities for all the recovery processes, procedures for reproducing the computer media, location of the backup media, priorities for recovery, sources of replacement hardware and software, and alternative data communication facilities.

Output Reports: One of the basic principles in the computerized environment is known as GIGO i.e., 'Garbage in Garbage out. This means that, if the input to the system is garbage (or meaningless), the output will also be garbage. Reports and printouts are generated in the computerized environment to ensure the correctness of the inputs and processing. Reports are also important to ensure that the application system programs serve the needs of the organisation. Any lacunae or bugs in the application software can be located by checking the reports and printouts. The importance of checking the reports can never be overemphasized. The IS auditors should scrutinize output reports on a sample basis to identify the trend, the quality of follow-up, and the control exercised by the management. The audit trail report should generate the user ID of the data entry operator and the authorized official for any addition, change, modification, and deletion of transactions effected in the database. It should provide evidence/information of unauthorized access outside the application menu. The IS auditors should verify whether the audit trail reports are generated and checked by the designated officials. Exceptional transaction report is also very important to report.

Version Control: Data integrity is very much dependent on the version of the software running in the system. An authorized version of the software can lead to accurate processing. Non-standard programs are a potential threat to integrity. A complete listing of the programs loaded in the system should be available on record for verification. The IS auditors should verify that licensed copies of the operating system and the application system software are used for computerized operations.

Virus Protection: A computer virus is a program that is self-replicating and can corrupt or destroy data irretrievably. It resembles biological viruses in behaviour. It may have a dormancy period and get activated on a certain date. It is potentially disastrous. Anti-virus software is available and is capable of countering against known viruses, malicious programs. Anti-virus software is updated by the manufacturers regularly to counter against the new viruses coming up. It is necessary to keep the anti-virus software updated at all times. All extraneous floppies and other media should be checked/scanned for viruses before use.

D. System Effectiveness:

It is expected that the Information system should improve the overall quality of work including accuracy and time consumed in performing the tasks. Further, it should be user-friendly. The IS auditors should judge how effective the system is in accomplishing the goals with which computerization was introduced.

E. System Efficiency:

The IS auditors should examine whether every computer asset is used to its maximum operational capacity.

F. Organisation and Administration:

Efficiency in computerized operations is dependent on the efficiency of the personnel using the computer resources. Computer personnel should do their work completely, timely, accurately and that too, with minimum resources. They should deliver more output quantitatively and qualitatively. Proper placement of the computer personnel based on their aptitude, skill, knowledge, and experience is very important. Computer personnel should be used effectively and efficiently with proper security for the organisation to reap maximum advantages.

Segregation of duties, the job description for each level, proper training to the staff, dual control aspect in performing important operations, a designated system administrator with the suitable back-up arrangement, etc., are important points to be considered. Records of work assigned to the staff, rotation, training imparted, login name given, etc. are to be checked/verified by the IS auditors.

To Sum Up:

Information Security Audit is an evaluation process that assesses an organisation's established security practices. It is a process that determines the effectiveness of the defense systems established against any threats.

The Information Security Audit typically includes vulnerability scans, penetration testing, network assessments, and much more that help determine vulnerabilities and security loopholes in the IT systems. The audit is a combination of administrative, physical hardware, software application, and network assessment. This way, the evaluation process can help a company/organisation gain an understanding of its current security posture.

Solved Cases

Case Study: 1

Practical 'IS Audit' Case Study for Verification of 'Know Your Customer (KYC)' in Core Banking System (CBS) of Banks.

The objective of this Case Study is to Test KYC Norms on 'Savings Bank Account' from Customer Master Data in Core Banking **Solutions (CBS) of Banks.**

To Test this objective, the auditor has to issue a 'Data Request' to IT Department in the following format:

- **Data Required:** Savings Bank Account Customer Master Information in CBS.
- **Period:** Period of Audit Coverage.
- **Fields of Reference:** Branch ID, Customer ID, Account ID, First Holder & Joint Holder/s Name, Address, PAN Number, Mobile Number, Residence Number, Office Number, Mode of Operation, and Clear Balance.
- **Format of Data:** Text Form.

IT Department in turn ran a SQL Query on the production database and generated a text file dump, which was saved by IT in a secure folder with special access to the Audit Team only.

The Audit team has to import the text file, using the Text Report import option within the Generalised Audit Software (GAS).

Post import, the Auditor has to use the Duplicate Key test within the GAS to identify fictitious accounts opened with similar PAN Numbers, Mobile Numbers Address Office Numbers, or Residence Numbers but different Customer IDs.

The Auditor has to identify where account opening details like PAN Number, Mobile Number, etc. were similar for different Customer IDs. These cases have been taken up for further checking with the account opening forms from the respective Branch to ascertain the validity of the accounts opened.

Additionally, the Auditor has to employ a SOUNDEX (**Soundex** is a phonetic algorithm for indexing names by sound, as pronounced in English) Test on the Customer Name Field. The SOUNDEX Test generates a unique alpha-numeric code in a new computed field. This code depends on the mnemonic of the Name rather than the spelling. For example. Two Customer Accounts with the names Prasanna Iyer and P AIyer will have the same SOUNDEX Code. After arriving at this code, duplicate tests can be run on the code rather than the Name. The advantage here is that the Duplicate on Code will generate similar-sounding names (Essence of De-Dup Tests Globally), whereas a pure Duplicate will perform an exact match.

The Auditor has to perform De-Dup Tests to Identify Customers who have multiple Savings Bank Accounts within the same Branch of the Bank, which is a potential Red Flag.

The above is the IS Audit Procedure to identify the KYC-which is an important aspect while opening Customer Accounts by the Commercial Banks.

The same procedure is to be adopted by the IS Auditor to verify the various Electronic Products of the Banking, but the Characteristics / Objectives / Fields may be different from One Bank Product to another Bank Product.

Case Study: 2

Vodafone Intelligent Solutions (VOIS), formerly known as Vodafone Shared Services Ltd, is a Vodafone Group partnership whose mission is to create a world-class digital experience to connect and inspire people to build a better tomorrow. Founded in 2009, Vodafone Shared Services Ltd provides voice support for IT shared services, network shared services, financial and HR shared services along with BI & Analytics, digital experience, and automation to Vodafone Group, local markets, and companies across the globe.

For Vodafone, maintaining strict cybersecurity measures is an integral part of delivering an exceptional digital experience to its customers. Cybersecurity is built into all systems, processes, and applications, to proactively defend against the prolific and increasingly sophisticated cyber threats facing organisations today.

Challenges:

As a partner to Vodafone UK Customer Care, VOIS India is required to maintain resilient adherence to PCI DSS compliance at all times, since Vodafone UK Customer Care has to deal with various customers of the UK Mobility with an obligation to protect their data. These companies typically store significant amounts of personally identifiable information (PII), including names, addresses, and financial details belonging to their customers. Given the nature and range of information, the impact of a cyberattack can be both serious and far-reaching.

As part of Vodafone's PCI DSS requirements, Gururaj Kannarpadi, General Manager of IT at Vodafone, was tasked with evaluating potential vendors for a cost-effective File Integrity Monitoring (FIM) and Change Control solution to help them safeguard sensitive customer credit card data is stored within their environment as well as meeting the strict compliance requirements laid out by the PCI-DSS.

Gururaj explained, "I began my evaluation by running a POC with a company who I originally believed to be the leader in this space. After 2 months and resources spent running the POC, their solution was not picking up suspicious changes within our environment, or collecting much data at all, to be frank, so we had to cut our losses and move on to explore other possible solutions."

Solution:

After searching for vendors in the FIM and Change Control space, Gururaj quickly learned of NNT Solutions (No-Name Technologies Inc.) and discovered early on that its Change Tracker Gen7 R2 solution was not only the most feature-rich, but that it was also the most competitively priced solution on the market combined with vastly superior proactive pre-sales and technical support.

Gururaj noted that "Once I requested a demonstration of NNT's solution I was immediately surprised to see just how quickly and responsive their team was. Overall, the excellent pre-sales experience with NNT set the tone for how I would be treated if I was a customer and compared to the alternative provider we were originally speaking to - the difference was night and day."

Like most organisations, VOIS was looking for a reliable FIM solution that could help spot malicious changes, but not be inundated with overwhelming change noise. Fortunately for VOIS, NNT's Closed-Loop Intelligent Change

Control Technology captures and identifies reoccurring change patterns and automatically identifies them as either harmless or potentially harmful, as well as highlighting changes that were not part of a pre-approved change request. NNT puts the 'Integrity' back into FIM.

Gururaj claims, "From the start of my journey with NNT, the sales and technical support teams were nothing but helpful and committed to finding us a solution to our PCI compliance needs. Not to mention that we purchased Change Tracker at a fraction of the cost of their competitors. There's no comparing Change Tracker to anything else – Change Tracker is undoubtedly the clear winner in the FIM and Change Control market."

Results:

Working with NNT has allowed Vodafone to address their mandatory PCI DSS requirements by adopting an integrity monitoring and change control solution that assures their customers that their data is being properly tracked for any changes that may be harmful.

Gururaj claimed, "To anyone looking for vendors in this space, I would blindly close your eyes and go with NNT. Don't even bother with the demo - just go for it. I've done the research and have seen first-hand the kind of results you can expect to see."

With Change Tracker, Vodafone is now able to achieve continuous PCI compliance and streamline the audit process by removing the need for internal staff to spend countless hours collecting evidence to present to external auditors.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Control in the design of an information system is used to ______ .

   (a) Inspect the system and check that it is built as per specifications.

   (b) Protect data from accidental or intentional loss.

   (c) Ensure that the system processes data as it was designed to and that the results are reliable.

   (d) Ensure the privacy of data processed by it.

2. Controls are necessary for information systems as ______ .

   (i) Massive amounts of data are processed and human errors are expected in data entry.

   (ii) Accidental errors can lead to loss of money and credibility in a system.

   (iii) To protect the system from virus attack.

   (iv) Data may be lost due to disk crashes.

   (a) (i) and (ii)

   (b) (i) and (iii)

   (c) (i) and (iv)

   (d) (ii) and (iii)

3. The major objectives of control are ______ .

   (i) Guard against frauds in data entry/processing.

   (ii) Check clerical handling of data before it enters a computer.

   (iii) To provide a method to trace the steps and find where an error has occurred.

   (iv) Automatically correct errors in data entry/processing.

   (a) (i), (ii), and (iv)

   (b) (i), (ii), (iii), and (iv)

   (c) (i), (ii), and (iii)

   (d) (i) and (iii)

4. A two-way check is used to ______ .

   (i) Check program correctness.

   (ii) Find data entry errors.

   (iii) Find multiplication errors.

   (iv) Find an arithmetic error in processing.

   (a) (i) and (ii)

   (b) (ii) and (iii)

   (c) (ii) and (iv)

   (d) (i) and (iv)

5. A check-point procedure ______ .

   (a) Checks program correctness at certain points.

   (b) Divides a program into smaller parts.

   (c) Breaks programs into portions at the end of each of which a check point program is executed.

   (d) Finds points in a program where it is convenient to check it.

6. Audit in the design of information system is used to ______ .

   (a) Inspect the system and check that it is built as per specifications.

   (b) Protect data from accidental or intentional loss.

   (c) Ensure that the system processes data as it was designed to and that the results are reliable.

   (d) Ensure the privacy of data processed by it.

7. By auditing around the computer, we mean ______ .

   (a) The inputs and the corresponding outputs are compared and checked for correctness.

   (b) The programs and procedures are checked for correctness.

   (c) Special synthetic data is input and outputs checked for correctness.

   (d) Programs are written to check the functioning of the computer.

8. An audit trail is established in a system to ______ .

   (a) Detect errors in a system.

   (b) Enable auditing of a system.

   (c) Localize the source of an error in a system.

   (d) Trail a program.

9. In auditing with a computer ______ .

   (a) Auditing programs are designed and used to check a system.

   (b) The hardware of the computer is thoroughly checked for malfunctions.

   (c) System software is thoroughly checked to ensure error-free operations.

   (d) Auditors check the system with a computer.

10. By information system testing we mean ______ .

    (a) Testing an information system correctly.

    (b) Determining whether a system is performing as per specifications.

    (c) Determining whether a system is performing optimally.

    (d) Ensuring proper function of a system.

11. Parallel runs are used ______ .

    (a) During regular operation of an information system.

    (b) When a system is initially implemented.

    (c) Whenever errors are found in a computerized system.

    (d) Whenever management insists.

12. To protect a system from viruses one should ______ .

    (i) Not allow unauthorized use of floppy disks.

    (ii) Scan viruses in files received via a network or floppies.

    (iii) Isolate a system from networks.

    (iv) Install a roll-back recovery program in the system.

(a) (i) and (iii)

(b) (i) and (ii)

(c) (ii) and (iv)

(d) (i), (iii), (iv)

13. A firewall is used in a system connected to a wide area network to ______ .

(a) Prevent the spread of fire in the network.

(b) Prevent unauthorized access by hackers.

(c) To scan for viruses in files.

(d) To extinguish fire spreading via network cables.

14. Security in the design of information systems is used to ______ .

(a) Inspect the system and check that it is built as per the specifications.

(b) Protect data and programs from accidental or intentional loss.

(c) Ensure that the system processes data as it was designed to and that the results are reliable.

(d) Ensure the privacy of data processed by it.

15. It is necessary to protect the information system from the following:

(i) Natural disasters like fire, floods, etc.

(ii) Disgruntled employees.

(iii) Poorly trained employees.

(iv) Hackers.

(v) Industrial spies.

(vi) Data entry operators.

(a) (ii), (iii), (iv), (v)

(b) (i), (ii), (iii), (iv), (v)

(c) (i), (iv), (v)

(d) (i), (ii), (iii), (iv), (v), (vi)

Short Essay Type Questions

1. What is an RFC?
2. What types of processes can you add to deployment plans to help security?
3. What are some ways that companies can lose data?
4. In evaluating the use of a biometric system in an environment that has high-security requirements, what is an item that is important to consider?
5. Describe a honeypot.
6. When an auditor evaluates an IT system, what user features should be evaluated?
7. Auditors are used to review security controls and policies. What are the pitfalls of inadequate control implementation and policy definitions?
8. What is the purpose of network encryption?
9. Name two types of backup methods used for remote backup sites.
10. What is sociability testing?
11. Discuss the nature and significance and scope of the systems audit. Also mentions various steps involved in conducting an information system audit.
12. Discuss system audits of computerized secretarial functions.
13. Write short notes on:
    (a) Norms and procedures for computerization
    (b) Computer control and security
    (c) Testing of computer system
    (d) Objectives of Information Systems Auditing
14. Discuss the Foundations of Information Systems Auditing.
15. What do you mean by operation control? Describe in details.
16. What do you mean by test pack? State the use of the test pack in IS Audit.
17. What is the meaning of documentation standards? Explain its importance.
18. State the relationship between Systems audit and various management functions.

Answer:

Multiple Choice Questions

1.	(c)	Ensure that the system processes data as it was designed to and that the results are reliable.
2.	(a)	(i) and (ii)
3.	(c)	(i), (ii), and (iii)
4.	(c)	(ii) and (iv)
5.	(c)	Breaks programs into portions at the end of each of which a check point program is executed.
6.	(a)	Inspect the system and check that it is built as per specifications.
7.	(a)	The inputs and the corresponding outputs are compared and checked for correctness.
8.	(c)	Localize the source of an error in a system.
9.	(a)	Auditing programs are designed and used to check a system.
10.	(b)	Determining whether a system is performing as per specifications.
11.	(b)	When a system is initially implemented.
12.	(b)	(i) and (ii)
13.	(b)	Prevent unauthorized access by hackers.
14.	(b)	Protect data and programs from accidental or intentional loss.
15.	(d)	(i), (ii), (iii), (iv), (v), (vi)

SECTION - C

INTERNAL CONTROL, INTERNAL AUDIT, OPERATIONAL AUDIT AND OTHER RELATED ISSUES

Internal Control and Internal Audit

14

This Module includes:

Internal Control and Internal Audit

SLOB Mapped against the Module

To obtain a detail understanding of the scope and structure of internal control to conduct an evaluation of the same to identify the root causes of inadequacies and thereby recommend appropriate corrective actions. (CMLO 3a, c)

Module Learning Objectives:

Internal control is a system that comprises of control environment and procedure, which help the organisation in achieving business objectives. On the other hand, internal audit is an activity performed by professionals to ensure that internal control system implemented in the organisation are effective. After studying this module, the students will be able to –

- Reinforce key elements related to internal audit, its scope and function within the organisation
- Distinguish the types of internal audit assignments related to operational, compliance or process internal audit
- Develop engagement process based on considerations, objectives, scope and risk-based internal audit engagements
- Identify reportable items, report formulation, and methods of communication

Introduction

14

Internal Control can be defined as the whole system of controls, financial or otherwise, established by the entity's management; which includes Internal Check, Internal Audit and other forms of control.

Internal control is a system that comprises of control environment and procedure, which help the organisation in achieving business objectives. On the other hand, internal audit is an activity performed by professionals to ensure that internal control system implemented in the organisation are effective.

Control is one of the most prominent human need, that is present in almost every human activity. So, in business too, control have a great role to play in ensuring best possible use of resources and escalate profits. Most of the business activities are performed by computers, individuals and other equipment, which requires periodic examination, to make sure that losses and wastes do not occur.

Internal control and internal audit help business firms to keep an eye on the regular activities. These are commonly used interchangeably, but they hold different meanings.

Internal Control can be understood as a system developed, implemented and maintained by the entity's management, in order to ensure the achievement of objectives concerning:

- Effectiveness and efficiency of operations.
- Protection of assets.
- Prevention and detection of frauds and errors.
- Accuracy and completeness of financial reporting.
- Adherence to relevant laws.

It comprises of five elements, which are interconnected to each other and apply to all firms, but their implementation depends on the size of the firm. The elements are control environment, risk assessment, control activities, information and communication and monitoring.

Objectives of Internal Control

- Examining whether the transactions are executed as per the management's authorization/policies set out.
- Accounting period, to which it belongs.
- Ascertaining assets are protected from unauthorized access and use.
- Comparing recorded assets with the existing ones, at various time intervals and taking actions in case of differences observed.
- To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

Internal Control Review Methods

The most important part of the internal control system is its review, for which the auditor can use any of the methods:

- Narrative Records.
- Checklist.
- Questionnaire and
- Flowchart.

Definition of Internal Audit

It is an independent, objective assurance and consulting activity designed to **add value and improve an organisation's operations**. It helps an organisation accomplish its objectives by bringing a **systematic**, **disciplined approach to evaluate and improve effectiveness of risk management, control and governance process**.

Internal Audit Process

The task of reviewing controls and its effectiveness carried out by the internal auditor, who is appointed by the company's management/Board of Directors. For listed entities, the Internal Audit Head is appointed by the Audit Committee and supposed to report to Audit Committee. He/she furnishes reports to the management with recommendation post review/appraisal; for management feedback and initiating necessary actions against the recommendation.

Objectives of Internal Audit

- To check the accuracy and authenticity of the accounting records, which are reported to those charged with governance.
- To identify whether the standard accounting practices, which are deemed to be pursued by the entity, are complied with or not.
- To ensure early detection of fraud,errors and prevention of fraud.
- To examine that transactions are recorded after due approval by appropriate authority.
- To verify that the liabilities are incurred only for business causes and not for any other purpose.
- To review the activities of the internal control system, so as to report management regarding deviations and non-compliances.

Key Differences Between Internal Control and Internal Audit

The difference between internal control and internal audit can be drawn clearly on the following grounds:

1. Internal Control refers to the methods and procedures implemented by the entity's management to control the operations, so as to help the organisation in achieving the desired goals. On the contrary, Internal Audit reviews the existence and effectiveness of controls. The Internal auditing program perused to review its financial and operational activities; the gaps, if any; and suggest corrective actions to mitigate the same.
2. While internal control is combination of 'Internal Check' and 'Internal Audit' system designed, implemented and maintained in an organisation. Internal Audit function is designed by those charged with governance, to keep a check on the activities of the entity.
3. In the internal control system, checking is performed simultaneously, while carrying out work. On the contrary, in internal audit system work is checked after it is performed.
4. The basic objective of the internal control system is to ensure compliance with management policies. In contrast, internal audit aims at detection of fraud.

The scope of internal control is wider than that of internal audit, as the former includes the latter.

Internal Control-Concept

14.1

Internal Controls are systematic and procedural steps adopted by an organisation to mitigate risks, primarily in the areas of financial accounting and reporting, operational processing and compliance with laws and regulations.

Internal Controls (ICs) are essentially risk mitigation steps taken to strengthen the organisation's systems and processes, as well as help to prevent and detect errors and irregularities. The actual steps of mitigation (e.g., review, approval, physical count, segregation of duty, etc.) are referred to as 'Control Activities'.

When ICs mitigate the risk of financial exposure, they are also referred to as Internal Financial Controls (IFCs) and when they mitigate operational risks, they are also referred to as Operational Controls (OCs). ICs generally operate with human intervention (Manual Controls), but in an automated environment, system controls are deployed to secure the systems and called IT General Controls (such as access controls) or check transaction processing at an application level and called Application Controls (such as sequential numbering of invoices, etc.).

Internal Controls can be broad-based covering the whole entity (i.e., Code of Conduct), or focused to a specific process or area (such as Order processing or Payroll, etc.). In the former case they are generally referred to as "Entity Level Controls (ELCs)" as part of the "Control Environment". In the case of later, they are also referred to as "Process Level Controls (PLCs)".

"Internal Controls Framework" is a pre-defined benchmark Internal Control System, based on suitable criteria, which can be used by management or auditors to assess the design, adequacy and operating effectiveness of the overall internal control system.

Responsibilities for Internal Control

As per Companies Act, 2013, in a limited company, the board of directors are responsible for ensuring that appropriate internal controls are in place. Their accountability is to the shareholders, as the directors act as their agents. In turn, the directors may consider it prudent to establish a dedicated internal control function. The point at which this decision is taken will depend on the extent to which the benefits of function will outweigh the cost.

The directors must pay due attention to the control environment. If internal controls are to be effective, it is necessary to create an appropriate culture and embed a commitment to robust controls throughout the organisation.

Internal Control Procedures

- Physical controls over assets.
- Authorization and approvals
- Segregation of Duties.
- Management design of the Controls.
- Effective operational controls.

Internal Audit

Internal audit carries out assessment of internal controls and as such is a management responsibility to ensure compliance and conformity of internal controls to pre-determined standards.

Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives.

As per SIA (Standards on Internal Audit) 210 issued by ICAI, the Internal Audit Function is the responsibility of the Chief Internal Auditor or the designated person. He performs a number of activities to achieve the objectives as outlined in Terms of Engagement. A few of the critical activities are as follows:

- Define the overall plan, scope and methodology of the Internal Audit Function on a periodic basis.
- Oversee and monitor various audit assignments, their proper planning, execution, reporting of findings andrecommend action plan to mitigate risk/concerns w.r.t observation/s and subsequent closure of reported observations.
- Plan, engage and review the performance, training and development of professional staff, talent and other resources to achieve its objectives.
- Identify, source, engage and manage external experts and technical solutions, if required.
- Communicate and engage with all key stakeholders regarding progress and achievement of objectives.
- Develop and maintain a quality evaluation and improvement program.

Responsibility of Internal Auditor

The Internal Auditor shall ensure that the entity has designed, implemented and maintains effective and efficient Internal Controls. The audit procedures shall be sufficient to allow the Internal Auditor to check the design, proper implementation and operating effectiveness of the Internal Controls.

Any shortcoming shall result in recommendations for improvement and suggestions on how to make the Internal Controls more efficient and effective in line with the objectives.

Where the Internal Auditor is required to provide an independent opinion over the presence, design, implementation and/or operating effectiveness over Internal Controls, this shall be consistent with the requirements of SIA 110, "Nature of Assurance", especially with regard to the need to have a clear understanding of the Internal Controls Framework which shall form the basis of the assurance.

Key Risks

The Internal Auditor shall review and reports on internal controls in relation to key risks affecting the organisation. The objective should be to test the extent to which the controls will manage the risk if it crystallizes. The conclusions of these reports should enable management to reconsider the controls and modify or redesign them if appropriate.

Compliance

Organizations have to implement performance standards in relation to compliance. This may be to satisfy the demands of external regulators, or to operate to pre-determined internal standards. Internal audit should review operations for compliance with such standards. In this respect, the work of internal auditors has broadened, as organisations increasingly pursue compliance not only with industry standards for products and service provision, but also with criteria relevant to environmental standards.

14.1.1 Objectives of Internal Audit

The overall purpose of an internal audit is to create a roadmap to improve business success. Throughout the process, an auditor examines, reviews, and tests the efficiency of operations in the day-to-day activities of an organisation.

The auditor evaluates findings to provide management with appraisals regarding the quality of internal controls, recommendations for improvement, and advice on how to fine-tune operating style to advance achievement of objectives within the business.

The key piece of a successful audit is to properly evaluate and test the specific internal controls of an organisation.

The COSO Framework as an Audit Tool

COSO's Internal Control-Integrated Framework defines Five Components of Internal Control:

- Control Environment.
- Risk Assessment.
- Control Activities.
- Information and Communication, and
- Monitoring.

Although the main focus of an internal audit is on the reliability of financial reporting, the audit will encompass the entire internal control system.

Control Environment

The foundation of an effective internal control system relies on the support of everyone within the organisation. COSO refers to the concept of "tone at the top," which explains that the adoption of internal controls begins with an entity's board of directors, trustees, or management. An auditor wants to understand management philosophy regarding the importance, acceptance, and adherence to the internal control system.

A few examples of Internal Control environment:

Is everyone in the Organization aware of the policies and procedures of the entity?

Are ethical values encouraged, exemplified, and rewarded by management?

Do staff have a solid understanding of and receive training on how to perform control activities associated with their individual responsibilities?

Risk Assessment

As an internal auditor, risk management is one of the primary responsibilities. By nature of the process, one of the internal control audit objectives is to conduct a Risk Assessment.

Control Activities

Internal control review objectives are defined by the specific control activities adopted within an organisation. Control activities are the basis of an auditor's evaluation and testing of controls.

Information and Communication

Information systems provide reporting in all areas of operations, including financial, operational, and compliance. To correctly perform its function, the audit staff monitors the quality of communications and information systems within the organisation.

Monitoring

Ongoing monitoring of internal controls is a management function with many monitoring activities built into the daily operations of an organisation. Some internal controls are classified as monitoring activities. Additional and periodic monitoring occurs in the form of an internal audit.

Understanding Internal Control review Objectives

Any organisation in operation has risks. Risks need controls. Controls need to be evaluated, improved, redefined, or discarded. To complete a comprehensive internal control audit, auditors test control activities against specific control objectives.

Definition of internal control objective: A control objective is the reason a control activity is put into action. More specifically, a control objective is a series of actions and statements describing how a control activity is designed to avoid or reduce risk to an acceptable level.

Three Categories for Control Objectives

Control objectives are generally classified into three categories:

- Operational.
- Reporting.
- Compliance.

Operational Objectives

Objectives revolving around effective and efficient business operations. Examples of control activities designed to meet operational objectives:

- Business performance reviews.
- Physical safeguards and security over assets.
- Education, training, coaching.
- Review and approval.
- Segregation of duties.

Reporting Objectives

Objectives pertaining to reliable, transparent, and timely reporting of both financial (internal and external) and non-financial transactions.

Examples of control activities designed to meet reporting objectives:

- Authorization.
- Review and Approval.
- Verification.
- Reconciliation.
- Password Protections
- Segregation of Duties.
- Performance Reviews.

Compliance Objectives

Objective relating to following and abiding by state and federal laws and industry regulations. Examples of control activities designed to meet compliance objectives:

- Verification (information is correctly captured).
- Performance reviews.
- Education and training.
- Policies and procedures manuals.

Internal Control Audit Objectives

Audit objectives are designed to verify that the preferred outcome of a control activity is achieved. This is completed by judging the control procedure against a set of predefined criteria. These are commonly referred to as audit objectives.

Transaction-related audit objectives include:

- Occurrence/Existence.
- Completeness.
- Accuracy.
- Classification.
- Cut-off/Timing.
- Reporting and Summarization.

To better understand the process, let's look at an example of applying internal control audit objectives to evaluate internal control over financial reporting.

Control objective: Verify that a misstatement was prevented or detected by a specific control activity

Control activity: Management authorization of expenditures

Application of Internal Control Audit Objectives

- Occurrence: management authorizes all expenditures.
- Completeness: Authorizations are recorded in appropriate fashion.
- Accuracy: Authorizations are stated in correct amounts throughout financial statements.
- Classification: Authorized expenditures are classified according to established guidelines.
- Timing: Authorizations are dated and recorded on correct dates.
- Reporting and summarization: Authorizations are documented in appropriate reports and include a summary of each transaction.

Internal control audit objectives not only serve to find potential problems, but to discover opportunities for improvement and help implement necessary changes.

14.1.2 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 organisation 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.

14.1.3 Structure of Internal Control

There is no uniform or identical in its approach of internal control in all the organisations. 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 organisation.

(d) Potentiality of the human resources and their outlook.

Therefore, while designing an internal control system, the following factors must be considered to ensure greater chances of successful internal control system.

Segregation and Rotation of duties: It is very necessary for successful internal control system that no one person handles the complete transaction i.e., those who physically handle assets are not those who record the asset movements also. The systems are so designed that no single individual is responsible for all the stages involved in a transaction i.e., duties are allocated in such a way that no single individual has an exclusive control over any one transaction or a group of transactions.

Similarly, the people responsible for authorizing these transactions or reconciling of the records should also be different i.e., the work done by one person is either complementary to the work done by other person or the accuracy or correctness of work done by one person is independently checked by another person. The broad functions which are generally segregated are:

(a) Execution of transactions;

(b) Authorization of transactions;

(c) Maintenance of records and documents; and

(d) Physical custody of related assets.

Apart from segregation of duties, it is sometimes considered more desirable to rotate the duties of various officers and staff in an attempt to ensure that a fraud or error, if any may not remain undetected for a very long time. It also ensures that a person does not develop a vested interest by holding to a post for a very long time. In addition, it removes the impression of indispensability about an employee. This also ensures that the job profile of each post is well defined because employees can be rotated only if the content of each respective job is well defined.

- **Competence and integrity of people:** Internal control systems are not an end to themselves unless these systems are manned by the competent people, who are honest enough to consistently do so. The controls to be successful and effective, necessitate the need for competent people to enforce such controls. In other words, the presence of detailed procedures may have no meaning unless these procedures are carried by the competent people, who can also envisage the changes required in the system over a period of time.

- **Appropriate levels of authority:** A common error usually made is to grant too much authority within control boundaries. Sometimes, this is deliberately done to expedite the things or to handle the emergencies. This is sometimes done to reduce the number of people i.e., cost reduction. However, controls to be effective require the authority to be granted on a need-to have basis only. If there is no need for a particular person to have a specific authority, he/she should not be granted such authority.

- **Accountability:** The internal controls to be successful presuppose that there is full accountability for all the decisions taken and there are controls present, which allow the determination with acceptable level of confidence of a person taking particular decision or authorizing particular transaction or took specific action. However, mere presence of these controls may have no meaning or may give a false sense of security unless strict action is taken every time, a discrepancy is noticed. Otherwise, these controls may be left with no meaning.

- **Adequate resources:** Controls that are enforced with inadequate resources (manpower, finance, equipment, materials, and methodologies) will generally fail whenever they come under stress. Therefore, it is very necessary that minimum resources necessary to enforce the controls must always be present to enable the controls to be successful and effective.

- **Supervision and periodical updation:** Unfortunately, many people prefer to work only if they are being supervised or watched. It is, therefore very necessary for the controls to be adequately supervised and periodically updated in line with changing environment to be effective and successful. For example, in case of banks, if new service i.e., internet banking is also being started, it is very necessary that internal control system is also updated accordingly.

14.1.4 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 organisation 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?). Cost of control should not exceed the benefit achievable.

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 organisation 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 ₹2 crores per annum to make computer hacking free or error free and the risk assessment shows an estimated loss of ₹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 unusual nature may still escape all controls despite all precautions. Further, all controls need to be updated regularly to keep pace with changing conditions. So rigorous and effective internal controls of past may no longer be effective in present or future.

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 organisation 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, on the financialstatements.

14.1.5 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. Clause – XIV of the Companies (Auditor's Report) Order, 2020 (CARO 2020) requires that the auditor's report on the account of a company to which this Order applies shall inter-alia include a statement as to whether there is an adequate internal control system commensurate with the size of the company and the nature of its business, whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor.

As per section 177 of the Companies Act, 2013, the Board of directors of every listed company and the following classes of companies, as prescribed under Rule 6 of Companies (Meetings of Board and its powers) Rules, 2014 shall constitute an Audit Committee:

(i) All public companies with a paid up capital of ₹10 Crores or more;

(ii) All public companies having turnover of ₹100 Crores or more;

(iii) All public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding ₹50 Crores or more.

The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Sub-section (5) of section 177 of the Companies Act, 2013 provides that the Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

Sub-section (6) of section 177 of the Companies Act, 2013 provides that the Audit Committee shall have powers to investigate any activity within its terms of reference, to seek information from any employee, to obtain outside legal or other professional advice, to secure attendance of outsiders with relevant expertise, if it considers necessary.

The roles of the Audit Committee are:

(i) Evaluation of internal financial controls and risk management systems;

(ii) Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;

(iii) Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit;

(iv) Discussion with internal auditors of any significant findings and follow up there on;

(v) Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board

(vi) Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.

The Audit Committee shall mandatorily review the Internal audit reports relating to internal control weaknesses; and the appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

The evaluation of internal controls including internal accounting controls gives an opportunity to the auditor to a clearer insight into the operational systems and an overall view of the organisational 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 organisation. 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.

Internal Control and the Auditor 14.2

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 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 organisation. 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 i.e as part of the monitoring process.

Control compels events to conform to plans. Internal control is an essential part of control mechanism within an organisation, which functions for the success of an organisation by way of implementation of organisational 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.

The importance of role of an internal auditor in the context of internal control cannot be exaggerated.

(a) The purpose of the review of the systems of internal control is to ascertain whether the system established provides reasonable assurance that the organisation'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 organisation'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.

At times, 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 organisation into reality and accomplishments. Internal auditing, as has been seen, can therefore reveal a sound internal control system but nevertheless the support of the management is a must.

Internal Auditing – Evolution of the Profession

14.3

Chanakya (350-283 BC) was an advisor and Prime Minister of first Maurya emperor Chandragupta (340 – 293 BC) in his Book 'Arthasastra' mentioned about maintenance of Accounts, periodicity of Accounting, verification,certification and various avenues of fraud (40 types of embezzlement – Chanakya Chalisha) of Government Fund /Exchequer. He cited an example that it is very difficult to ascertain 'how much water the fishes are consuming from a pond full of water'. 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.

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.

Section 301 (Public Company Audit Committee) of the Sarbanes-Oxley Act passed by the U.S. Congress in the year 2002 requires an audit committee in all the listed companies. Section 404 (Management Assessment of Internal Controls) of the said Act requires an annual report on management of the internal controls and their effectiveness. The law requires annual reports to contain an assessment of the effectiveness of internal control over financial reporting. In addition, it also requires the adoption of standards for independent auditors to attest to management's report on internal control. Separately, the act requires a company's CEO and CFO to certify quarterly and annual reports. These developments will ensure the necessity for the adequate and effective internal audit department in all the listed companies to assist management with these requirements. Similar provisions are already in place under the Indian Companies Act, 2013.

The role of internal audit is to provide independent assurance that an organisation's risk management, governance, and internal control processes are operating effectively. Internal audit is conducted objectively and designed to improve and mature an organisation's business practices.

Internal auditing provides insight into an organisation's culture, policies, procedures, and aids board and management oversight by verifying internal controls such as operating effectiveness, risk mitigation controls, and compliance with any relevant laws or regulations.

Necessity of Internal Audit

The necessity of internal audit is as follows:

1. Internal Audit assists management to improve internal controls by identifying weaknesses in systems. and provides an opportunity to correct those weaknesses. Internal auditors deal with issues that are important to the continued existence and prosperity of any organisation.
2. It helps to detect errors and frauds and provides suggestions to rectify the same and to pre-empt possibility of recurrence.
3. It steps in time to detects the misuse of resources, in time which helps to reduce infructuous unnecessary expenses.
4. It helps in improving the processes and workflow. It also works as a morale check.

5. The Internal Audit checks the books of accounts, detects errors and frauds and helps in its correction which makes the act of External/Statutory Auditor can rely on the internal audit reports and reduce the audit time easier.
6. The vigil by Internal Audit team and timely intervention, keeps operating staff on their toes for keeping Books updated.
7. Independent review of operations/business.

Sum Up

Internal control is the process, effected by an entity's Board of Trustees, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Reliability of financial reporting,
- Effectiveness and efficiency of operations, and
- Compliance with applicable laws and regulations.

Types of Internal Controls

1. **Detective:** Designed to detect errors or irregularities that may have occurred.
2. **Corrective:** Designed to correct errors or irregularities that have been detected.
3. **Preventive:** Designed to keep errors or irregularities from occurring in the first place.

Limitations of Internal Controls

No matter how well internal controls are designed, they can only provide reasonable assurance that objectives have been achieved. Some limitations are inherent in all internal control systems. These include:

Judgment: The effectiveness of controls will be limited by decisions made with human judgment under pressures to conduct business based on the information at hand.

1. Bypassing laid down control parameters by changing the process flow makes the earlier one redundant and for setting a new one entire process flow to be re-examined for suitability.
2. Overriding attitude to make the control ineffective.

   Breakdowns: Even well-designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems.

   Management Override: High level personnel may be able to override prescribed policies and procedures for personal gain or advantage. This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.
3. **Collusion:** Control systems can be circumvented by collusion among employees for fraudulent activities.
4. Cost of controls should not exceed the benefits accruable from exercising control, e.g one external Agency is appointed to verify daily cash at a retail outlet, where daily turnover is ₹1000/-.
5. Multiple controls at the same point of time makes process slower, e.g despite existence of maker-checker control for release of Purchase Orders (PO), the same are placed for manual sign-off before release.

Internal Control Objectives: Internal Control objectives are desired goals or conditions for a specific event cycle which, if achieved, minimize the potential that waste, loss, unauthorized use or misappropriation will occur. For a control objective to be effective, compliance with it must be measurable and observable.

Internal Audit evaluates Mercer's system of internal control by accessing the ability of individual process controls to achieve seven pre-defined control objectives. The control objectives include authorization, completeness, accuracy, validity, physical safeguards and security and, error handling. and segregation of duties.

Authorization: The objective is to ensure that all transactions are approved by the person authorized to do so.

Completeness: The objective is to ensure that no valid transactions have been omitted from the accounting records.

Accuracy: The objective is to ensure that all valid transactions are accurate, consistent with the originating transaction data and information is recorded in a timely manner.

Validity: The objective is to ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorization.

Physical Safeguards & Security: The objective is to ensure that access to physical assets and information systems are controlled and properly restricted to authorized personnel.

Error handling: The objective is to ensure that errors detected at any stage of processing receive prompt corrective action and are reported /escalated to the appropriate level of management.

Segregation of Duties: The objective is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing the transaction.

A well-designed process with appropriate internal controls should meet most, if not all of these control objectives.

Major Components:

Control environment: Factors that set the tone of the organisation, influencing the control consciousness of its people. The seven factors are (ICHAMPBO):

- I - Integrity and ethical values,
- C - Commitment to competence,
- H - Human resource policies and practices,
- A - Assignment of authority and responsibility,
- M - Management's philosophy and operating style,
- B - Board of Director's or Audit Committee participation, and
- O - Organizational structure.

Risk Assessment: Risks that may affect an entity›s ability to properly record, process, summarize and report financial data:

- Changes in the Operating Environment (e.g., Increased Competition)
- New Personnel
- New Information Systems
- Rapid Growth
- New Technology

- New Lines, Products, or Activities
- Corporate Restructuring
- Foreign Operations
- Accounting Pronouncements

Control Activities: Various policies and procedures that help ensure those necessary actions are taken to address risks affecting achievement of entity›s objectives (PIPS):

- P - Performance reviews (review of actual against budgets, forecasts)
- I - Information processing (checks for accuracy, completeness, authorization)
- P - Physical controls (physical security)
- S - Segregation of duties

Information and communication: Methods and records established to record, process, summarize, and report transactions and to maintain accountability of related assets and liabilities. Must accomplish:

- Identify and record all valid transactions.
- Describe on a timely basis.
- Measure the value properly.
- Record in the proper time period.
- Properly present and disclose.
- Communicate responsibilities to employees.

Monitoring: Assessment of the quality of internal control performance over time.

What can happen when Internal Controls are weak or non-existent?

These arguments represent pitfalls to unsuspecting management. Each argument is in itself a problem that needs to be resolved.

1. Compensating controls can be implemented in situations where one person has to do all of the business- related transactions for a department.

2. If implementing a recommended control seems too expensive, be sure to consider the cost of a fraud that could occur because of the missing control. Fraud is always expensive and the prevention of fraud is worth the cost.

3. Finally consider the issue of trust. Most employees are trustworthy and responsible, which is an important factor in employee relations and departmental operations. However, it is also the responsibility of administrators to remain objective. Experience shows that it is often the most trusted employees who are involved in committing frauds.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Several checks & controls exercised in a business to ensure its efficient working is known as:
   (a) Internal check.
   (b) Internal control.
   (c) Internal audit.
   (d) Interim check.

2. The work of one clerk is automatically checked by another clerk is called:
   (a) Internal control.
   (b) Internal check.
   (c) Internal audit.
   (d) None of the above.

3. Internal controls and internal checks are:
   (a) One and the same.
   (b) Different.
   (c) Internal control includes internal checks.
   (d) None of the above.

4. Which of the following statements is not true about a continuous audit?
   (a) It is conducted at regular intervals.
   (b) It may be carried out on daily basis.
   (c) It is needed when the organisation has a good internal control system.
   (d) It is expensive.

5. In comparison to the independent auditor an internal auditor is more likely to be concerned with:
   (a) Cost accountancy system
   (b) Internal control system
   (c) Legal compliance
   (d) Accounting system

6. Verification is _____.
   (a) The art of recording the business transaction.
   (b) An examination of the books of accounts.
   (c) The act of establishing the accuracy of entries in the books of accounts.
   (d) None of the above.

7. The main objectives of investigation is ______.
   (a) To discover errors and frauds.
   (b) To prevent errors and frauds.
   (c) To verify statements.
   (d) All the above.

8. The company's auditor is expected to give ______ .
   (a) His expert opinion about the accounts.
   (b) A factual position about the accounts.
   (c) A critical review of the accounts.
   (d) Financial assistance.

9. Which of the following is not likely to be a fraud risk factor relating to management characteristics?
   (a) Tax evasion.
   (b) Failure to correct known weakness in internal control system.
   (c) Adoption of conservative accounting principles.
   (d) High management turnover.

10. The primary purpose of establishing quality control policies and procedures for deciding on client evaluation to _____.
    (a) Ensure adherence to generally accepted auditing standards.
    (b) Acceptance or retention of clients whose management does not lack integrity.
    (c) Ensure audit fees is charged according to the type of audit work assigned.
    (d) Medical policies.

Essay Type Questions

1. Explain the steps to prepare for and perform an internal audit.
2. The utility of the audit programme can be retained and enhanced only by keeping the programme and also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed". Discuss stating clearly the advantages of an audit programme.
3. "The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting". Explain.
4. "The audit engagement team should hold discussions to gain a better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference". Explain.
5. "An internal control system consists of the policies and procedures companies use to protect assets, ensure reliable accounting, promote efficient operations, and urge adherence to company policies". Explain.

Answer:

Multiple Choice Questions

1.	(a) Internal check.
2.	(b) Internal check.
3.	(c) Internal control includes internal checks.
4.	(c) It is needed when the organisation has a good internal control system.
5.	(b) Internal control system
6.	(c) The act of establishing the accuracy of entries in the books of accounts.
7.	(d) All the above.
8.	(a) His expert opinion about the accounts.
9.	(c) Adoption of conservative accounting principles.
10.	(b) Acceptance or retention of clients whose management does not lack integrity.

Operational Audit and Internal Audit under Companies Act, 2013

15

This Module includes:

Operational Audit and Internal Audit under Companies Act, 2013

SLOB Mapped against the Module

To obtain in-depth knowledge about the existing regulatory framework for internal and operational audit to conduct effective audit procedure in organisations. (CMLO 4a, b)

Module Learning Objectives:

Operational audits are audits that focus on the effectiveness, productivity and cost efficiency of the operations of the business. Internal audits focus on what has happened already. Businesses look at the mistakes that were made and the vulnerabilities in the system which allowed those mistakes to be made. After studying this module, the students will be able to –

- Appraise the company's objectives with regards to Operational and Internal Audit
- Evaluate company's policies, the structure of organisation and its Control Systems
- Conduct Appraisal of performance, which involves examination of work flow, determination of ideal work force, performance, productivity, profitability, performance, and appraisal of costs and looking for swags opportunity, if any.

Introduction

15.1

As per section 138 of Indian Companies Act, 2013 read with Rule 13 of Companies (Accounts) Rules, 2014, certain class of companies are required to appoint Internal Auditors. An extract of Rule 13 of Companies (Accounts) Rules, 2014 is as follows-

Extract of Rule 13 of Companies (Accounts) Rules, 2014:

Companies required to appoint internal auditor.

The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely: -

(a) every listed company; Always applicable

(b) every unlisted public company having:

   (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

   (ii) turnover(income) of two hundred crore rupees or more during the preceding financial year; or

   (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year;

   (iv) outstanding deposits of twenty-five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having:

   (i) turnover of two hundred crore rupees or more during the preceding financial year; or

   (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

Provided that an existing company covered under any of the above criteria shall comply with the requirements of section 138 and this rule within six months of commencement of such section.

Explanation: For the purposes of this rule – The internal auditor may or may not be an employee of the company. The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, the rule specifies that an internal auditor may or may not be an employee of the company. The Internal auditor may be a CA/CMA or any other professional. Also, neither the rules nor the Act, has specified the duties and responsibilities. So even if the rules and act made the appointment of Internal Auditor mandatory, the same rules and Act provides option to companies to appoint any person as internal auditors. Anyone who has the knowledge can become an Internal Auditor, because the rules did not define the word "any other professional".

Understanding of Operations of the entity is the pre-requisite for conducting Internal Audits (IA). The definition of Internal Audit (by The Institute of Internal Auditors) clearly indicates the IA's role of value addition and improve an organisation's operations.An unremitting commitment is elemental to accomplish success and ceaseless application of process specific operational audits is to be undertaken on a proactive basis.

Simple way of defining 'operation audit' is adopting the residuary approach that is **'auditing which goes beyond financial transactions and accounting records and examines into the operating, managerial or administrative performance of the entity'**. In other words it is a future-oriented, systematic, and independent evaluation of the entire gamut of organisational activities, for example, how an organisation's management and it's operating procedures are functioning with respect to their efficiency in meeting stated objectives.

The objective of the operational audit process is to improve the way the business performs e.g. operational audit can help businesses lower costs, decrease the turnaround time for many processes, directly improving service delivery and customer satisfaction.

Discovering opportunities for improvement:

Operational audit programs are much more in-depth than normal internal audits. They do not look at how things are, they also look at how things could be. This means that in an operational audit, the auditors do not simply audit the performance of the organisation, they also look for better ways of accomplishing the same tasks effectively.

Preparation for an Audit

15.2

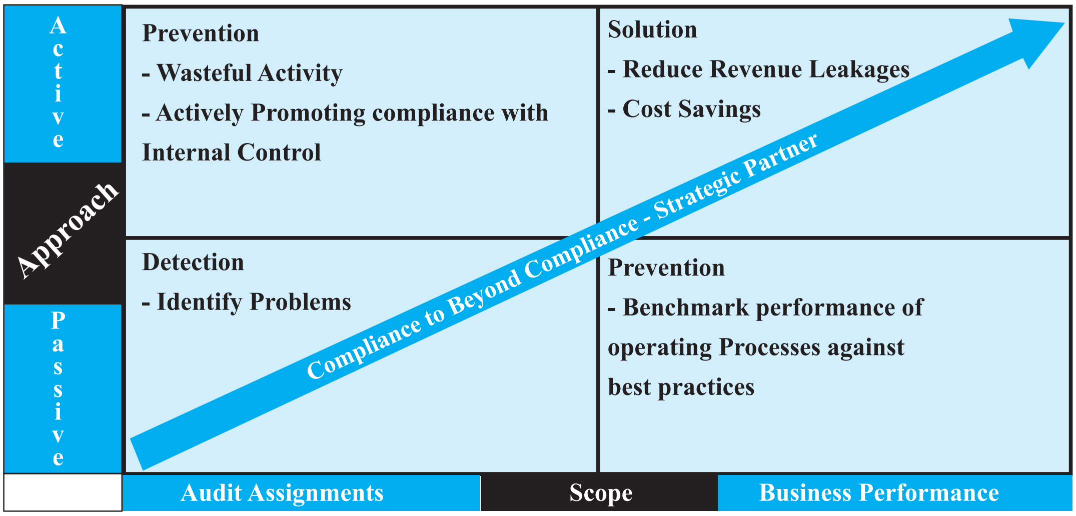


Figure 15.1: Preparation for Audit

The aforesaid diagram indicates 'active' and 'passive' approach in all types of 'audit assignments' and especially for 'operational Audit' for a paradigm shift to 'beyond compliance'. As evident from above, the active zone of 'operational audit' is to prevent "wasteful activities" with a view 'to reduce revenue leakages and cost'. This in turn having a positive impact on business performance.

The contemporary approaches of 'Risk Based Audit' are not in total sync with 'Operational Audit'. Risk pertaining to "Operations" is prioritized for 'Risk Based Audit' and recommended mitigation, fails to provide a holistic coverage for the entire gamut of risk associated with the 'Operation' and improvement in 'value chain' through a set of corrective measures.

With the introduction of 'Operation Audit' the entire activities related to the operation reviewed for achieving the defined objective /s.

"Operational Audit" Objective:

'Operational Audit 'objective has been coined here after the name of connoisseur of TQM (Total Quality Management), W.E. Deming. To define the objective the word 'DEMING' is used, where each of the word stands for a definitive objective accomplishment.

D	–	Detailed understanging for existing process to suggest improvement
E	–	Eliminate Waste, Duplication of work
M	–	Merge Operations/Processes to reduce Turn Around Time
I	–	Improve/Increase Quality, Volume, Revenue
N	–	New Methods, Techniques, Devices for better result/throughput
G	–	Govern Man, Machine, Methods and Money

To carry out the heightened expectations of 'stakeholders' on their shoulder, Auditors can no longer spend their time looking down at financial controls and compliances rather to spend much more time in operation Reviews.

Gone are days of 'pushing the pencil'; 'brain power' is taking place of 'brawn power'. To support the accomplishment of aforesaid objective, the audit process to lend appropriate support. Process provides a methodology for intelligently and efficiently integrating People, Tools, Procedures and Technology for the best results/ outcome.

Advantages and Disadvantages of 'Operational Audit'

- Going through the operational audit process provides a company with objective opinions. These opinions often generate quicker production by lowering TAT (Turn Around Time), pointing process inefficiencies, the location of areas of delay/lapses, cost rationalization/reduction.
- Move towards operational excellence.

The mental fear of 'resistance to change' is the only disadvantage in organisational culture.

The following are the important steps:

(i) Defining the scope of audit work.

(ii) Obtaining knowledge of the business, processes and formulating the audit programme.

(iii) Evaluation of the accounting and internal control system existing in the auditee enterprise.

(iv) Determining the nature, timing and extent of audit procedures, keeping in mind the audit risk and materiality vs involvement.

(v) Adequate documentation is also necessary, i.e. preparation of audit note book and working papers.

(vi) Formulation of opinion.

(vii) Issuance of audit report.

The auditor uses the following techniques to collect the necessary evidence:

(i) Electronic data processing for understanding the gaps.

(ii) Process Flow Charting

(iii) Discussion for clarity

Audit Program:

An audit program is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item and the financial statements and the estimated time required. To be more comprehensive, an audit program is written plan containing exact details with regard to the conduct of a particular audit. It is a description or memorandum of the work to be done during an audit. Audit program serves as a guide in arranging and distributing the audit work as well as checking against the possibility of the omissions.

Advantages of Audit Program:

The main advantages of an audit program are as follows:

(i) It serves as a ready check list of audit procedures to be performed.

(ii) The audit work can be properly allocated to the audit assistants or the article clerks.

(iii) The auditor may easily know the extent of work done at any point of time. Thus, the progress of work done can be under the supervision and control of the auditor.

(iv) Audit program would not only be useful for the audit assistants in carrying the audit work but for the principal too as he would be in a position to account for the individual responsibilities.

(v) A uniformity of the work can be attained as the same program would be followed from time to time.

(vi) It is a useful basis for planning the program for the following year.

(vii) It may be used as evidence by the auditor in the event when any charge is brought against him. He can prove that there has no negligence on his part and he exercised reasonable care and skill while performing the task.

Disadvantages of Audit Program:

The main disadvantages of an audit programare as follows:

(i) The auditor's task becomes mechanical and the auditors may lose interest and initiative.

(ii) Drawing up of an audit programmay be unnecessary for a small concern.

(iii) Though audit program helps in fixing responsibilities but inefficient staff may defend themselves by stating that the matter was not contained in the audit program.

(iv) Rigid program cannot be laid down for each type of business.

Though an audit program may suffer from the above disadvantages, but these can be removed by taking some initiatives such as consulting the audit assistants, modifying the program on the basis of experience gained during audit, etc.

Continuous and Final Audit:

(a) Continuous Audit:

Continuous audit involves the detailed examination of all the transactions by the auditor continuously throughout the year or at regular intervals, say fortnightly or monthly. A continuous audit is one which is commenced and carried on before the close of the financial year to which it relates. It involves the constant engagement of auditor's staff at the client office throughout the period under review. Continuous audit is suitable in cases where the final accounts are desired to be presented soon after the close of the financial year or there is great volume of transactions or the system of internal check is weak.

(b) Final Audit:

A final audit is also called as Completed Audit or Periodical Audit. Final audit is done after the close of the financial year, i.e., after the books of accounts have been closed and the final accounts are drawn up. In this type of audit, the client gives the possession of books of accounts to the auditor for audit and routine checking and other audit procedures begin only after that.

Audit Working Papers:

Audit working papers are the record of the planning and execution of the audit engagement. Auditors retain a set of working papers for each audit engagement for each year. The audit working papers for the current year are referred to as the current working papers. Working papers that are relevant to more than one audit engagement are often kept separately in a file referred to as permanent working papers. The audit working papers (current and permanent) for a client audit engagement are sufficiently detailed to enable another appropriately experienced and competent auditor that is not familiar with the client to obtain an overall understanding of the engagement.

Working papers (or documentation) serve three purposes (i) aid in planning and performance of the audit; (ii) aid in supervision and review of the audit work; and (iii) these papers serve as evidence of the audit work performed by the auditor to support his opinion.

These working papers also facilitate audit planning and supervision of the audit work. The form and content of working papers vary from audits to audits, but they are affected by the following matters:

(a) Nature of engagement;

(b) Form of audit report;

(c) Nature and complexity of client's business;

(d) Nature and condition of client's records;

(e) Degree of reliance of internal controls;

(f) Supervision of work performed by assistants.

Types of Working Paper Files:

In case of recurring audits, some working papers files may be classified into permanent audit files and current audit files. While the former is updated with the information of continuing importance, the latter contains information relating to audit of a single period. The contents of these files are given below:

Permanent Audit File	Current Audit File
(a) Legal and organisational structure of the entity, e.g., MOA and AOA in case of a company.	(a) Correspondence relating to acceptance of annual reappointment.
(b) Extracts or copies of legal documents, agreements and minutes relevant to the audit.	(b) Extracts of important matters in the minutes of Board Meetings and General Meetings relevant to the audit.
(c) A record if study and evaluation of internal controls.	(c) Copies of management letters
(d) Analysis of significant ratios & trends.	(d) Analysis of transactions and balances.
(e) Copies of the audited financial statements of previous year(s).	(e) Copies of communication with other auditors, experts and third parties.
(f) Notes regarding significant accounting policies.	(f) Audit program.
(g) Signification audit observations of the earlier years.	(g) Conclusions reached on significant aspects of audit.

Working papers are the property of the auditor, the portions or extracts of, which can be had at his discretion. These working papers should keep in safe custody and in confidential manner for such time as is sufficient to meet the requirements of his practice or to satisfy any related legal or professional requirement of record retention.

Audit Note Book:

An audit book is usually a bound book in which a large variety of maters observed during the course of audit are recorded. The audit note book is a permanent record of the auditor. For each individual audit, the auditor usually maintains a separate audit note book. The audit note book should be maintained clearly, completely and systematically. An audit note book is a great evidential tool available as a defence with the auditors in the event of any charge is brought against them. In case of City Equitable Fire Insurance Company, the auditors were relieved because they have maintained record of the audit work performed at each stage.

Contents of Audit Note Book:

(i) Name of the business enterprise.

(ii) Organisation structure.

(iii) Important provisions of Memorandum and Articles of Association.

(iv) Communication with the previous auditor, if any.

(v) Management representations and instructions.

(vi) List of books of accounts maintained by the enterprise.

(vii) Accounting methods, internal control systems followed by the enterprise, applicable laws etc.

(viii) Key management personnel.

(ix) Errors and fraud discovered.

(x) Matters requiring explanations or clarifications.

(xi) Special points that need attention in the audit report and for subsequent audits

Specimen of Audit Note Book

M/s. XYZ Private Limited Audit Notes for the Financial Year

Voucher/ Reference No.	Account Involved	Amount	Query/ Remarks	How disposed of
21	Machinery	2,000	Amount wrongly capitalized	Rectified after consulting with Mr. A, Chief Accountant
64	P.F.	1,750	Late deposited	Clarified with Mr. B from HR
80	Advertisement	5,000	MD sanction required	Sanction obtained
150	Colonel Securities	40,000	No TDS	TDS deducted and deposited with interest
167	Rent	2,000	Receipt required	Receipt obtained

Audit Engagement Letter 15.3

Auditors agree with the client's management, in writing, about the scope, terms and conditions of the audit engagement. This written communication is referred to as an engagement letter. The letter is usually addressed to chairman of the audit committee or, in the case of a corporation, the chair of the board of directors, with a copy being sent to the audit committee. The purpose of such a letter is to minimize any possible misunderstanding concerning the scope and terms of the audit engagement.

The letter is sent to all new audit clients and where there has been a change in the terms of the engagement or the auditor considers that management may not understand the existing terms of the engagement, the letter is also sent to continuing clients.

Terms of Audit Engagement:

- Agreeing the terms of the engagement with the client; and
- The auditor's response to a request by a client to change the terms of an engagement to one that provides alower level of assurance.

The auditor and the client should agree on the terms of the engagement. The agreement should be in writing.

Though the objective and scope of audit is determined by the relevant statue and the pronouncement of the Institute, the audit engagement letters will be informative to the clients.

The auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any misunderstanding with respect to the engagement. This will be in the interest of both the client and the auditor.

Specimen Internal Audit Engagement Letter

[DATE]

[NAME, TITLE] [DEPARTMENT] [ADDRESS]

[CITY, STATE PIN]

Dear [HEAD OF DEPARTMENT]

The Internal Audit Team is planning its audit for [DEPARTMENT NAME], The objectives of this audit will be: [LIST ACTUAL OBJECTIVES HERE]

For example:

- Reliability and Integrity of Financial and Operational Information,
- Compliance with Laws, Regulations, and Contracts,
- Safeguarding of Assets, and
- Effectiveness and Efficiency of Operations of the [AUDIT AREA], and
- To follow-up on recommendations included in prior audit reports. The proposed timetable for this year's audit is as follows:
- Start date in the field: [DATE]
- Estimated weeks to complete: [NUMBER OF WEEKS] The audit team will include the following members:

[NAME], Manager [NAME], Staff Auditor [NAME], Staff Auditor

At the beginning of our audit, we would like the opportunity to meet with you to discuss our audit objectives and solicit your input. Our goal is to perform an effective and efficient audit. We will need your staff to provide us the following documents and schedules on:

1. [DOCUMENTS] and [DATE]
2. [DOCUMENTS] and [DATE]

At the conclusion of our audit, we will discuss audit results and potential recommendations with management of the audited area before scheduling an exit conference with you. Prior to the exit conference, you will receive a draft audit report. After the exit conference, a final audit report will be delivered to you with a request for formal management's responses to include in the audit report.

Our mission is to help you achieve [DEPARTMENTS] objectives by providing you information about the effectiveness of internal control and by recommending courses of actions which improve performance. If you have any questions about this year's audit, please do not Hesitate to call.

Yours truly,

[XYZ] [Designation]

Role of CMAs in Internal Audit and Operational Audit

15.4

Presently, the role of Internal Audit has become more critical. The backdrop and changing business scenario and the role metamorphosed as technology have erased global barriers. Customer expectations have increased and compliance demands are growing both in terms of quantity and complexity. The Enterprise Risk Management is emerging as the key element in Corporate Management.

The expectations of the Board from Internal Auditors are now to assist the Board in identification, monitoring and management of business risks and also to offer and provide insight, advice and assurance on enterprise risks. The Internal Auditors should also inform directors about the tone of the organisation-culture, ethics, performance and continuously evaluate the efficiency and effectiveness of operations. They should also check compliance with laws and regulations and authenticate the reliability of financial and management reporting. Internal Auditors has the added role of safeguarding the assets of the company. They should evaluate performance management and control systems and act as an advisor to the Management. The role of effective Cost Management involves in waste reduction and enhancing productivity and process improvement.

The Internal Audit must be synchronized to the expectations of the Board. It must develop an Internal audit strategy that is linked with the organisation's strategic plan with a focus on optimizing risks, costs, and value. It must develop dynamic risk based internal audit plans. The communication must be done frequently with key stakeholders on their needs, expectations, satisfaction with the internal audit. It should leverage technology to optimize audit operations and assist management in developing and maintaining a comprehensive performance management framework. It should support and facilitate business process improvement and re-engineering and provide active support in furthering good Corporate Governance. CMAs have a colossal role to play as they have a unique blend of core competencies in accounting, management and strategy. CMAs can apply their forward-looking insights across the organisation to manage risks, reduce costs and create new opportunities, preserve and enhance value.

CMAs possess the expertise to evaluate the operational efficiency, productivity and profitability, wastages, losses, inefficiency. They can apply their knowhow in judging efficiency of management of resources, capacity utilization, channeling resources into productive channels, standards of efficiency of performance, production processes and performance of respective units. Efficiency of business processes, Enterprise Performance Management, Business risks. Efficiency of Supply Chains, Efficiency of Utilities / Energy Consumption, Sustainability of Business are critical drivers to keep the business focused on priority areas.

The perspective of CMAs has changed in the present era of mergers & acquisitions, new product development and also to climate change and sustainability. The financial perspective, customer perspective, operational perspective and people perspective all can be aligned to meet the goal of the business.

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. 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 of this audit 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.

Internal Audit under Companies Act, 2013

15.5

Legislative Background:

The Notes on clauses to the Companies Bill, 2011 read as follows:

"Clause 138. - This is a new clause and seeks to provide that prescribed Companies shall be required to conduct internal audit of functions and activities of the company by internal auditor appointed by the company. Manner of conducting internal audit shall be prescribed by the Central Government". Addition of this clause was suggested by the Standing Committee on Finance (2009-10). In 57th Report of the Standing Committee on Finance (2011-12) While dealing with the suggestion that in-house employees shall be allowed as internal auditors, it was stated by the Ministry that "the provisions of clause 138 do not prohibit appointment of in-house employee. Further, the provisions also empower the Board of relevant company to appoint any professional (even other than a CA or CMA) as internal auditor if it so decides. Hence both the suggestions are already taken care of."

The concept of internal audit was present in the Companies Act, 1956 in the form of Section 581ZF which stipulated that 'Every Producer Company shall have internal audit of its accounts carried out, at such interval and in such manner as may be specified in articles, by a chartered accountant'.

'Internal Audit' was first made mandatory for some of the companies vide the Manufacturing and Other Companies (Auditor Report) Order, 1975 (MAOCARO, 1975). MAOCARO, 1975 required the auditor to certify whether the company has an internal audit system commensurate with its size and nature of its business and also, 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 stores, raw materials including components, plant and machinery, equipment and other assets, and for the sale of goods.

Thereafter, MAOCARO, 1988 replaced the MAOCARO, 1975 and MAOCARO, 1988 was replaced by the Companies (Auditor's Report) Order, 2003 and which is recently amended and issued as CARO, 2020. Section 138 enshrines this concept with the power being given to Central Government to prescribe the class of companies where the appointment of internal auditor is mandatory.

The terms "functions" and activities" used in sub-section (1) of section 138 connote a much wider scope than "Financial Audit" and "Operations Audit". Therefore, it is clearly evident that the scope of internal audit is very wide and it covers the compliance systems in companies covering all the functions of any company. Internal Audit requires an in depth understanding of the business culture, systems and processes, understanding and improvement of internal controls for effective risk management, understanding the governance structure of the organisation and ability to provide value additions for improvement in governance processes.

The internal audit may contribute in the following areas:

(a) Independent review and appraisal of control systems across the organisation (both financial control systems and operational areas where the organisation may reap benefits)

(b) Ascertainment of the extent of compliance of policies, procedures, regulations and legislations. Checking and compliance of management systems of an organisation.

(c) Facilitate good practices in management of risk. This requires systems for ascertaining, measuring, managing and where possible mitigation or dispersion of the risk.

(d) Achieve savings by identifying waste, inefficiency and duplication of effort across the organisation

(e) Structuring programs and activities such that company assets are safeguarded and there are internal check systems which minimize the possibility for reducing fraud / early warning signals for identifying fraud.

Compulsory requirement for appointment of internal auditor(s) in listed and specified companies

Section 138 read with rule 13 of the Companies (Accounts) Rules, 2014 provide that following class of companies shall be required to appoint an internal auditor or a firm of internal auditor; namely:

(a) every listed company

(b) every unlisted public company having:

  (i) paid up share capital of 50 crore rupees or more during the preceding financial year; or

  (ii) turnover (income) of 200 crore rupees or more during the preceding financial year; or

  (iii) outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore rupees or more at any point of time during the preceding financial year; or

  (iv) which has accepted deposits of 25 crore rupees or more at any point of time during the last financial year;

(c) every private company having

  (i) turnover of 200 crore rupees or more during the preceding financial year; or

  (ii) outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore rupees or more at any point of time during the preceding financial year:

Provided that an existing company covered under any of the above criteria shall comply with the requirements of section 138 and this rule within six months of commencement of such section.

Explanation — For the purposes of this rule—

The internal auditor may or may not be an employee of the company; The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, the rule specifies that an internal auditor may or may not be an employee of the company. The Internal auditor may be CA/CMA or any other professional. And also neither the rules nor the Act, has specified the duties and responsibilities. So even if the rules and act made the appointment of Internal Auditor mandatory, the same rules and Act provides option to companies to appoint any person as internal auditors. And also anyone who has the knowledge can became an Internal Auditor, because the rules did not define the word "any other professional"

Eligibility for appointment as internal auditor

Such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

Requirement for filing of Form MGT-14 with the RoC on appointment of the Internal Auditor

The appointment of internal auditor can be done only by means of a resolution passed at the meeting of the Board as specified under rule 8 of the Companies (Meeting of Board and its Powers) Rules, 2014 and accordingly, the company is also required to file Form MGT-14 with the Registrar within 30 days from the date of passing of resolution by the Board. However, filing of resolutions under clause (g) of sub-section (3) of section 117 has been exempted for private companies vide Ministry of Corporate Affairs notification No.G.S.R.464(E) dated 05.06.2015. However, the Private Company is still required to comply the requirements of Section 179.

Authority to appoint the Internal Auditors

Rule 13(2) of the Companies (Accounts) Rules, 2014 set forth that the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

Statutory Auditors cannot be appointed as Internal Auditors

MCA Circular No. 29 of 1976, dated 27-8-1976 states that the internal auditor is appointed by the management and hence is in the position of an employee, whereas the statutory auditor is appointed by the company in accordance with the provisions of section 224 [section 139 of the Companies Act, 2013] and the auditor is required to perform the duties enjoined on him under section 227 [section 143 of the Companies Act, 2013] and the Rules/ Orders issued there under. As such, in the opinion of the Department (MCA), a statutory auditor of a company cannot also be its internal auditor.

Formation of policy and procedure for appointment of the internal auditor

The Companies (Accounts) Rules, 2014 provides that the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

Existing companies need to appoint the Internal Auditors within a period of six months, i.e. before 30th September, 2014

In case of an existing company, this needs to appoint internal auditors pursuant to the provisions of section 138 of the Companies Act, 2013 read with Rule 13 of the Companies (Accounts) Rules, 2014, shall appoint the internal auditor within a period of 6 months from the commencement of the section, i.e. needs to comply with the requirement before 30th September, 2014.

Scope of internal audit

Sub-section (2) of section 138 gives power to central government to make rules and prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the board. Rule 13 does not provide the scope of internal audit. However, rule 13 prescribed that the audit committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit

Powers and duties of internal auditor

There are no powers and duties of internal auditor prescribed under the Act. The same may be governed by the terms of reference of the appointment of internal auditor which may be decided mutually between the company and the internal auditor.

Punishment and Compound ability

There are no specific penal provisions provided in this section 138. Therefore the penal provisions under section

450 would apply in case of any non-compliance of this section. Accordingly, for contravention, the company and every officer of the company who is in default shall be punishable with a fine upto ₹10,000, in case the contravention is a continuing one then the further fine shall be ₹1,000 every day. The offences under this section are compoundable under section 441 of the Act.

Internal Audit and Companies (Auditor's Report) Order

15.6

The Central Government in exercise of the powers conferred under sub-section (4A) of the section 227 of the Companies Act, 1956, has issued the I Companies (Auditor's Report) Order, 2003 ("the Order" or "the CARO") vide I Notification No. GSR 480(E), dated June 12, 2003. The Order contains certain I matters on which the auditors of the Companies (excepting those companies which are specifically exempted under it) have to make a statement in their audit report.

Section 227(4A) of the Companies Act, 1956 ceased to be operational from 1 April 2014 after notification of section 143 (11) under the Companies Act, 2013. Though section 143(11) of the 2013 Act provides requirements similar to section 227(4A) of the 1956 Act, the MCA had not prescribed CARO related requirements. Consequently, after consulting the Institute of Chartered Accountants of India (ICAI), the MCA on 10 April 2015 issued the Companies (Auditor's Report) Order, 2015 (CARO - 2015) prescribing certain reporting requirements for auditors of certain class of companies. CARO - 2015 amended again and recently CARO 2020 issued by MCA which is effective from the date of its publication in the Official Gazette, 25th February, 2020.

Clause (xiv) of CARO, 2020 spells out the requirements as to reporting by the statutory auditors on the internal control system and internal audit system respectively. Each of these clauses is discussed as below.

Clause (xiv) of CARO, 2020

(a) Whether the company has an internal audit system commensurate with the size and nature of its business;

(b) Whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;

(i) Internal Control System

As per SA 200, Internal Control System refers to all the policies and procedures adopted by the management of the entity to assist in achieving management's objective ensuring the orderly and efficient conducting the business, the accuracy and completeness of accounting records, the timely preparation of financial information, safeguarding of assets of enterprise and defection of fraud and error in a timely manner.

(ii) Extent of Reporting

It may be noted that obtaining an understanding of internal control system is a normal audit procedure. As per SA 315, the internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly evaluated. While the requirement of the Order is confined only to the internal control system as regards purchases of inventory, and fixed assets and the sale of goods and services, it does not in any way reduces the responsibility of the auditor to examine other areas. It only signifies that while a special attention is required for the reporting on specified items of this clause, but to ensure a true and fair view of the financial statements, the examination of internal controls has to be extended to all the other areas.

(iii) Major Weakness

The Order does not define as to what constitutes 'major weakness.' Thus, it may be interpreted that major weakness depends upon the facts and circumstances of each case. For this, an auditor has to exercise his professional judgment. One view may be taken that any weakness in internal control which exposes the enterprise to a risk of significant loss is material weakness. Another view may be that a weakness in internal control exposing an organisation to the risk of material misstatement(s) in the financial statements is major weakness. It may be noted that while evaluating what is major weakness, the concept of audit materiality should always be given due consideration. It should also be noted that adequacy of internal controls and major weakness should be considered as distinct aspects of this clause, i.e. it does not mean that if there are no major weakness in internal control system, then the internal control system is adequate.

(iv) Adequacy of Internal Controls

As per SA 200 read with SA 315, the auditor should obtain an understanding of the accounting system sufficient to identify and understand major classes of transactions, manner of initiation of transactions, significant accounting records, supporting documents and specific accounts in the financial statements and the accounting and financial reporting process. Accounting control comprises the plan of an organisation and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial controls. Internal control so far as financial and accounting aspects are concerned, aims at the following:

(i) Providing the flow of work through various stages.

(ii) There should be proper segregation of personnel duties so that no single person can be in a position to handle whole of the work from its beginning to its end.

(iii) Adequate documentation should be made at each stage of work.

(iv) The transactions are recorded with appropriate amounts and in timely manner and that too as per the applicable accounting policies and practices.

(v) The assets should be properly safeguarded.

(vi) The access to the assets should be restricted to only authorised persons.

(vii) Existence of organisational chart would help in fixing responsibilities.

(viii) Building up of a system to locate the deviations and departures from the prescribed procedures and to detect the frauds and errors automatically without mush loss of time.

(ix) Standardized records and formats should be evolved. It would ensure availability of right information at right time.

(x) There should be an efficient Management Information System.

(xi) Minimization of loss and wastages.

(xii) Employees should be encouraged to do good work and comply with the procedures. Special attention should be given to the disgruntled employees.

(xiii) Adequate cut off procedures should be formulated so that the transactions of one period can be separated from the transactions of other period.

(v) Continuing Failure

This expression has also not been defined by the Order. What constitutes 'continuing failure' again depends upon the facts and circumstances of each case. For example, if the auditor has identified a weakness in the previous year and reported the same to the management, but it continues to exist in the current year, then it would constitute 'continuing failure.' Further, where the auditor based on the preliminary discussions with management, intimated the management of the major weakness at the audit planning stage at the beginning of the year, but the same was not corrected even at the time of issuing audit report, this would also constitute a 'continuing failure.'

(vi) Checklist and Specimen Reporting

1. On the basis of the understanding, documentation and validation thereof of the activities in the areas of Inventory cycle, property, plant and equipment cycle, revenue and receivables cycle, review of internal audit reports whether satisfied that there is an adequate internal control system commensurate with the size of the company and the nature of its business for the purchase of inventory and fixed assets and for the sale of goods and services;
2. If not, document the inadequacies and weaknesses thereof and consider implications for reporting;
3. Review the reports of internal audit, minutes of the Board, Audit committee, management committee, if any and any other relevant internal reports to identify major weaknesses in internal controls and whether there is any continuing failure to correct such weaknesses;
4. In the case of continuing failure to correct any major weakness identified, report the weakness and steps taken by the management to correct such weakness, if addressed subsequent to the balance sheet date or the fact of failure to correct such weakness;
5. Consider the implications of such control weaknesses on the nature, extent and timing of audit procedures in those areas and implications, if any, on the adequacy or reliability of the books of account and the overall report.

Applicability of CARO Report

Ministry of Corporate Affairs has deferred the applicability of CARO 2020 from the financial year commencing from 1st April 2021 instead of 1st April 2020 as per its notification of 17th December 2020. It was done to ease the burden on companies and their auditors for the year 2020-21 amid corona virus disease (Covid-19).

Applicability of CARO Report: companies

CARO 2020 applies to all companies, including any foreign company, except for the followings:

- One person company (OPC) as defined in clause (62) of section 2 of the Companies Act, 2013
- Small companies (Companies with paid-up capital less than or equal to ₹50 lakhs and with last turnover less than or equal to ₹2 crores)
- Banking companies as defined under clause (c) of Section 5 of the Banking Regulation Act, 1949
- Insurance companies, as defined under Insurance Act, 1938
- Companies registered for charitable purposes under Section 8 of the Companies Act.
- Private companies with gross receipts or revenue (including revenue from discontinuing operations) of more than ₹ 10 crores as per financial statements during the financial year.
- Private companies with paid-up share capital and reserves and surplus not more than ₹1 crore as on balance sheet date, i.e., at the end of the financial year.
- A private company that is not a holding or subsidiary of a public company.
- A private company that does not have total borrowings of more than ₹1 crore from any financial institution, including banks, at any point time during the financial year.

Internal Audit in Companies under Manufacturing Sector

15.7

Internal Audit of Manufacturing Company

Purchase, Store, Production, Sales, Marketing, Security, Lab, are important department of every Manufacturing Company, Internal audit have big role to analyze for smooth functioning of every department. Here is brief function of Internal audit of Manufacturing Company:

Annexure - I

Production

Risk	**List of Controls**
Production Planning	
1. Untimely production as compared to the marketing requirements resulting in holding of inventory 2. Excess/short production as compared to plan 3. Loss of production due to non-consideration of sales forecast/raw materials availability	Timely compilation of Production budget/plan for each of the product variety (e.g OPC, PPC, Non-Trade etc.)
	Pre-defined authority level for review and modification in the production plan
	Periodic review of Production Plan vis-à-vis changes in Sales Plan or availability of raw materials & documentation thereof
	Compilation & documentation of reason-wise analysis of actual consumpt3ion vis-à-vis standard consumption
	Shift-wise production data logging in place
Consumption standard/norms & actual consumption	
Excess production cost due to excess consumption of raw materials, ingredients , utilities or high process wastage	Compilation of documented consumption standards i.e BOM
	Periodic comparison of actual capacity utilization
	Review of periodicity of comparison of actual consumption and standard consumption and compilation of reason-wise variance analysis for deviation in consumption
	Identification of controllable and non-controllable factors resulting in variation in the consumption norms and department's action plan to remedy the controllable factors
	Verification of overall material reconciliation highlighting total material consumed, standard input-output norms and actual

Capacity Utilisation	
1. Opportunity loss due to inadequate capacity utilization 2. Excessive utilization of production capacity 3. Interruption in production process	Periodic comparison of actual capacity utilization with the synchronized 'sales plan'
Documentation & record maintenance:	
1. Inadequate documentation of prodn. data/results, may result in incorrect decision or non availability of timely information 2. ambigous authority levels /access for generation of production documentation resulting in unauthenticated generation of production data	Compilation of Daily Production Report from DCS & its validation by the authorized personnel
	Periodic review of conformance to the ISO requirement
	Pre-defined authority levels to generate, add, and modify production data in DCS/SAP
Quality control and inspection report:	
1. Absence of standard quality control parameters resulting in sub-standard production/ high re-work cost 2. Non-standardized Inspection Reports resulting in inconstancy in inspection of parameters	Standard Operating Procedures for quality control and inspection including in-built process controls
	Review of QC norms periodically to ensure their validity
	Adherence to the pre-determined sampling techniques & exception reports for the results deviating from the QC norms
	Review of complaints received by the Production department pertaining to quality/quantity of cement sold in the market or lying at godown/s
	Customer-complaints closed in time for amicable solution
	Engagement of external agency for quality validation are approved and reports are reckoned to pre-empt possibility of quality non-conformity issues.
	The process for re-working QC failed products exists after obtaining due approval from appropriate authority against QC failed product.
	All products are bagged after the same being qualified for /passed by QC
	Variations over standard Bag consumption is measured and monitored
Review of process losses and recycling	
Excessive process losses or inadequate recycling of materials due to improper monitoring of process parameters	Process loss incurred during the period are compared with the standard
	System exists of analyzing the reasons for abnormal process losses, if any and documentation of remedial action plan
	Identification of quantity of material non-conforming to the specification and sent for recycling.
	Preparation of comparative analysis of percentage increase or decrease in the recycling materials and reasons thereof

Preventive & break-down maintenance:	
Non-adherence to the preventive maintenance schedule resulting in process bottleneck / plant shut down/ loss of production.	Compilation of preventive maintenance schedule & its adherence
	Compilation of report on breakdown maintenance and opportunity loss of production are measured
	Ascertainment of the impact of breakdown maintenance on the production schedule
MIS Reports	
1. Inadequate MIS reports resulting in unauthenticated/ unreliable production details resulting in improper decision 2. Inconsistency in compilation of production reports due to non-standardized definition of periodicity	Compilation of MIS reports from the source data & their approval by the authorized personnel

Deployment of Workmen on Contractual basis

Risk	List of Controls
Assessment of requirement and approval	
1. Unskilled labour engaged at the rate applicable for skilled labour; 2. Labour called without requirement for the same; 3. Jobs to be done not approved by appropriate authority; 4. Actual engagement not in tandem with requirement	Skill profiles of labourers are available/maintained and Job Requisitions raised against the specific skill requirement availability.
	Requisitions are raised with job description indicating requirement (number. of heads) for manpower.
	All job requisitions are approved by appropriate authority.
	Excess/short engagement in comparison to Requisition is traced, compared for deviations with reasoning.
	Purchase/Service Orders are released against approved Requisitions.
Selection of Contractors and their approval	
1. Non-statndard P.O terms; 2. Un-competitive rates; 3. High Rates; 4. Delay due to nonavailability of Contractor, who can handle the assignment	Standard order terms as to job nomenclature, payment terms etc. are maintained.
	Contractors for a job is selected on competitive basis.
	List of Contractors are maintained for jobs on offer and addition/deletions are considered on approval by appropriate authority.
Labour identification and authentication	
1. Ghost Workmen; 2. Same workmen deployed by multiple Contractors	Each labour is traceable against identification/ employment number with photograph.
	Periodical "parole" to identify dummy workmen is conducted by HR and Engaging Dept..
	Change/transfer of workmen from one Contractor to another is traced and records updated accordingly.

Wage agreements and adherence	
1. Un-competitive /high rates; 2. Rates applicable are higher than prevalent local rates; 3. Non-update of labour rates for a long time	Systematic study as to rate contract fixation is carried out periodically and rates finalized accordingly.
	Benchmarking with local rates for pricing/labour contract rate is carried out.
	Effectiveness of fixed rate schedule verified periodically and it's validated from time to time.
	Labour rate agreements with Unions against specific skill/trade etc. are validated from time to time.
Fulfilment of safety requirements	
1. Unsafe working environment; 2. No formal training to safe work mode; 3. Inadequate training and follow-up resulted in non-adherence to safety rules/ guidelines	Details of safety training to be imparted to Contract Workers with varied skill/ work engagement is documented.
	Safety Dept. certifies the training completion of the workmen before allowing to work/job.
	Adequacy of safety requirements are validated from time to time for ensuring compliance.
Engagement - Requirement vs. Actual	
1. High rates due to dependency on single Contractor; 2. Un-benchmarked rates; 3. Dismal 'work permit' mechanism; 4. Uncertified jobs paid for; 5. Booking for labour supply and turnkey engagement for the same workmen; 6. Uncontrolled entry-exit mechanism	List of multiple Contractors as per engagement in different Job area is available.
	Rates applicable are benchmarked and applied for rate fixation/PO.
	'Work permits' are issued with predetermined strength required for the job and maintained in seriatim.
	Work permits on job completion are signed-off and jobs in Contractor Bills be traced therefrom.
	Actual engagement is certified by the engaging Dept.
	Same contractor workforce is not allowed to work under 'turnkey' as well 'labour supply' to pre-empt possibility of multiple booking against same attendance.
	Lower or higher engagement against requirements or extra time required/ booked is compared and deviation with reasoning documented.
	Gate Security certifies entry/exit of workmen or "time recorder "and the same tallied with billing/hours booked/claimed.

Bill Payment and booking	
1. Non-deduction for drawing Co. material; 2. Attendance record not verified causing excess payment; 3. Penalty not inflicted; 4. Wrong passing of bills resulted in extra payment to Contractors; 5. Quality of jobs performed not reflected in certification as well payment; 6. Performance guarantee/ BG/SD not applied on Contractors for poor quality of jobs	Reconciliation of materials supplied to Contractors and passing on of appropriate impact against their billing is ensured before payment. System as to verification of 'Attendance Record' of the labourers maintained by Contractors and reconciliation with time billed/ engaged, for actual booking and that paid by the Contractor exists. Penalty for non-fulfilment of contractual obligation i.e. delay, quality adherence etc. are duly accounted for. Checks are carried out before making payment of bills as to : Rates, Attendance, Job, Quality etc. All appropriate taxes are levied / deducted and deposited in time. System of collecting Security Deposit or 'performance guarantee' or 'bank guarantee' to bind the contractor against quality issues exists.
Legal compliances under labour laws	
1. Relevant licenses (by Company as well as Contractor) not obtained; 2. Failure in filing statutory returns; 3. Engagement over stipulated working hours; 4. Breach of statues in engagement/ payment/ Factories Act	System in place to ensure necessary Licenses under relevant laws prior to engagement is obtained by the Contractor. All necessary returns are filed timely by the Company. Engagement of labourers over stipulated hours are tracked. Overtime work is regulated through adequate and timely supply of labour at the 'job area' All Applicable statues e.g Minimum Wages, Factories Act etc. are followed and adhered to.
Principal employer's liability	
1. Wage distribution not certified; 2. Workforce interest not protected by Principal Employer; Fines/ Penalties may be inflicted by appropriate authority	Lack of proof for payment to workmen P.F, E.S.I (Employee State Insurance) and other statutory dues are monitored by HR/ Admin. to ensure timely deposit and protection of workforce interest.

Fixed Asset

Risk	Controsl
ASSETS MANAGEMENT POLICY/DOCUMENTATION/SOP	
Policy/SOP for fixed assets not available	Documented SOP's for fixed assets
CAPITAL BUDEGT & APPROVALS	
Capital Expenditure Policy not available	There is a Capital Expenditure Policy highlighting the procedures to be followed for estimation of Capex & pre-defined authority for sanction of the Capital Expenditure budget with value limits.
Inaccurate estimation of capital expenditures	Estimation of capital expenditures /sanction approved.
Technical & commercial feasibility studies not done	Technical & commercial feasibility studies are done before initiation of the specific Capex proposal.
Unauthorised capital expenditure	The Capex is approved as per DOA.
Excessive delays	There is an internal mechanism to ascertain tracking of capital proposals till raising of POs to identify excessive delays.
FIXED ASSETS REGISTER	
Missing Assets	A register of all fixed assets (including fully depreciated assets) is maintained and updated.
	There is adequate description of all assets to identify assets physically available.
	The FA Register is periodically reconciled with the financial records.
No Policy/SOP on physical verification	SOP is established and all procedures are complied with.
	Physical verification of assets is carried out every year.
Company's assets physically not available	There is a set procedure for verification and confirmation of fixed assets lying with third parties.
Discrepancies observed during physical verification not adjusted.	All discrepancies are adjusted after taking approval as per DOA within time.
Title deeds not available	Physical verification of title-deeds is carried out periodically by officers not connected with assets accounting/assets administration.
Assets not being used	Periodic verification of Assets not in use is being done.
FIXED ASSET ADDITIONS	
Purchase of asset not authorised properly/ Non tracking of indent	Request for capital expenditure from user is received in standardized form. There is a separate identification number for each form.
	Formal documented approval as per DOA
	For every acquisition, Purchase order giving full details of fixed asset requirement.

	Every P.O. authorised as per DOA
	Actual transaction is as per P.O.
Lack of audit trail in ERP	Availability of audit trail in ERP/ SAP for all transactions
Unauthorised master record of asset	Master data (class, useful life, rate of depreciation) of new asset created subject to approval
Asset capitalised at WIP stage	Capitalisation only on the basis of 'put to use certificate' by proper person (technical person) only after inspection
Actual utilisation exceed the budgeted allocation	Approval as per DOA is obtained wherever actual utilisation exceed the budgeted allocation
No clear and correct distinction between capital and revenue expenditure	There is clear and correct distinction drawn between capital and revenue expenditure
Unduly delay in installation/commissioning/commencement of warranty	Reasons are documented for delay in installation/commissioning/ commencement of warranty.
VALUATION OF ASSETS	
Wrong valuation of assets	System to ensure that cost consist of purchase price, import duties (if any), other non-refundable taxes & direct attributable cost for bringing the asset to its working condition for its intended use.
	Self-generated asset consist of direct as well as allocable factory expenses allocated on systematic basis.
Wrong valuation of assets	Fixed assets are revalued on adequate independent evidence.
SALE OF ASSETS	
Possibility of sale of performing assets	Disposal request from user.
Unauthorised sale	Approval as per DOA
Items replaced, scrapped or sold not removed/written off.	Items replaced, scrapped or sold are removed / written off from the books?
Profit or loss on sale of fixed assets	Profit or loss on sale of fixed assets is properly disclosed in the accounts
MOVEMENT/TRANSFER OF ASSETS	
Loss of asset / non accountability of asset	The standard form filled by user as well as sending and receiving locations.
	There is a system to track the assets transferred on a temporary basis.
Unauthorised transfer	Transfer of asset should be approved as per DOA.
Transfer not recorded in books	Transfer is properly recorded in the books.
IDENTIFICATION OF IDLE ASSETS	
No system to identify idle assets	Documented process in place to identify the idle assets
	Identification always from user documenting the reason to classify asset as idle asset.

WRITE OFF OF ASSETS	
Write off approval for shortage/ missing asset is not obtained	Write off note for any shortage/missing asset is put up for approval as per DOA.
CAPITAL WIP	
Delay in capitalisation leading to deferment of depreciation charge. Under statement of F.A. / depreciation	Capitalisation of asset within two days of its ready to use certificate obtained
	Ageing analysis to find out old WIP & reasons for non- capitalisation
	Projects scrapped is charged off.
CAPITAL ADVANCE	
Advance is given to unauthorised vendor	Request from vendor for capital advance, which should be approved as per DOA
	Analysis of vendor history before granting of any advance
Non availability authentic documentary evidence	Signed agreement for purchase of fixed asset mentions all the terms including advance to be given
	Analysis of unadjusted advances.
Excess payment to capital creditor	System to check any balance in advance account before making any payments.
SECURITY OF ASSETS	
Company's asset not properly Safeguarded	Controls to ensure Physical Safeguarding of Assets.
Company's asset wrongly owned by third party	All invoices/registration cards (for motor vehicle)/title deeds(for land, building etc.) clearly specifies the TCL ownership.
Encroachment of land	Adequate provisions to protect the asset from encroachment.
TRACKING OF INTERNAL RATE OF RETUR	
Gaps between the projected	Analysis of asset performance
NPV/IRR and actual asset performance	against the projected NPV/IRR is being done.
	Reasons for gaps between the projected NPV/IRR and actual asset performance are documented.
STATUTORY-COMPLIANCES	
Non identification of Impairment to the asset	Documented & approved process in place for identification of Impairment & implementation of same
	Periodical review of the assets for the impairment.
Non-compliance with Companies Act	Depreciation is charged as per provisions of the Companies Act.
No/under cover of insurance for Assets	Sum insured justifies the replacement value of Assets

Sl. No.	Functions
1	**Plant Operation**
(a)	Yield-Machinery, Manpower & Material
(b)	Budgeted Variance of Production
(c)	Power Analysis
(d)	Labour Analysis
(e)	Production Delay due to unavailability of Resources (Material, Labour, Machinery & others)
(f)	Capacity Utilisation of Machine &Labour
(g)	Transit damaged Material
(h)	Abnormal Losses, if any
(i)	Quality Audit of Inward and Outward
(j)	Review of Man Power Allocation Planning
(k)	Review of Plant HR Policy-Labour Policy
2	Security
	(i) Security Register Abnormal Report Review (Shift Change)
	(ii) Rotation of Security Staff
	(iii) Insurance of Machinery Labour, Factory, Vehicle & Cash in Transit
	(iv) Input & Output Matching with Inward/Outward/Dispatch/Tally etc.
	(v) Audit of Security Gate Process

Sl. No.	Functions
2	**Purchase**
a	Review of PO Made during the Period
b	Listing of unauthorized Purchase as per Power Limit
c	Review of Contract Made during the period
d	Review of Vendor Selection Process
e	Review of Vendor Payment Policy
f	Overdue PO
g	Vendor Performance
h	Review of Forward Contract
Sl. No.	**Functions**
3	**Stores Audit**
a	Inward /Outward of Store Register with Gate Records
b	Review of Inward & Issue Activity
c	Adhoc. Audit of Bin Card Maintenance
d	GRN Date vs. Security Date Review

e	Review of Quality Control Of Stores items
f	Review of Store Management
g	Review of Action taken on Short Delivery
H	Review of Slow/Non-Moving Stock
I	Minimum order Quantity Review
Sl. No.	**Functions**
4	**Statutory compliance**
A	Excise Register Matching with Inward & Outward
B	Job work Register
C	TDS Deduction Practice
D	Review of GST
E	Foreign Payment Review
F	PF & PT Review
G	Cases Pending Under Negotiable Instrument Act

Sl. No.	Functions
5	**ROC compliance & Corporate Governance**
a	Review of Minute Books
b	Review of Filing
c	Review of Power Used by Company Officer
d	CSR activities
e	Any Non-Compliance as per Companies Act
Sl. No.	**Functions**
6	**Ledger Scrutiny**
Sl. No.	**Functions**
7	**Cash & Bank Review**
a	BRS
b	Physical Verification Cash
c	LC Discounting & Charges
d	Interest & Charges Review
e	Stale Cheque Report
f	Cheque Bounce Report
g	Fund Management
Sl. No.	**Functions**
8	**Corporate HR & Payroll**
a	Application of HR Policy
b	Review of Reimbursements
c	Review of Grievances
d	Status of Vishakha Committee Report Implementation

e	Surprise Head Count as per attendance Report
f	Reconciliation of Employee Loan & Advances
g	Review of Staff Welfare (Medical, working Environment, Staff Motivation, Training)
h	Late Coming Report
i	Performance Review of System, Policy & Technology
Sl. No.	**Functions**
9	**Audit of Exp.**
a	Verification of Bills with ERP
b	Approval Review of Bills
c	Review of Bill Supporting
d	Review of Debit Note-To be Raised
e	Trend Analysis according to Sales/Production
f	Forex Gain/Loss Calculation
Sl. No.	**Functions**
10	**MIS Authenticity**

Sl. No.	Functions
11	**Audit of Sales**
a	Verification of Bills with ERP
b	Review of Bill Supporting
c	Review of Credit Note-To be Raise/Raised
d	Review of Transport Challan Attached with Invoice
e	Penalty & Price Variation Review
f	Budgetary Performance
g	C & F Form Status
h	Utilisation of Advance Authorization Licenses
Sl. No.	**Functions**
12	**Marketing**
a	Customer Complaint Addressal Review
b	Target Performance-KAM
c	Debtors Performance-Ageing
Sl. No.	**Functions**
13	**Business Analysis**
a	Industry Overview-Future Prospect of Business
b	Ratio Analysis -In comparison with Industry
c	Technology Review
d	Costing & Pricing of Product

Sl. No.	Functions
14	**Capex**
a	Capex Bills Review
b	Capitalization Checking
c	FAR Checking
d	Barcode & Tagging Status
Sl. No.	**Functions**
15	**Overview Assurance on Internal Control**
Sl. No.	**Functions**
16	**Transporting & Logistic**
a	Review of Transportation Contract & Rate
b	Transportation Expense & Pooling Review
Sl. No.	**Functions**
17	**Follow up of Previous Audit**
Sl. No.	**Functions**
18	**Stock Audit**
Sl. No.	**Functions**
19	**Any other area Requested by management**

Purchasing: a high-risk area subject to fraud – where an organisation spent a significant amount of its money and can heavily impact the company's quality, Environmental & safety objectives & targets. It is the first and most basic nature of expenditure, that any manufacturing company is required to incur, which is in direct proportion to their manufacture/production activity. Hence audit of this area for a manufacturing organisation if of high importance and care to be taken while auditing this area.

During the preliminary survey, the auditor should gain an understanding of how purchasing occurs within an organisation.

Audit Objectives/Checking:

- Requisition Note – An internal company document used in the purchasing process to authorize the requisition of materials prior to initiating a purchase order. Purchase indents are audit documents used to track the movement of materials prior to their receipt by the buyer.
- Each Purchase made should be supported by a proper Requisition Note, which is properly authorised by the concerned Authorised Person & to check the adequacy, authenticity and completeness of indents w.r.t. cost benefits, desired information, back papers.
- If there are delays in receiving the intends and raising of P.O., then identify the reason for the same & report.
- The PO must have required terms & conditions mentioned on it, such as Expected Delivery date, Payment due date, Advance to be given if any. All such terms, mentioned on PO must be strictly adhered to.
- Item, quantities, or other information relating to the order may be incorrectly recorded on the input document resulting in the requesting department/personnel not getting the material as per requirement.
- Compare purchase order prices with vendor catalogues after obtaining at least three vendor's quotation. And

in case of purchase from a sole supplier or t higher rates, then obtain adequate justification and authorization.

- Any advance payment to the vendor should be properly authorized Invoicing is being done as per P.O. Orderand Quotations.
- Identify the various types of purchasing transactions and document the flow of those transactions throughout the organisation & prepare a computer system flowchart and review it with the data processing project leader.
- Ensure that there are sufficient controls to monitor the receipt, storage and issue of material in the storesdepartment.
- All receipts of goods must be recorded in two different stages:
  - At Unit/factory Gate (Goods Inward Register with the Gate-keeper)
  - Before entry in the Stores (Goods Receipt Note – GRN)
- The above books must be properly reconciled and the entries in both the above-mentioned records should be exactly the same, in terms of date, quantity, quality of items received and party names.
- In case unauthorized goods or services accepted by the company, thus, obligated the company to pay for unwanted items, hence receipt of goods to be verified properly.
- The Vendor has billed the company as per the quotations / negotiated rates.
- The payments for these purchases are made as per the authorisation and within due dates.
- All purchases, receipt & issue of material and payments are accounted for in the books of accounts properly under proper ledger accounts.
- The controls in the purchasing department must be capable of generating appropriate documents at each process level. Thereby documenting the complete purchase process.
- The issue of material must be supported by MRN (Material Requisition Note), approved by the respective departmental head.
- Proper Stock levels must be maintained & Stock must remain insured at all time.

Auditing is a big ocean of ideas and concepts, it is very difficult to draw a complete packaged audit program, so above is an overview for the audit of Purchase Department of an organisation.

Solved Cases

Case Study 1. High RM Consumption Variance – President Production

Points Need to Know:

1. History of BOM for each of the Product.
2. BOM Approval Authority.
3. Any change in major Production Equipment.
4. Any change in Production Process of a Product.
5. Feeding of RM – Manual or Mechanized and any changeover? If so from which Date.
6. Changeover Note for BOM change and approval authority.

7. Actual consumption recording Process and any change made?
8. Whether up-keep/Storage of RM remained same all throughout the period?
9. Whether Production Orders are closed at the end of each run?
10. RM Quality remained constant/same in last couple of years.
11. Booking for consumption i.e how consumption entry is passed?

Production of ‘P’ started from February 2022, since then the BOM change made for 12 times and significantly RM- & RM-2, the two mother RM BOM consumption varied between 5% to 75%. We are given to understand that the RM Quality yet to be finalized, which causing significant variation in actual consumption.

RM- X, used in ‘Product Q’ in place of RM-3 due to sudden spurt in price by about 50% (₹380 Per Mt. to ₹575/- per Mt.) However, BOM yet to be prepared/modified for introduction of the new RM since June 2022.

New Waterbase coating Raw Material is in use on trial basis since last six months. The Oilbase RM is also in use. However, same Product Code is used for booking consumption of both and units produced also not separately recorded.

Since the FG passes through various production processes and each process consumes Raw Materials of fixed volume as per BOM. However, month closing date exercise carried out for different processes not identical and varied between 25 to 31 days. In Process i.e Semi Finished Product volume varies significantly, which in turn causes high variance in consumption when compared with BOM.

W.R.T six Products (A, B, C, X, Y, Z) the BOM consumption was fixed based on manual dozing for which about 10% handling loss was considered. Since last two years, OLBC (Over Land Bulk Conveyor) is in use, which caused losses even less than 1%. The change not given effect in BOM.

In the BOM Database maintained in SAP, multiple BOMs are available for the same Product. The Production Team and approver consider any of available ones not the particular one used. The multiple BOMs having same RM specification varying between 3 p.c to 13 p.c weightage. This caused significant variation with actual consumption.

BOM authorization process was to be there before booking consumption against the related BOM. However, despite elapse six months, some of BOMs in use are yet to be approved.

Case Study 2. Inventory Accumulation

Background

Unfortunate Limited with three Plants located at Uphill, Downhill and Hill. All the Plants are pretty old, except Hill Plant. Hill Plant started operation since 2012. The Management is now facing a huge Working Capital blockage in Inventory worth Rs. 666 Crores. Annual turnover hovers around Rs.5000 Crores.

Highest accumulation reported by the new Plant i.e worth Rs.355 Crores, out of the three. The Company having a valuation policy. As per Policy, more than 5 year old inventory to be value at 10% of cost and balance at Cost. Slow and Non-moving inventories are categorised for holding over 5-years. In last 8 years, no liquidation action for accumulated inventory was considered by the Management.

Management wants that IA Dept. to point out reasons for accumulation and necessary steps to pre-empt possibility of further accumulation. Moreover, steps for unlocking value also need to be decided as per guidance from IA

Dept. The Report to be discussed with Audit Committee in the ensuing meeting. Hence, the Report to be submitted by 31st August 2022.

Root Cause

- Lack of control over Project surplus items – accumulated value ₹22 Crores.
- Stock position of one Plant is not visible to other Plant/s. Uphill continuously procuring 11 such items, which are not in use since last 7 years at Downhill Plant. Such accumulation at Downhill worked out to ₹44. Crores.
- On introduction of four new products viz. NP, PN, P and N in 2018 at all the three Plants simultaneously; the Raw Materials of earlier blockbuster Products namely BP, OP, HP, GP remained at hand. Accumulated value stood at ₹55 Crores.
- Pumps, Motors, Generator, Power House etc. received as replacement against failed Equipment within 'Warranty Period', considered in Books as fresh procurement. Value of such wrong entries worked out to ₹33 Crores.
- Physical verification reveled, Material and Spares having book value amounting to ₹22 Crores not in existence. Last issue date was recorded in ERP Database not even more than 3 years old. We are informed by Stores In-charges of respective locations that the same items recoded as missing, mishandled.
- Storage of raw materials was to be made properly. We have noticed, huge piles of Raw Materials in mixed-up condition. Segregation and recovery is remote and can't be used used in production due to quality, performance will not match expectations. As per Book records, value of such mixed-up inventory worth ₹44 Crores. The item codes found in mixed-up condition, was inwarded frequently and used in Production.
- Undefined Stock level (Minimum, Maximum, Re-order and Average), causing accumulation. Based on average annual consumption level, at least 111 item Codes having more than 4-years inventory at hand valuing ₹222 Crores (each item code holding more than ₹1.5 Crores each).
- Spare Parts worth ₹55 Crores not recorded in Books as Inventory, shown as transit for more than two years. Advance payment to Vendors already made for the same.
- Material Sent for Outside Processing (MASOP) worth ₹88 Crores, yet to be accounted, despite aged over 3-years.

As part of our review process, we have circulated the presentation with necessary documents and discussed at length the 'Actionable Points'. The 'Actionable Points' are circulated separately.

Action Plans

- For easy identification and making plan for use in future Projects/requirement, Project surplus items need to be codified separately with regular item code reference in ERP.
- View only access to be given to all who are authorized for releasing PR (Purchase Requisition) for assessing stock of the required item Code at other locations. Excess stock at other locations need to be reckoned before Ordering for liquidation and usage in other location.
- New Product introduction to be made only after getting clarity /clearance from COO on consumption of RMs required for the old FG. If required, sometime gap may be fixed for the purpose.
- Necessary rectification/value adjustment to be carried out for replaced item received against Warranty.

- Periodical physical verification process need to be strengthened to avoid 'surprise' w.r.t missing items. Movement of men, vehicles through security gate requires special attention to preempt possibility of theft.
- Identified storage location for bulk items , Bins for Spares to be created to avoid mix-up. Necessary wall, dividers to be made available for proper storage.
- Average consumption trend with max. safety cushion for order time lag of a month to be considered for Order level. Inventory levels to be fixed for all items.
- In-transit and returnable items to be investigated for proper resolution. Maximum period of 60 days from the issue date to be allowed for closing the matters appropriately.

Sum Up:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal auditing is a catalyst for improving an organisation's governance, risk management and management controls by providing insight and recommendations based on analyses and assessments of data and business processes. With commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. Professionals called internal auditors are employed by organisations to perform the internal auditing activity.

Charging Provision:- Section 138 of Companies Act, 2013: Such class or classes of companies as may be prescribed in Rule 13 of the Companies (Accounts) Rules, 2014 shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

Applicability

- Every listed company and unlisted public company having paid up share capital of 50 crore or more, turnover of 200 crore or more, outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore, outstanding deposits of 25 crore or more at any point of time during the preceding financial year
- Every private company having turnover of 200 crore rupees or more, outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year

Exception: In case of Specified IFSC Public Company and IFSC Private Company - Section 138 shall apply if the articles of the company provide for the same

Objectives

- To protect the interest of the various stakeholders like customers, employees, revenues, management, environment, Directors & officers of the company.
- To avoid any unwarranted legal action by the law- enforcing agencies and other persons as well.
- To ensure better compliance of laws and enhanced corporate governance.

Benefits and Beneficiaries: Benefits of Internal Audit are Manifold and its Beneficiaries including company itself are many like:

- Management
- Promoters
- Directors
- Government Authorities
- Investors
- All Stakeholders

Scope of Internal Audit: The scope and functions of internal audit is not been defined in Companies Act, 2013 & not in the rules prescribed. The Audit Committee of the company or board shall, in consultation with the internal auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

The report of the Board of Directors of the company falling under the provisions shall contains the details in respect of adequacy of internal financial controls with reference to the financial year.

The scope of internal auditing within an organisation is broad and may involve topics such as:

- Organisation's governance
- Risk management
- Management controls over efficiency/effectiveness of operations (including safeguarding of assets)
- The reliability of financial and management reporting
- Compliance with laws and regulations
- Proactive fraud audits to identify potentially fraudulent acts
- Participating in fraud investigations under the direction of fraud investigation Professionals
- Conducting post investigation fraud audits to identify control breakdowns and establish financial loss.

Internal auditors are not responsible for the execution of company activities; they advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities. As a result of their broad scope of involvement, internal auditors may have a variety of higher educational and professional backgrounds.

Eligibility: Internal auditor can be either an individual or a partnership firm or a body corporate which may or may not be the employee of the company. Thus, an employee of the company may be appointed as an internal auditor of the company and every registered member of the Institute of Company Secretaries of India (CS) or Institute of Chartered Accountants of India (CA) or Institute of Cost Accountants of India (CMA) & firm. of Company Secretaries or Chartered Accountants or Cost Accountant can be appointed as an Internal Auditor of Company.

Exception: Statuary auditor appointed under section 139 of this Act cannot be appointed as an Internal Auditor in the Same Company.

Power and Duties of Internal Auditor: The duties and responsibilities of the internal auditor depend on the size and technology of the organisation.

1. To access the books of accounts and other relevant vouchers at all time during the course of Audit.
2. Right to information & explanations from the officers of the company on various transactions and decisions of the company whether financial or non-financial.

3. To verify from the books of the company that whether loans and advances made are secured or not.
4. To form a view of the true and fair view of the affairs of the company.

Main Duties of an Internal Auditor:

The internal auditor shall:

1. Execute a wide range of audits and reviews in a diverse and highly computerised environment
2. Provide an independent, objective assurance and consulting service to management, with the principal aims
   a. Of evaluating and improving the effectiveness of risk management, control and governance processes;
   b. Make recommendations on increasing operational efficiency, having regard to value for money auditing;
   c. Agree the annual audit plan with the Chairman prior to approval by the Audit Committee
3. Ensure compliance of various laws applicable to corporate with the aim of enhanced corporate governance.

Internal audit is always in the better interest of every corporate management as, an independent professional will manage & certify that the company has carried out all the necessary compliance required under Companies Act, 2013 and which builds an fair image in the minds of all the Stakeholders, Government, Investors etc.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Financial auditor submits reports to the
   (a) Shareholder
   (b) Board of director
   (c) Debtors
   (d) Employees
2. Auditor finds that there is change in the method of valuation of stock whether he should
   (a) Allow it
   (b) Disallow it
   (c) Allow it with a note to this effect
   (d) None of the above
3. Audit under any statute in a country is called
   (a) Final audit
   (b) Internal audit
   (c) Proprietary Audit
   (d) Statutory audit
4. CAATTS is also known as
   (a) Cost And Accounts Treatments
   (b) Computer Assisted Audit Tools and Techniques
   (c) Classification and Accounting of Tax Tools
   (d) Computer Aided Audit Tools and Techniques
5. Auditor has got no lien on
   (a) Audit Note Nook
   (b) Audit working papers
   (c) Books to Accounts of Client
   (d) Both (a) and (b)
6. Internal audit is conducted
   (a) Periodically
   (b) Throughout the year
   (c) Once in a year
   (d) Once in Five years

7. Test checking is done when there is an effective system of ________.
   (a) Internal control
   (b) Internal audit
   (c) Internal check
   (d) Both (a) and (b)
8. Treating revenue expenditure as capital expenditure is an example of error of
   (a) Principle
   (b) Compensating
   (c) Clerical
   (d) None of the above
9. Verification of assets involves a critical examination of
   (a) Ownership
   (b) Existence
   (c) All of these
   (d) None of the above
10. One of the major components of a government audit is/are:
   (a) Government Revenue
   (b) Union Budget and Control
   (c) Government Expenditure
   (d) Taxation and Fiscal Policies
11. There is no requirement for Audit Working Papers while conducting an audit and they only result in loss of time.
   (a) The Statement is Correct
   (b) The Statement is Incorrect
   (c) The Statement is Incomplete
   (d) None
12. Aspects may be taken into consideration for proper inventory control
   (a) Maximum, minimum and reorder level fixation
   (b) Fixed order quantity system and different replenishment systems.
   (c) Fast-moving, slow-moving and non-moving analysis, etc.
   (d) All of the above.

13. Qualities of a good Internal Auditor are/is
    (a) Right Attitude
    (b) Technical Expertise
    (c) Communication and other soft skills.
    (d) All of the above.
14. NGO(s) are incorporated under
    (a) Societies Registration Act, 1860
    (b) India Trust Act, 1882
    (c) As Section 8 Company
    (d) All of the above.
15. Who can be appointed as Internal Auditor as per the Companies Act, 2013
    (a) A Chartered Accountant
    (b) A Cost Accountant
    (c) Such other professional
    (d) All of the above
16. The management auditor shall consider in the evaluation of capacity utilization –
    (a) Method of measuring base machine capacity
    (b) Capacity measurement is based on "capital-output ratio" or sundry other factors.
    (c) Technical terminology like licensed capacity, installed capacity, rated capacity, etc. should be properly defined.
    (d) All of the above.

Essay Type Questions

1. ITC Ltd. organized a three-day International Conference of Accountants in Mumbai. You are asked to conduct an internal audit of the accounts of the conference. Draft the internal audit program for audit of receipt of participation fees from delegates to the conference.
2. You have been appointed as an internal auditor for M/s ELECTROCON Ltd which is a large manufacturing concern. You are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools, and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit program for the above.
3. What is an Audit program? What are the advantages of the Audit Programme?
4. Draft Internal Control Questionnaire Relating to Inventory.
5. What do you understand by Propriety Audit in the Context of Government Audit?
6. What are the points to be considered by the Management Auditor while determining the adequacy of the Budgetary Control System?

7. Discuss in brief regarding Summary Report to Top Management.
8. Draft Internal Audit Programme in respect of Wages.
9. Describe the need for capacity determination.
10. What are the factors to be considered by Cost Auditor while evaluating MIS?
11. Give an Audit program as an Internal Auditor of Wage Audit.
12. As per the Companies Act, 2013, which companies are required to conduct an Internal Audit?
13. Who can be appointed as an internal auditor as per The Companies Act, 2013?
14. What is the Role of Management in Internal Control?
15. Write a note on the "Audit Committee" under the Companies Act, 2013 in brief.
16. Which companies are required to constitute Audit Committees? What is its responsibility regarding the internal audit?
17. What are the qualities of a good internal auditor?
18. KPC Pvt. Ltd took a consortium loan in 2021-22 amounting to ₹ 80 crores of which State Bank of India is the leading Bank for setting up a new plant in Haldia. During the year 2020-21, its outstanding loan was ₹ 70 crores of which repayment was made in the year 2021-22 to the extent of ₹ 20 crores. Should KPC Pvt. Ltd. conduct an internal audit as per the Companies Act, 2013?

Answer:

Multiple Choice Questions

1.	(a) Shareholder
2.	(c) Allow it with a note to this effect
3.	(d) Statutory audit
4.	(b) Computer Assisted Audit Tools and Techniques
5.	(c) Books to Accounts of Client
6.	(b) Throughout the year
7.	(c) Internal check
8.	(a) Principle
9.	(c) All of these
10.	(c) Government Expenditure Audit of Government Expenditure is one of the major components of government audit conducted by the office of C & AG.
11.	(b) The Statement is Incorrect. Audit working papers are the record of the planning and execution of the audit engagement. Auditors retain a set of working papers for each audit engagement for each year.

12.	(d) All of the above. The following aspects may be taken into consideration for proper inventory control: 1. Maximum, minimum, and reorder level fixation 2. VED analysis 3. Just-in-time (JIT) purchasing 4. Fast-moving, slow-moving, and non-moving analysis.
13.	(d) All of the above. According to 'Technical Guide on Internal Auditing' by The Institute of Cost Accountants of India, Internal Auditors should have the following three traits: – Technical Expertise – Right Attitude – Communication and other soft skills. An Internal Audit team has to have representation from diverse professional fields in order to understand the organisation better.
14.	(d) All of the above. Non-Governmental Organizations (NGO) are generally incorporated as societies under the Societies Registration Act, 1860 or as a trust under the India Trust Act 1882, or under any other law corresponding to these Acts enforced in any part of India. NGOs can also be incorporated as a company under section 8 of the Companies Act, 2013.
15.	(d) All of the above. As per Section 138 of the Companies Act, 2013 an internal auditor, shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.
16.	(d) All of the above. Yes, the management auditor shall consider the following points in the evaluation and measurement of capacity utilization.

Audit of Different Service Organisations

16

This Module includes:

Audit of Different Service Organisations

SLOB Mapped against the Module

To develop detail understanding of the audit procedure in various service organisations with an objective to facilitate risk-based performance management and maximisation of value creation or minimisation of value destruction. (CMLO 1a, b)

Module Learning Objectives:

Currently, there is a substantially high level of potential for entrepreneurs to leave a mark with new service business ideas. Convenience-craving customers of today are searching for quicker and cheaper products or services that they can avail themselves easily. Today, the service sector contributes 55% to India's GDP. The popularity of the service industry stems from the fact that they are low-investment ideas. The break-even occurs comparatively sooner compared to other companies as a non-infrastructure-centred business in the start-up stage. After studying this module, the students will be able to –

- Identify the nature of the services provided by the service organisation and the significance of those services to the user entity
- Understand the nature and materiality of the transactions processed by the service organisation
- Analyse the effect of the transactions processed by the service organisation on the client's internal control

Introduction

16

A strategically orientated and structured internal audit function can play a vital role in assisting the Board of Directors, Audit Committees and management in achieving these business challenges. Internal audit can add value by:

- Focusing on risk areas through the participation in corporate governance and risk management processes.
- Evaluating and recommending process improvement opportunities.
- Researching best practices and making recommendations for change.
- Monitoring the implementation of management strategic actions.
- Organising itself as a cost-effective business unit. When designing an internal audit function, strategy must drive tactics, not the reverse.

Too often, the internal audit functions respond to immediate tactical needs. In a rush to implement responses, key strategic issues can be overlooked. The result can be a tactical internal audit function in search of a strategy.

Having discussed about Internal Audit and its concepts in the previous module, we now discuss in this study note how internal audit is to be conducted in various service organisations.

Audit of Hospitals

16.1

The following points are to be considered necessary for conducting an audit of Hospital.

(i) Check the letter of appointment to ascertain the scope of responsibilities.

(ii) Ownership and control of the institution.

(iii) Process (e.g admission, release, outdoor check-up, pathology and other test facilities, Operation Theatre facility, vaccination etc.) and related controls till revenue generation. Normally facilities not provided for other than cash terms.

(iv) Donation, Special Grant, Interest and/ or dividend income etc. to be validated through necessary supporting documents, should be vouched with reference to the Investment Register and Interest and Dividend warrants.

(v) Ensure purposive donations, grants etc. spent for the particular purpose only.

(vi) Clear distinction should be made between the items of capital and revenue nature.

(vii) Adherence to Standard Operating procedure w.r.t Expenses (Capex and Opex)

(viii) Verify the system of internal check as regards purchases and issue of stores, medicines , medical equipment etc.

(ix) Examine that the appointment of the staff, visiting specialist doctors, payment of salaries etc. for expenditure booking validation.

(x) Physically verify the investments, fixed assets and inventories.

(xi) Check appropriateness of capitalization and depreciation rates charged and value in Books.

Audit of Hotels

16.2

Quality of service is the essence of hospitality sector. It is a service-oriented industry. The business is characterized by handling of large amounts of liquid cash, sufficient stock of foods and raw materials for food preparation as per taste buds of Customers, ensure service delivery to satisfy Customers by providing a variety of services, and keeping watch on customers to ensure that they do not leave hotel without settling the dues. In view of these, the following matters require special attention by the auditor.

(i) **Internal Control**

Internal control system should address - revenue leakage; pilferage of food/utensils; prompt cash/bank collection process, appropriate billing as per service delivery and tariff, issue/consumption control, proper usage of Bar and other licence, procurement as per quality norm at appropriate market rate etc. Pilferage is one of the greatest problems in any hotel and it is extremely important to have a proper internal control to minimize the leakage. The following points should be checked:

(a) Effectiveness of arrangement regarding receipts and disbursements of cash.

(b) Procedure for purchase and stocking of various commodities and provisions.

(c) Procedure regarding billing of the customers in respect of room service, telephone, laundry, etc.

(d) System regarding recording and physical custody of edibles, wines, cigarettes, crockery and cutlery, linen, furniture, carpets, etc.

(ii) **Room Sales and Cash Collections**

(a) Grade-wise (Ordinary, Luxury, Super Luxury) Room tariff and booking as per Front Office and verification with Billing Desk to ensure appropriate billing for room-nights. Room Service (food drinks, laundry), Minibar (Fridge kept inside room with food, drinks and beverage) material, sports facility usage etc. recorded and billed appropriately for collection. There are various sales points scattered in a hotel and sales are both for cash and credit. The control over cash is very important. The charge for room sales is made from the guest register, and tests are to be carried out to ensure that the correct number of guests are charged for the exact period of stay. Any difference between the rate charged to the guests and standard room rent is to be investigated to see that it is properly authorized. Credit Card/Debit Card, Cash, Foreign Exchange and Cheque (special Corporate Bookings), RTGS/NEFT etc. to be tallied with Bill value.

(b) Daily room occupancy report, Check In – Check Out Record and Billing for occupancy to be validated on daily basis. The total sales reported with the total bills issued at each sales point have to be reconciled.

(c) Food Bills with KOT(Kitchen Order Token) and signed Customer copy as evidence for consumption, other facility charges with respective facility usage token as per prevalent tariff. Special care must be taken in respect of bills issued to customers who are staying in the hotel, because they may not be required to pay the bills immediately in cash but at a future date or by credit cards. Billing is to be done room-wise. It must be ensured that all customers pay their bills on leaving the hotel or within specified dates.

(iii) **Stock**

A. Utensils purchased, records for issue to Housekeeping/Kitchen etc. to be regularly updated and periodically verified. The stocks in a hotel like all saleable items, food and beverages need to be compared with Kitchen and other relevant records, consumption of raw items etc. These should be physically verified (with or without surprise element) at periodic intervals.

B. The following may be noted in this regard:

(a) Food procurement and Issue to Kitchen, KOT validation process with Guest Orders. Stale, outdated food to throw Bin also be recorded for reference. All movement and transfer of stocks must be properly documented.

(b) Store Keeper is responsible for all movement records to justify stock at hand. Areas where stocks are kept must be kept locked and the key retained by the departmental manager. A key holding register (shift-wise) to be maintained to fix responsibility w.r.t noticing mishandling at the time of verification, if any.

(c) Unauthorized persons should not be permitted in the stores area without specific permission.

C. Many hotels use specialized professional valuers to count and value the stocks on a continuous basis throughout the year.

D. Periodical physical verification and documented valuation process need to be adhered. The auditor should ensure his presence at least for part of the time during verification process to strengthen vigil. The Auditor to consider that all stocks are valued at the year end.

E. Fixed Assets Register with all necessary noting as to installation date, cost, description, life class etc. to be maintained and depreciation on reporting dates to be computed. The fixed assets should be properly depreciated, and the Fixed Assets Register must be updated.

(iv) Section-wise /Cost Centre-wise detail e.g manpower deployed, maintenance spent, wages, managerial expenses etc. to be maintained on regular basis for cost analysis and necessary help in decision making.

(a) Casual Labour: In case the hotel employs a casual Labour, the auditor should consider, whether adequate and accurate records have been maintained in this respect. Automated time recording facility is now available in most of the hotels and time clocked there collected for considering attendance.

(b) The wages payment of the casual Labour must also be checked thoroughly.

(v) Cost – Revenue comparison facility-wise (Swimming Pool, Golf Course, Spa etc.) to be monitored for service level assessment with recovery rate /change required to maintain service level.

The compliance with all statutory provisions, and compliance with the Foreign Exchange (FE) Regulations must also be verified by the auditor, especially because hotels offer facility of conversion of foreign exchange to rupees/Receiving FE from foreign travelers.

A. **Receipt and Payment verification:**

(a) Consumption shown in various physical stock accounts must be traced to the customers' bills to ensure that all issues to the customers have been billed.

(b) All payments to the foreign collaborator, it any, are to be checked. Agency commission agreements and spent validation payment made to Brand Owner as per arrangement.

(c) Expenses and receipts are to be compared with figures of the previous year, having regard to the average occupancy of visitors and changes in rates.

(d) Special receipts on account of letting out of auditorium, banquet hall, spaces for shops, boutiques, and special shows, marriage parties etc. should be verified with bookings and the arrangements made.

(e) In depth check should be carried out on the customers' ledgers to verify that all charges have been properly made and recovered.

(f) The occupancy rate should be worked out, and collection made against the same. Benching of rates with other similar hotels and same quality of services, and with previous year. Material deviations should be investigated.

(g) Expenses for painting, decoration, renovation of building, etc. are to be properly checked.

(h) It is common that hotels get their bookings done through travel agents. The auditor should ensure that the money is recovered from the travel agents as per credit terms allowed. Commission paid to travel agents should be checked by reference to the agreement on that behalf.

(i) Apart from control over stock of edibles, control over issue and physical stock of linen crockery, cutlery, glassware, silver, toilet items, etc. should be verified.

(j) The auditor should verify the restaurant bills with reference to KOT (Kitchen order Ticket).

(k) The auditor should ensure that all taxes have been included in the client's bills.

(l) Computation and payment of salaries and wages vis-a-vis number of employees must be checked.

Audit of Educational Institutions

16.3

Ownership of Educational Institutions are of varied types, Government run, Private, Trust owned etc., accordingly regulatory implications are different.

The special steps involved in the audit of an educational institution are the following:

(i) Documents relating to formation of the institution, affiliation, Management structure, Governing Body, ownership etc. requires due attention for fund monitoring, donation, spent approval process, affiliation fees payment etc.

Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Approving authority for expense, fund transfer, bank account operation etc. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, especially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Semester/Class-wise Student Register with details of Student name, address, Aadhar No./Card, Guardian details, Contact No. etc. and fee structure (full fees, half fees, sanctioned waiver etc.) mapped for ensuring accuracy of collection. Where collection through direct Banking takes place, the Bank Statement to be equivated with 'fees receivable/recoverable' for completeness check and proper revenue /collection (advance/arrear) recognition. Fees collected and Fees Book counterfoil reconciliation also can be carried out, for fees collected at the Counter. Collection against every student, whose names are appearing in the 'Student Register' to be validated and unpaid ones to be followed-up.

(iv) Updation of 'Student Register' w.r.t discontinued, transferred students, drop-outs etc. to be carried out on timely basis.

(iv) Fees condonation by appropriate authority to be considered for reconciliation between receivable fees and received.

(vi) Admission and other collections (late fees, transfer charges etc.) need to be tracked for separately and booked under appropriate Account Heads.

(vii) Confirm that hostel dues were recovered before students' accounts were closed and their caution deposits appropriately adjusted/refunded.

(viii) Verify other sources of income (rental income from landed property with the rent rolls, bank Fixed Deposit interest from Deposit Certificates etc.)

(ix) Grants received with the relevant papers of grant.

(x) Appropriate account head for Grant receipt and spent eligible thereunder to be checked for compliance.

(xi) Review of Receipts and Payments, Income and Expenditure for completeness and accuracy of Fund balances and bank balances.

(xii) Completeness and accuracy of income and expenditure need to be ensured.

(xiii) All statutory deposits P.F, Municipal /Corporation Taxes, Affiliation Fees etc.), filing to be checked for compliance.

(xiv) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xv) Vouch in the usual manner all establishment expenses, approvals and enquire into any high volume expenditure.

(xvi) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. against the spent booked for the period under review and physical existence. These should be checked by reference to Stock Register and values applied to various items should also be test checked.

(xvii) Appropriate Fund Accounts are maintained to verify dedicated Bank balance tallies with the books maintained by the Organization.

Audit of Co-operative Societies

16.4

Section 17 (2) of the Co-operative Societies Act, 1912 specifically requires the auditor to conduct an examination of the overdue debts, if any, and a valuation of the assets and liabilities of the society. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departures from the provisions of the Act, rules framed thereunder, and the bye-laws of the society.

The special features of co-operative societies audit, to be borne in mind while conducting the audit are as follows:

1. **Examination of overdue debts:** Overdue debts for a period from six months to five years and more than five years will have to be classified and shall have to be reported by an auditor. It affects its working capital position. They will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts is made and whether the same is satisfactory. The percentage of overdue debts to the working capital and loans advanced will have to be compared with last year, so as to see whether the trend is increasing or decreasing whether due and proper actions for recovery are taken, the position regarding cases in co-operative courts, District Courts etc. and the results thereof.

2. **Overdue Interest:** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue.

3. **Certification of Bad Debts:** Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists, the managing committee of the society must authorize the write-off.

4. **Valuation of Assets and Liabilities:** Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalized. If the difference in the original cost of acquisition and the present market price is of far-reaching significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflationary conditions. The current assets be valued at cost or market price, whichever is lower. Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.

5. **Adherence to Co-operative Principles**: The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.

6. **Observations of the Provisions of the Act and Rules:** An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported. Some of the State Acts contain restrictions on payment of dividends, which should be noted by the auditor.

7. **Verification of Members' Register and examination of their pass books:** Examination of entries in members, pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation.

8. **Special report to the Registrar:** During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society, he may report these special matters to the Registrar, drawing his specific attention such irregularities. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:

    (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

    (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.

    (iii) Specific examples of mis-management including decisions of management against co-operative principles.

    (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

9. **Audit classification of society:** After a judgment of an overall performance of the society, the auditor has to award a class to the society. This judgment is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

Audit of Co-operative Societies:

Annexure - I

Any ten persons who are competent to enter into a contract may make an application to the Registrar of Co-operative Societies as per section 6 of the Co-operative Societies Act, 1912. By-laws may be framed by each society and should be registered with Co-operative Societies. The effectiveness of change in by-laws of societies is applicable only when changes are approved by the Registrar of Societies. There are two types of societies, limited liabilities, and un-limited liabilities societies. Any member is not liable to pay more than the nominal value of the share held by them and no member can own more than 20% of shares of societies.

The government is encouraging co-operative societies to help society. Co-operative societies are operative in various sections like a consumer, industrial, service, marketing, etc.

Under the accounting system of Cooperative societies, the terms receipt and payment are used for the two-fold aspect of the double-entry system.

Members are elected at the annual general meeting of the society. The day-to-day work of a co-operative society is managed by the managing committee.

Audit of Co-operative Society

The provisions for Audit as Per Section 17 of the Co-operative Society Act, 1912.

- The Registrar shall audit or cause to be audited by some person authorized by him by general or special order in writing on his behalf, the accounts of every registered society once at least every year.
- The Audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.
- The Registrar, the Collector, or any person authorized by general or special order in writing on his behalf by the Registrar, shall at all-time have access to all the books, accounts, papers, and securities of society, and every officer of the society shall furnish such information concerning the transactions and working of the society as the person making such inspection may require.

Appointment of Auditor:

The appointment of an Auditor is done by the Registrar of Co-operative Societies. The Auditor conducts his audit on behalf of the Registrar. The Audit fees are paid by the co-operative society according to the statutory scale of fees prescribed by the Registrar in this regard according to the category of society. The Auditor is required to submit his audit report directly to the Registrar and one copy of the audit report is submitted to the concerned society.

Rights of an Auditor:

- As per Section 17, an Auditor can access all the books, accounts, documents, and securities of the society.
- He has to see that Balance Sheet of society shows a true and fair view of a business according to the information and explanation are given to him.
- Every officer of the society is bound to give all information regarding working and transactions of the society.

Duties of An Auditor:

An Auditor needs to consider the following points to be able to perform his duties efficiently:

- An Auditor should be well-versed with the Co-operative Society Act, 1912 and the by-laws of the society.
- If there is any type of irregularities and improprieties found by an Auditor during his audit regarding the Co-operative Societies Act, 1912 and by-laws, he should immediately point out the same.
- An Auditor should ascertain how many shares are held by each member of the society; for this, he should check the membership registers.
- An Auditor should be well aware of the power of officers regarding loans, investment and borrowings, and advancing of the funds.
- He should thoroughly check and vouch for the cash book and bank book.
- An Auditor should check all the receipts and payments of the society according to standard auditing practice.
- He should go through the agreements between society and the borrower to check the interest due on the loan and repayment schedule. An Auditor should also check and compare the actual interest received and the repayment of the loan received with dues from them.
- He should carefully vouch and verify that loan given to members of the society is according to the agreement, regulation, and resolution passed by the Managing Committee of the society or not.

- An Auditor has to assure that a loan given to a non-member is not without the permission of the Registrar.
- He should verify the loan given by the Cooperative bank should be according to the prescribed limit.
- An Auditor should physically examine and verify the assets of a society.
- He should adopt different methods for different kinds of societies.
- Balance sheet, profit and loss account, and Auditor report should be according to the proforma given by the Chief Auditor of the Co-operative Society of the State.
- Accounts should be according to the Co-operative Society Act and also with the provision of the Income Tax Act.
- All the assets, expenses, income, cash-in-hand, etc. should be vouched and verified according to standard accounting procedures and principles.

Books, Accounts, and Other Records of the Society

Under Section 43(h) of the Co-operative Society Act, 1912, the Government of a state can frame rules prescribing the books of accounts to be kept by a Cooperative society. Following books and accounts are prescribed by the Maharashtra Government.

- Cash Book
- General Ledger
- Stock register
- Personal Ledger
- Register of Members
- Register Shares and debentures
- Minutes books of general body meetings and committee meetings
- Property Register
- Register recording loan applications
- Maintenance of register of audit objections and their rectifications

Special Features of Co-Operative Audit

The checking of posting, arithmetical accuracy, vouching, verification of assets and liabilities, and scrutiny of the balance sheet are the same as auditors do in any other case.

Examination of Overdue Debts

An Auditor has to examine and classify overdue debts:

- From six months to five years and,
- Overdue above five years in two categories and shall have to report it in his audit report.

Overdue Interest:

While calculating the profit of Co-operative society overdue amount of interest outstanding should be excluded.

Valuation of Assets and Liabilities

General principles of accounting and auditing conventions and standards are adopted at the time of valuation of assets and liabilities. No specific provisions or instructions under the Act and Rules are provided.

Adherence to Co-operative principles

An Auditor should ascertain how far the objectives, for which the Co-operative society is set up, have been achieved in course of its working. It is not necessarily in terms of profit but in terms of extending benefits to members who have formed the Society.

Certification of Bad-debts

As per Rule No.49 of the Maharashtra State Co-operative Rules, 1961, it is very interesting to note that no bad debts can be written off unless they are certified as bad debts by the Auditor. Where no such requirement of law exists, the managing committee of the society must authorize the write-off.

Observation of the Provisions of the Act and Rules

An Auditor should be well versed with the provisions of the Act and Rules of the Co-operative Society and the by-laws thereof. If the Auditor finds any irregularity, it should be immediately assessed and reported to the next level.

Verification of Members Register and Examination of their Pass Books

This is essential, especially in rural and agricultural credit societies where members are illiterate, the Auditor should verify the passbook and members register to verify the amount of loan granted and their repayments. It will help to ensure that the books of accounts are free from any manipulation.

Special Report to the Registrar

During the audit, if any irregularities are found by the Auditor they should be reported to the Registrar and appropriate action may be taken by the Registrar against the society.

Audit Classification of Society

After assessing the overall performance, an Auditor has to award a class to the society. The judgment of the Auditor should be based on the criteria fixed by the Registrar. The Auditor should be very careful when making decisions related to the classes in the society; if management is not satisfied with the award, he may file an appeal to the Registrar and the Registrar may direct to review of the audit classification.

Discussion on Audit Draft

After completion of the audit, minor irregularities may be settled and rectified; matters concerning policies should be discussed in detail. The audit report can never be finalized without discussion with the managing committee.

By-laws

Each registered society is required to frame its by-laws which have to be registered with the Registrar of Co-operative societies. According to Section 11 of the Act, the amendment of the by-laws of a registered society shall not be valid until the same has been approved by the Registrar of the Co-operative societies.

Investment of Funds

A registered society can invest or deposit its funds only in:

- Saving bank accounts of Government Banks.
- Any of the securities specified under Section 20 of the Indian Trust Act, 1882.
- The shares or in the security of any other registered society.
- Any bank or person carrying on the business of banking approved for this purpose by the Registrar.
- Any other mode permitted by Section 32 of the Co-operative Societies Act.

Restriction on Co-operative Society

Restriction on Shareholding

According to Section 5 of the Act, where liabilities of the members of a society are limited, no member other than a registered society can hold more than 20% of the share's capital or shares of the society worth more than Rupees one thousand.

Restriction on Transfer of Share

A member of a registered society with unlimited liability, cannot transfer any shares held by him or his interest in the capital of the society unless:

- He has held that share for at least one year, and
- The transfer and change are made to the society or a member of the society.

Restriction on Loan

- According to Section 29 of the Act, a registered society cannot advance any loan to any person other than a member except with the prior permission of the Registrar.
- A society with unlimited liability cannot lend money on the security of a movable property except with the sanction of the Registrar of Co-operative society.
- The State Government has the power and can prohibit or restrict loans against mortgage of immovable property by any registered society or class of registered societies.

Restriction on Borrowings

A registered society can receive deposits and loans from persons who are not members of the society, only to such an extent and under such conditions as may be prescribed by the rules of the Co-operative Societies Act or by-laws of the concerned society.

Exemptions

According to Section 28, Central Government may exempt any registered societies or class of registered societies from Income Tax (Payable on the profits of the society or dividends or other profit related to payments received by the members of the society), Stamp duty or registration fees.

Reserve Fund, Contribution to Charitable Funds, and Distribution of Profit

- According to Section 33, the first 25% of the net profit earned during the year should be transferred to a Reserve Fund.
- 10% of the Balance amount of net profit after transferring 25% to the Reserve fund, a registered society can contribute for charitable purposes with the sanction of the Registrar.
- Under such conditions as may be prescribed by the rules or by-laws, the balance amount of current profit plus past years' profit can be distributed to members of the society.
- Dividend can be distributed according to rules and by-laws but cannot be more than 6.25%.

Only after special order of the State Government, unlimited liability society can distribute its profit, otherwise not.

Audit of Self-Help Groups

16.5

Self Help Group (SHG) Movement in India has been recognized as an effective strategy for mobilization and empowerment of rural people, particularly poor women and other marginalized groups. In India, Self Help Groups or SHGs represent a unique approach to financial intermediation. The approach combines access to low-cost financial services involving a process of self-management, with an objective of social and economic development for the women SHG members. Formations of SHGs are facilitated by the Government or by NGOs. SHGs are linked not only to banks but also to wider development programmes, SHGs are seen to confer many benefits, both economic and social.

As expert accounting professionals are hardly available at Gram Panchayat level, the need of the hour is "Community Audit" and it is necessary to develop sufficient number of "Community Auditors" for the sake of financial transparency.

The Institute of Cost Accountants of India and WBSRLM have entered into a MOU to enable undertaking of various collaborative activities for establishing "Community Audit" system for Self Help Groups in West Bengal by developing sufficient number of qualities "Community Auditors" for meeting the audit needs of SHGs in the state.

Applying the Field Balance Sheet Approach to Audit:

1. **Background Review**: During a background review, a preliminary examination of the group level records, including the cash book, is conducted. The auditor also does a general review of the group level records and member passbooks to verify/ cross-check data entries for their accuracy and correct posting.

2. **Prepare Field Balance Sheet**: The auditor prepares the Field Balance Sheet for the group, as on the date of the audit, based on the SHG's internal records and then cross checks the correctness of balance sheet items. The primary objective is to ascertain the retained earnings of the SHG.

Sl. No.	Liabilities	Amount	Sl. No.	Assets	Amount
1	Cash in Hand		1	Voluntary Savings	
2	Cash at Bank		2	External loan Outstanding	
3	Loan Outstanding with Members		3	Equity:	
4	Fixed Deposit		a	Compulsory Saving	
5	Fixed Asset		b	Retained Earning	
	Total			**Total**	

3. **Private Meetings with Members:** The auditor conducts private interviews with 25% of total members to triangulate information collected from the background review, as well as from the Field Balance Sheet and to ascertain the decision-making pattern in the group.

4. **Meeting with the SHG Group:** If serious issues were raised during the course of the audit, the auditor will meet with the entire group for further discussion.

5. **Reporting:** Once the auditing is complete, the auditor summarizes any weak practices that put savings at risk or make records unreliable, and recommends any better methods. Auditor submits the Field Balance Sheet, along with a summary report to the MFI/bank, to all group members and adds relevant comments to enable decision making regarding provision of credit.

Audit of Non-Government Organisations (NGOs)

16.6

Audit Procedure for Conducting the Audit of Non-Government Organisation NGO's can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.

Non-Government Organisations are generally incorporated as societies under the Societies Registration, Act, 1860 or as a trust under the Indian Trust Act, 1882, or under any other law corresponding to these Acts enforced in any part of India. NGO's can also be incorporated as a company under section 8 of the Companies Act, 2013.

While planning the audit of a Non-Government Organisation (NGO), the auditor may concentrate on the following;

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates.

(ii) Reviewing the legal form of the organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(iii) Reviewing the NGO's Organisation chart, Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and Formats, budgetary policies, if any.

(iv) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(v) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted:

(i) **Corpus fund:** The contributions/grants received towards corpus be vouched with reference to the letters from the donor(s). The interest income be checked with investment Register and physical investments in hand.

(ii) **Reserves:** Vouch transfers from projects/programmes with donors' letters and board resolutions of NGO. Also check transfers and adjustments made during the year.

(iii) **Ear-marked Funds:** Check requirements of donors' institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.

(iv) **Project/Agency Balances:** Vouch disbursements and expenditures as per agreements with donors for each of the balances.

(v) **Loans:** Vouch loans with loan agreements receipt counter –foil issued.

(vi) **Fixed Assets:** Vouch all acquisitions/sale or disposal of assets including depreciation and the authorizations for the same. Also check donor's letters/agreements for the grants. For immovable property, check title, etc.

(vii) **Investments:** Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis-investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

(viii) **Cash in Hand**: Physically verify the cash in hand and imprest balance, at the close of the year and whether it tallies with the books of accounts.

(ix) **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

(x) **Stock in Hand:** Verify stock in hand and obtain certificate from the management for the quantities and valuation of the same.

(xi) **Programme and Project Expenses:** Verify agreement with donor/contributor (s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

(xii) **Establishment Expenses:** Verify that provident fund, life insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

(i) **Contribution and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) **Receipts from Fund raising programmes:** Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) **Membership Fees:** Check fees received with membership register, ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(iv) **Subscription:** Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine/circulars/periodicals. Check the receipts with subscription rate schedule.

(v) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

Audit of Local Bodies

16.7

Local bodies are institutions of the local self-governance, which look after the administration of an area or small community such as villages, towns, or cities. The Local bodies in India are broadly classified into two categories. The local bodies constituted for local planning, development and administration in the rural areas are referred as Rural Local Bodies (Panchayats) and the local bodies, which are constituted for local planning, development and administration in the urban areas are referred as Urban Local Bodies (Municipalities). Article 243J of the Constitution states that the Legislature of a State may, by law, make provisions with respect to the maintenance of accounts by the Panchayats and the auditing of such accounts.

Article 243Z of the Constitution states about the audit of accounts of Municipalities. The Legislature of a State may, by law, make provisions with respect to the maintenance of accounts by the Municipalities and the auditing of such accounts.

Financial Administration of Local Bodies.

Salient Features of Financial Administration of Local Bodies

(i) **Budgetary Procedure**: The objective of local bodies budgetary procedure are financial accountability, control of expenditure, and to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or Council. Different aspects covered in budgeting are determining the level of taxation, fees, rates, and laying down the ceiling on expenditure, under revenue and capital heads.

(ii) **Expenditure Control**: At the State and Central level, there is a clear demarcation between the legislature and executive. In the local body, legislative powers are vested in the Council whereas executive powers are delegated to the officers, e.g., Commissioners. All matters of regular revenue and expenditures are generally delegated to the executive wing. For special situations like, reduction in property taxes, refund of security deposits, etc., sanction from the legislative wing is necessary.

(iii) **Accounting System**: Municipal Accounting System has been conventionally prepared under the cash system.

In the recent past however, it is being changed to the accrual system of accounting. The accounting system is characterized by

(a) subsidiary and statistical registers for taxes, assets, cheques etc.,

(b) separate vouchers for each type of transaction,

(c) compulsory monthly bank reconciliation,

(d) submission of summary reports on periodical basis to different authorities at regional and state level.

The objectives of this audit are:

- To report the content and presentation of financial statements are true and fair
- Detection and prevention of error fraud, misuse of funds
- To ascertain that full value received for money spent
- Legal and administrative requirements fulfilled

The audit programme for local bodies includes the following:

- All sanctions are accorded by competent authority
- Expenditure incurred are according to provisions and as per regulations framed by competent authority
- Different schemes, programmes, and projects are running economically and the purpose such programme is achieved.

Audit of Government Expenditure 16.8

Government Expenditure Audit: Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below:

(i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.

(ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.

(iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.

(iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditors aim to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.

(v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

Role of C&AG in the Audit of a Government company: The auditor of a government company is appointed by the C&AG.

The C&AG have powers under section 143 of the Companies Act, 2013 as follows:

(i) to direct the manner in which the company's accounts shall be audited by the auditor and to give such auditor instructions in regard to any matter relating to the performance of his functions as such;

(ii) to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorize in this behalf; and for the purposes of such audit, to require information or additional information to be furnished to person or persons so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General may, by general or special order; direct. In addition, the C&AG has a right to comment upon or supplement the audit report in such manner as he thinks fit.

Propriety Audit in the context of Government Audit

16.9

Propriety Audit: Under 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. However, some general principles have been laid down in the Audit Code, which have for long been recognized as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

1. The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

2. No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

3. Public moneys should not be utilized for the benefit of a particular person or section of the community unless:

   (i) the amount of expenditure involved is insignificant; or

   (ii) a claim for the amount could be enforced in a Court of law; or

   (iii) the expenditure is in pursuance of a recognized policy or custom; and

   (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Audit of Commercial Accounts 16.10

The government also engages in commercial activities and for the purpose it may incorporate following types of entities:

(i) Departmental enterprises engaged in commercial and trading operations, which are governed by the same regulations as other Government departments such as defence factories, mints, etc.

(ii) Statutory corporations created by specific statues such as LIC, Oil Marketing Companies (OMC) etc.

(iii) Government companies, set up under the Companies Act, 2013. All aforesaid entities are required to maintain accounts on commercial basis. The audit of departmental entities is done in the same manner as any Government department, where commercial accounts are kept. Audit of statutory corporations depends on the nature of the statute governing the corporation. In respect of government companies, the relevant provisions of Companies Act, 2013 are applicable.

Sum Up:

Today, in the face of economic uncertainty, companies around the world are faced with the need to maintain financial stability and competitive advantage in the market. At the same time, the service sectors are the first to suffer. In such a situation, the internal audit service can come to the aid of the business.

Internal audit services are created both in manufacturing enterprises and in service organisations. The main role of internal audit is to be a "business partner" and to contribute to profitable long-term growth and the achievement of other goals of the organisation.

In some organisations of the financial sector, for example, in banks and insurance companies, the presence of an internal auditor on the staff of the company is a mandatory regulatory requirement.

The main functions of internal audit are to give shareholders, the board of directors, and management an independent assessment of the effectiveness of internal control, risk management, and corporate governance systems.

Solved Case

Toshiba - A Case of Internal Audit Failure

Toshiba, a 140-year-old pillar of Japan Inc. is caught up in the country's biggest accounting scandal since 2011.

In 2011, Olympus Corp was embroiled in a scandal. In July 2015, Toshiba Corp president Hisao Tanaka and his two predecessors quit after investigators found that the company inflated earnings by at least $1.2 billion during the period 2009-2014. Toshiba is one of the early adopters of the corporate governance reforms initiated in Japan. The corporate governance structure met corporate governance standards. Time and again cases of corporate governance failures have provided evidence that good corporate governance structure does not necessarily lead to good corporate governance. Organisation culture is a critical determinant of the quality of corporate governance.

Some of the observations of the independent investigation committee of the company on internal audit demand discussion and debate.

The investigation committee observes, "According to the division of duties rules of Toshiba, the corporate audit division is in charge of auditing the corporate divisions, the companies, branch companies, and affiliated companies. However, in reality the corporate audit division mainly provided consultation services for the 'management' being carried out at each of the companies, etc (as part of the business operations audit), and it rarely conducted any services from the perspective of an accounting audit into whether or not an accounting treatment was appropriate."

The observations of the committee give the impression that the fault of the internal audit in Toshiba was that it focused on consultation service rather than assurance service. Should internal audit avoid providing consultation service? I do not think so. It was not the fault of the internal audit that it provided consultation service. The fault was that it did not pay attention to accounting audit.

In Toshiba, the top management used to set targets that are unachievable. There was excessive pressure from the top management to achieve those targets.

The variable pay is a significant portion of the total pay. The compensation of executive officers comprises a base compensation based on title and a role compensation based on work content. Forty per cent to 45 per cent of the role compensation is based on performance of the overall company or business department. 'Challenge' to achieve unachievable targets and performance-based pay provide enough motivation to manage earnings. Therefore, accounting audit should have been a focus area for internal audit.

Internal audit can function independently only if the audit committee is capable, independent and effective, and the internal auditor reports to the audit committee.

In Toshiba, the audit committee was neither capable nor independent. The three external members of the audit committee had no knowledge of finance and accounting. An ex-Chief Financial Officer (CFO), who was the CFO during the timeframe when accounting irregularities occurred, was the only whole-time member of the audit committee. Therefore, the internal audit was not independent of the management. Earnings management had the tacit approval of the top management. Therefore, it is not surprising that accounting audit was excluded from the scope of internal audit. It is incorrect to infer that the accounting audit did not receive the attention of the internal audit because its focus was on providing consultation service.

Contemporary literature defines internal audit as 'assurance and consulting service'. The issue is of balancing between consultation service and assurance service. Problem arises when the internal auditor forgets that the internal audit is primarily an assurance function. The consultation service flows from the assurance service. Although, the primary objective of operation audit is to obtain assurance that the internal control that is installed to achieve operation objectives is adequate and operating effectively, the auditees look to the internal auditor for suggestions and consultancy. Such consultation service is a by-product of the assurance service. Auditees should not be denied the benefits of internal auditor's understanding of the industry and the business, and the challenges before the auditees in achieving operation objectives. Exclusion of consultation service from the scope of internal audit would result in sub-optimal utilisation of internal audit resources.

Organisation culture also determines the effectiveness of internal audit. The investigation committee observes, "A corporate culture existed at Toshiba whereby employees could not act contrary to the intent of their superiors". In such a culture an upright internal auditor cannot survive, particularly if he is not independent of the management. Perhaps, it is the reason that the internal audit in Toshiba had chosen the easy path of focusing on 'consultation service' only without reporting internal control weaknesses.

Internal auditor is the 'eyes and ears' and 'go-to man' of the audit committee. Therefore, internal audit failure leads to corporate governance failure.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Management audit _______________ on financial matters.
   (a) Involves
   (b) Only concentrate
   (c) Does not concentrate
   (d) None of these

2. The main objectives of management audit is to ________________.
   (a) Suggest improvement in methods of operations
   (b) Framing basic policies for the organisation
   (c) Setting up an organizational framework
   (d) None of these

3. Management audit is the unique process of ________________ the performance of directors, managers or the performance of Management.
   (a) Appraising
   (b) Calculating
   (c) Auditing
   (d) Planning

4. The main emphasis of Management Audit:
   (a) Problem solving
   (b) Problem identification
   (c) Problem definition
   (d) Problem avoidance

5. Management audit is normally presumed to be a _________________ into a performance of a manager or group of managers.
   (a) Routine investigation
   (b) Non-routine investigation
   (c) Auditing
   (d) None of these

6. C&AG has the right to direct how the company's accounts shall be audited by the auditor and to give such auditor instructions regarding any matter relating to the performance of his functions as per section________________.

   (a) 44AB of Income Tax Act

   (b) 143 of the Companies Act, 2013

   (c) 173 of the Companies Act, 2013

   (d) 134 of the Companies Act, 2013

7. Non-Governmental Organisations can be incorporated as a company

   (a) Section 25 of the Companies Act, 1956.

   (b) Section 8 of the Companies Act, 2013.

   (c) Section 28 of the Companies Act, 2013.

   (d) None of the above

8. Under 'propriety audit', the auditors try to bring out what type of expenditure:

   (a) Improper

   (b) Avoidable

   (c) In fructuous

   (d) All of the above

9. What is the first step to conducting a Hospital Audit?

   (a) Check the letter of appointment

   (b) Study Trust Deed

   (c) Examine Records

   (d) Physical Verification

10. Co-operative Auditor has to examine the overdue debts if any, and a valuation of the assets and liabilities of the society while conducting an internal audit as per

    (a) Section 17(3) of the Cooperative Societies Act, 1912

    (b) Section 17(2) of the Cooperative Societies Act, 1912

    (c) Section 17(5) of the Cooperative Societies Act, 1912

    (d) Section 37(2) of the Cooperative Societies Act, 1912

11. ________ States about the audit of accounts of Municipalities.
    (a) Article 243Z of the Constitution
    (b) Article 243J of the Constitution
    (c) Both (a) and (b)
    (d) None of the above

12. Who appoints the auditor for the Government Company?
    (a) Board of Directors
    (b) Audit Committee
    (c) C&AG
    (d) CBDT

13. The government also engages in commercial activities and for this purpose, it may incorporate _________ type of entities.
    (a) Five
    (b) Three
    (c) Many
    (d) Various.

14. Financial Administration of Local Bodies includes
    (a) Budgetary Procedure
    (b) Expenditure Control
    (c) Accounting System
    (d) All of the above

15. Field Balance Sheet Approach to audit can be applied in case of audit of the
    (a) Co-Operative societies
    (b) Local Body Corporate
    (c) Self-Help Group
    (d) Club

Essay Type Questions

1. Discuss Audit Procedure for Conducting the Audit of Non-Governmental Organisation NGO.
2. Discuss the Role of C&AG in the Audit of a Government company.
3. Define Local Bodies and state the financial administrative features of local bodies.
4. What is the basic objective of the local body? Discuss the audit program of the same.
5. What is the first step in the audit of educational institutions?
6. How do you classify Local Bodies?
7. What point should be checked by an internal auditor while performing an internal audit of hotels concerning the internal control system?
8. What are the point to be considered while performing an audit of the Hospital?
9. What points should be considered in the audit program of Local Bodies?
10. Write a short note on the Self-Help Group.
11. Discuss the special feature of the Co-operative Society Audit.
12. Discuss the steps involved in the Audit of an Educational Institution.
13. M/s Hotel Hindustan Ltd. appoint you as an internal auditor for the year 2021-22. What point will you consider while conducting an audit? Discuss in short.

Answer:

Multiple Choice Questions

1.	(c)	Does not concentrate.
2.	(a)	Suggest improvement in methods of operations.
3.	(a)	Appraising.
4.	(b)	Problem identification. Management Audit pinpoints the areas requiring the attention of management, evaluates the existence of well-defined objectives, it seeks to review appraise, and, devaluates the corporate plans and policies based on certain standards of objectivity.
5.	(b)	Non-routine investigation.
6.	(b)	Section 143 of the Companies Act, 2013 The C&AG has powers under section 143 of the Companies Act, 2013 as follows: To direct how the company's accounts shall be audited by the auditor and to give such auditor instructions regarding any matter relating to the performance of his functions as such;

7.	(b)	Section 8 of the Companies Act, 2013. Non-Governmental Organisations are generally incorporated as societies under the Societies Registration, Act, 1860 or as a trust under the India Trust Act, 1882, or under any other law corresponding to these Acts enforced in any part of India. NGOs can also be incorporated as a company under section 8 of the Companies Act, 2013.
8.	(d)	All of the above. Under 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.
9.	(a)	Check the letter of appointment. Check the letter of appointment to ascertain the scope of responsibilities.
10.	(b)	Section 17 (2) of the Co-operative Societies Act, 1912 Section 17 (2) of the Co-operative Societies Act, 1912 specifically requires the auditor to examine the overdue debts, if any, and a valuation of the assets and liabilities of the society.
11.	(a)	Article 243Z of the Constitution. Article 243J of the Constitution states that the Legislature of a State may, by law, make provisions concerning the maintenance of accounts by the Panchayats and the auditing of such accounts. Article 243Z of the Constitution states the audit of accounts of Municipalities. The legislature of a State may, by law, make provisions concerning the maintenance of accounts by the Municipalities and the auditing of such accounts.
12.	(c)	C&AG. The auditor of a government company is appointed by the C&AG.
13.	(b)	Three. The government also engages in commercial activities and for this purpose, it may incorporate the following types of entities: (a) Departmental enterprises engaged in commercial and trading operations. (b) Statutory corporations created by specific statutes such as LIC, Oil Marketing Companies (OMC) etc. (c) Government companies, set up under the Companies Act, 2013.
14.	(d)	All of the above. Financial Administration of Local Bodies has three components Budgetary Procedure, Expenditure Control, and Accounting System.
15.	(c)	Self-Help Group. Field Balance Sheet Approach to audit can be applied in the case of audit of the Self-Help Group. The auditor prepares the Field Balance Sheet for the group, as on the date of the audit, based on the SHG's internal records and then cross-checks the correctness of balance sheet items. The primary objective is to ascertain the retained earnings of the SHG.

SECTION - D

FORENSIC AUDIT AND ANTI-MONEY LAUNDERING

Forensic Audit

17

This Module includes:

Forensic Audit

SLOB Mapped against the Module

To develop detail understanding of the financial forensics and forensic audit techniques to identify the scope left for committing frauds and recommend appropriate corrective actions. (CMLO 2a, b)

Module Learning Objectives:

The primary objective of this Forensic Auditing and Accounting is to empower the investigator or the overseer with the fundamentals of accounting practices and financial statement analysis. In-depth study of the procedures of fraud detection including methodologies to identify and categorize fraudulent practices. After studying this module, the students will be able to –

- Identify cases of fraud
- Prevent and reduce cases of fraud through the implementation of recommendations and advice, through internal control in the company
- Participate in the design and creation of fraud prevention programs
- Evaluate Internal Control Systems for adequacy to prevent formula and unethical activities.
- Perform investigation and collection of evidence that will be placed in the hands of the judicial authority.

Introduction

17

A forensic audit is an evaluation and examination of an individual's or a firm's financial records to stem up evidence that can be used in a legal proceeding or court of law. Forensic auditing is a specialization within the accounting field, and most large accounting firms have a forensic auditing department. Forensic audits necessitate auditing and accounting procedures as well as expert knowledge about the legal outline of such an audit.

Generally, Forensic audits cover a wide range of investigative activities. A forensic audit may be directed to prosecute a party for embezzlement, fraud, or additional financial crimes. Moreover, the auditor may also be called to help as an expert witness during trial proceedings of a forensic audit. Forensic audits could also involve situations such as disputes related to business closures, bankruptcy filings, and divorces that do not involve financial fraud.

Forensic audit investigations may interpret, or confirm, numerous kinds of illegal activities. In general, a forensic audit is used if there is a possibility that the evidence collected would be used in court in its place of a normal audit.

The forensic audit process is similar to a traditional financial audit accepting investigation, planning, assembling evidence, and writing a report with the added steps of a potential appearance in court. The lawyers offer evidence that the crime is one or the other discovered or disproved, which agrees with the harm sustained. In this procedure, they will explain their conclusions to the respondent should the case go to trial in front of the judge.

The reasons are as follows:

Corruption: Corruption is a significant obstacle to socio-economic development and also at different corporate levels. It can have come along with ill effects on the image of the business/company and jeopardize it severely. It consists of any illegitimate use of the office or dishonest behaviour and its resources. In such occurrences, a forensic auditor attempts to look for accounts of extortion and bribery, or anything that will amount to or relate to any conflict of interest.

Extortion: Taking a step ahead of any corruption, extortion involves the use of force, threat, or violence to extract money from another person/party. For the interest of the company, this may be done on the pretence of 'protection money or sophisticated cyber extortion schemes, small businesses, etc. Moreover, the identification of extortion in company finances reduces its reliability in the eyes of its suppliers, clients, etc. which is the most important reason for having a compacted financial statement.

Bribery: Bribery refers to the conduct of dishonestly influencing one's position or role to receive something as well as promising something favourable to the party demonstrating such benefit. There are a few problems where bribery arises, not always in such a role/position to offer anything. When one acts beyond his authority, it obstructs the company's profits and interests which is illegal to do so.

Conflict Of Interest: Anything on a related note, including bribery, that is done to gain personal profit, and which is unfavourable to the company. This conduct forms the objective of a forensic audit.

Fraud: There are a few reasons related to the fraud associated with the financial circle of any company. Those are as follows:

- False and Wilful representation or Assertion.
- Perpetrator of Representation.
- Intention to deceive.
- The representation must relate to a fact.
- The active concealment of facts.
- Promise made with no intention of performing it.
- The representation must have deceived the other party.
- Any other act fitted to deceive.
- Any such 'act or omission' that the law specially declares as void.
- Wrongful Loss and Wrongful Gain are Immaterial.

Asset Misappropriation: This included raising fake invoices, misappropriation of cash, payments made to non-existing employees or suppliers, theft of Inventory, or misuse of assets. It comes about in undesirable conditions when people who are entrusted to manage the assets of a company/organisation give away from it. Moreover, it can be the greatest detrimental to the company when it may lead to infiltration by other organisations to take control over control of the victim company. It directly hit on the cash flow of the organisation.

Financial Statement Fraud (FSF): Financial statement fraud is the willful and deliberate misstatement or misrepresentation, creating a false impression and omission of financial statement data to mislead the reader of a Company's financial strength. Generally, it defers revenues or expenses in a different period to show consistent earnings or growth. Another extreme consists of overstating revenues. It diminishes the confidence of market participants and capital markets in the dependability of financial information.

- Forensic Data Analysis (FDA).
- Fraud Triangle and Fraud Risk.

Introduction to Forensic Audit 17.1

A forensic audit is an analysis and review of the financial records of a company or person to extract facts, which can be used in a court of law. Forensic auditing is a specialty in the accounting industry, and most major accounting firms have a department of forensic auditing. Forensic audits include experience in accounting and auditing practices as well as expert knowledge of forensic audit's legal framework.

Forensic audits cover a large spectrum of investigative activities. There may be a forensic audit to prosecute a party for fraud, embezzlement, or other financial crimes.

The auditor may be called in during the process of a forensic audit to serve as an expert witness during trial proceedings. Forensic audits could also include situations that do not involve financial fraud, such as bankruptcy filing disputes, closures of businesses, and divorces.

When it comes to auditing, many organisations consider it is as simply a statutory requirement for getting the financials examined by a certified accountant to ensure compliance. However, this type of audit (financial audit) is just one of many other types of audits that any organisation would undergo. A forensic audit is one among such audits which involve an examination of past financial records of an entity to detect any illegal action, manipulation in the books of accounts, siphoning of funds, etc. The forensic audit begins with the suspicion and doubts and ends with the performance of investigation procedures either to confirm the case or dispel the suspicion.

Unlike financial audits which are focused more on statutory compliance, forensic audits are designed to investigate the financial records of an entity to derive evidence support of fraud that can be used in a court of law or legal proceedings.

It is an independent, comprehensive, and scientific approach to reviewing an entity's financial statements. To determine its accuracy, free from material misstate, and evidence be used in a court of law or legal proceedings.

Reasons for Conducting a Forensic Audit:

Forensic audit investigations may expose, or confirm, various kinds of illegal activities. Normally, instead of a normal audit, a forensic audit is used if there is a possibility that the evidence gathered would be used in court.

The forensic audit process is similar to a traditional financial audit planning, gathering evidence, and writing a report with the additional step of a possible appearance in court. The lawyers on both sides offer evidence that the crime is either discovered or disproved, which decides the harm sustained. They explain their conclusions to the defendant should the case go to trial before the judge.

Functions of Forensic Audit:

A forensic audit comprises the following steps:

- **Planning the Investigation**: The forensic auditor and the team will plan their investigation to meet their objectives.

- **Collecting Evidence:** The evidence gathered should be sufficient to prove in court the identity of the fraudster(s), reveal the details of the fraud scheme, and document the financial loss suffered and the parties affected by the fraud.
- **Reporting**: A forensic audit will need a written report on the crime to be given to the client so that if they desire, they can continue to file a legal case.
- **Court Proceedings**: During court proceedings, the forensic investigator must be present to clarify the evidence collected and how the suspect(s) were found by the team.

Need for Forensic Audit:

As of now, forensic auditing has emerged as a specialized field in the industry that requires a specific skill set to detect the fraud, leaving no scope for overlap, but to determine an organisation's needs, forensic auditing is significant in dealing with early warning signals of fraud. Thus, there are a few instances on the occurrence of which an entity should direct for forensic audit like:

I. Theft of business information or where business systems have been hacked.

II. Issues identified by Whistle-Blowers.

III. Reconciliations resulted in unidentified material differences.

IV. Suspicious of fraud or illegal activity.

V. Turnover has occurred and balances are showing negative results.

Forensic Audit Procedures:

Since the forensic audit is more of an investigation and collection of evidence, it is of great importance that the audit should be conducted with an attitude of professional scepticism. However, a scientific approach involving the use of forensic audit procedures should be used to conduct the assignments. These procedures are more towards detecting possible material misstatements in the financial records that result in fraudulent activities. Besides, forensic data analysis and fraud investigation techniques, a tool named 'triangle' also are used for addressing the presence of three-element that are common to any fraud being committed:

- Incentives- a motive that drives a person to commit fraud.
- Attitude- an ability to rationalize fraudulent behaviour.
- Opportunity- that enables a person to commit fraud.

Investigation Methodology of Forensic Audit:

The forensic audit investigation is the utilization of specialized investigation skills to conduct the forensic audit engagements in such a manner that the outcome can be presented in a court of law as evidence. The auditor should use an approach considering both the aspects of whether the fraud could have occurred and whether the fraud could not have occurred. With this approach, the forensic auditors will be able to bring the reality closer to the general, public especially the circumstances where perception and reality are not aligned. An auditor can follow a nine-step method for fact-finding in case of forensic audit engagements:

- Accept the forensic audit engagement.
- Evaluate the allegations or suspicions.
- Conduct due diligence background notes.

- Complete the preliminary stage of the investigation.
- Check the prediction assuming that there will be litigation.
- Begin with an external investigation.
- Gathering the required proofs and evidence.
- Preparing report on findings; and
- Court proceedings.

Common Areas of Forensic Audit:

With the increase in financial fraud popularly known as white-collar crime, forensic accounting and auditing has emerged as prominent to ensure the financial growth for businesses and the economies as well. Some of the common areas that are to be in elected for forensic audits are:

- Asset Misappropriation.
- Instances of Corruption.
- Extortion.
- Financial Statement Fraud.
- Conflict of interest.

Hence, forensic auditing is a detailed examination of past financial records which requires the expertise of professionals not only in accounting and auditing but also in the area of assessing legal framework and fact-finding. The forensic auditor is expected to adopt a practical approach to deal with the numerous loopholes which may arise during investigation procedures. With the key benefits of increased credibility, expert accounting, enhanced effectiveness, and accuracy, the forensic audit is seen as a rapidly growing area in the detection and prevention of fraud and white-collar criminal activities.

Business Frauds:

Corporate fraud consists of illegal or unethical and deceptive actions committed either by a company or an individual acting in their capacity as an employee of the company. Corporate fraud schemes are often extremely complicated and, therefore, difficult to identify. It often takes an office full of forensic accountants' months to unravel a corporate fraud scheme in its entirety.

When corporate fraud is perpetrated by the top executives of a large corporation, the fraud often extends to billions of dollars in scale. The victims of corporate fraud are consumers or clients, creditors, investors, other businesses, and eventually, the company that is the source of the fraud and its employees. When it is finally discovered, the company committing the fraud is often left in ruins and forced to declare bankruptcy.

- Corporate fraud consists of illegal, deceptive actions committed either by a company or an individual who is an employee of the company.
- Many corporate fraud schemes are highly complicated accounting schemes used to inflate a company's apparent profits and may take years to detect.
- When massive corporate fraud is eventually discovered, it can take down even huge multinational companies with billions in annual revenues.

Much of the money illegally obtained through corporate fraud is often never recovered, after being spent long ago by the perpetrators.

Why Do Corporate Frauds Happen?

(a) **The Desire or Perceived need to attract or Retain Investors:** Corporate fraud commonly occurs for the same reason as any other fraud scheme-greed. However, amid the highly competitive global business environment of the modern world, it may also occur for other reasons. Many corporate fraud schemes consist of fraudulent accounting schemes used to make a company appear more profitable than it is. The impetus behind such schemes is the desire or perceived need to attract or retain investors.

(b) **Problems or defects with a Company's Products:** Another cause of corporate fraud may be problems or defects with a company's products, which it tries to hide. Several recent corporate fraud cases have occurred with pharmaceutical companies that attempted to hide certain side effects or dangers associated with using certain medicines they manufactured and sold.

Government regulatory authorities, the Securities Exchange Board of India (SEBI) and the Securities and Exchange Commission (SEC) in the United States, use laws and regulations to try to prevent, detect and punish corporate frauds. However, fraud may go undetected for many years before it becomes apparent to authorities, especially if the guilty company is a private company that is not required to publicly disclose its financial records.

(c) **Major Corporate Fraud Cases in the World:** Due to the rise of so many large, multinational corporations and conglomerates, almost all of the largest corporate fraud cases have occurred within the past five decades. The following are some of the biggest incidences of corporate fraud on record:

(i) **Enron Company:** One of the most notorious cases of corporate fraud is the Enron scandal. At its height, Enron, a major energy company, was raking in billions upon billions in profits. However, when the company began to face declining revenues and debt troubles, company executives hid the facts through massive accounting fraud.

In the end, both Enron and its accounting firm, Arthur Andersen, went under. Thousands of employees lost their jobs, and Enron's creditors and investors lost billions.

The Enron Accounting scandal is credited with resulting in the passage of the Sarbanes-Oxley Act, which required more transparency in companies' financial reporting and imposed significantly harsher penalties on any company caught for committing accounting fraud.

(ii) **Waste Management:** Waste Management, the largest garbage and recyclables collector in the United States, appeared to be one of the most financially sound companies in the United States in the early 1990s. Investors eagerly bought up the company's stock, driving its price steadily higher.

However, when a New Chief Executive Officer (CEO) assumed the post in 1998, he eventually discovered that, like Enron, Waste Management previously perpetrated a multi-billion-dollar accounting fraud in an attempt to pump up its profitability numbers.

Unlike Enron, Waste Management was able, under its new leadership, to survive the resulting scandal, penalties from the Securities and Exchange Commission (SEC), USA, and a multi-million-dollar lawsuit by investors.

(iii) **ZZZZ Best Company:** The story of ZZZZ Best, a carpet cleaning company founded by a 15-year-old, is a rags-to-riches-to-rags story. Within six years of the company's founding, its entrepreneur owner was able to take the company public, with a valuation of approximately $300 million. There was just one problem- Barry Minkow, the founder, and owner of ZZZZ Best had made up out of thin air practically all of the company's alleged "Customers".

Minkow was keeping the company afloat by using money acquired from new investors to pay off previous investors. In short, engaging in a classic Ponzi scheme. Before Minkow could generate enough business to cover his fraud tracks and hopefully right the company's finances, his fraud scheme was discovered.

The result was that ZZZZ Best, once an inspiring success story, went completely burst just a few months after the Company's initial public offering (IPO).

(iv) **Wirecard Company:** One of the more recent corporate fraud cases is that of Wirecard, a payment transfer and processing company in Germany. In early 2020, accounting auditors discovered a whopping $2 billion discrepancy between the company's books and the actual money it held.

Like many corporate fraud schemes, Wirecard's cooking of its books had been going on for several years before it was detected. Wirecard was forced to declare bankruptcy, and its CEO was arrested by German authorities.

(v) **Wells Fargo & Company:** The fraud case of Wells Fargo revealed the danger of companies putting high-pressure sales quotas on employees. The result of such a practice at Wells Fargo Bank led hundreds of its employees to open fake accounts for Wells Fargo clients.

Short-term profits went up by millions, but when the widespread fraud was uncovered, the bank's fine imposed by the Securities and Exchange (SEC) ran into the billions. In addition, the bank lost hundreds, if not thousands, of clients.

Fraud Risk Management

17.2

Fraud is a deliberate act (or failure to act) to obtain an unauthorized benefit, either for oneself or for the institution, by using deception or false suggestions or suppression of truth, or other unethical means, which are believed and relied upon by others. Depriving another person or the institution of a benefit to which he/she is entitled by sharing any of the means described above also constitutes fraud.

Examples of fraudulent acts include, but are not limited to, the following:

- Embezzlement.
- Forgery or alteration of documents.
- Unauthorized alteration or manipulation of computer files.
- Fraudulent financial reporting.
- Misappropriation or misuse of resources (e.g., funds, supplies, equipment, facilities, services, inventory, or other assets).
- Authorization or receipt of payment for goods not received or services not performed.
- Authorization or receipt of unearned wages or benefits.
- Conflict of interest, ethics violations.

Fraud Triangle:

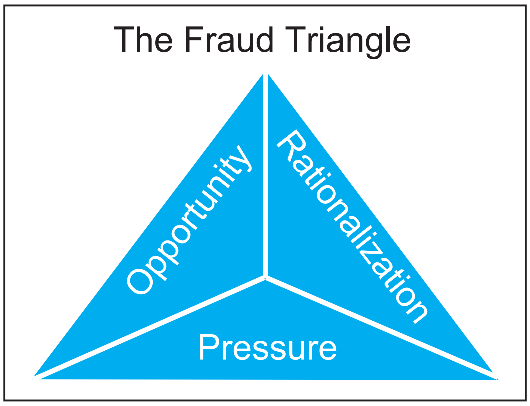


Figure 17.1: Fraud Triangle

Employees who commit fraud generally can do so because there is an opportunity, pressure, and rationalization.

(a) Opportunity is generally provided through weaknesses in the internal controls.

Some examples include inadequate or no:

- Supervision and review.
- Separation of duties.
- Management approval.
- System controls.

(b) **Pressure** (or motive) can be imposed due to:

- Personal financial problems; unforeseen expenses.
- Personal vices/addictions such as gambling, drugs, shopping, etc.
- Unrealistic deadlines and performance goals.

(c) **Rationalization** occurs when the individual develops a justification for their fraudulent activities. The rationalization varies by case and individual.

Some examples include:

- "I need this money and I'll pay it back when I get my pay check other people are doing it."
- "I didn't get a raise. The University owes me."

Breaking the Fraud Triangle is the key to fraud deterrence. Breaking the Fraud Triangle entails removing one of the elements in the fraud triangle to reduce the likelihood of fraudulent activities. "Of the three elements, removal of Opportunity is most directly affected by the system of internal controls and generally provides the most actionable route to deterrence of fraud" (Cendrowski, Martin, Petro, The Handbook of Fraud Deterrence).

Red Flags for Fraud:

Managers and employees are responsible and should be aware of the red flags for fraud. These are warning signs that may indicate that fraud risk is higher without any evidence that fraud occurring. The existence of one or two flags is not something to be overly concerned about. However, if multiple flags are present and accounting irregularities or weak controls are identified, then the Internal Audit department should be contacted.

Examples of red flags include, but are not limited to, the following:

Employee Red Flags:

- Employee lifestyle changes: expensive cars, jewellery, homes, clothes.
- Significant personal debt and credit problems.
- Behavioural changes- These may be an indication of drugs, alcohol, gambling, or just fear of losing the job.
- High employee turnover, especially in those areas which are more vulnerable to fraud.
- Refusal to take a vacation or sick leave.
- Lack of segregation of duties in a vulnerable area.

Management Red Flags:

- Management frequently overrides internal controls.
- Management decisions are dominated by an individual or small group.
- Managers display significant disrespect for regulatory bodies.

- Policies and procedures are not documented or enforced.
- Weak internal control environment.
- Accounting personnel is lax or inexperienced in their duties.
- Decentralization without adequate monitoring.
- An excessive number of checking accounts; frequent changes in banking accounts.
- An excessive number of year-end transactions; unnecessarily convoluted transactions.
- High employee turnover rate; low employee morale.
- Refusal to use serial numbered documents (receipts).
- The compensation program is out of proportion.
- Photocopied or missing documents.
- Reluctance to provide information to, or engage in frequent disputes with, auditors.

Suspect Fraud or Misconduct:

Any employee who suspects that dishonest, unethical, or fraudulent activity is occurring should not attempt to personally contact the suspected individual to determine facts, conduct investigations or interviews /interviews interrogations taken to avoid mistaken accusations or alert suspected individuals that an investigation may be under way.

An underway Corporate Scandals

Corporate scandals and frauds in India are as old as the hills. The 1950s witnessed the infamous Life Insurance Corporation / Mundhra scam, which was the first major financial fraud in independent India. Frauds continued with an alarming regularity thereafter in every decade – the infamous Harshad Mehta, Ketan Parekh, Sahara, and Satyam scams are just a few of them. These frauds were investigated by the law enforcement agencies under the relevant provisions of the Indian Penal Code, 1860 (**IPC**). The Companies Act, 1956 did not have any separate definition of 'fraud'. Legally, it was not necessary to have a separate one as Lord Macaulay's IPC adequately dealt with all such crimes. The Companies Bill, 2008 was the original legislative proposal to replace the Companies Act, 1956 basis Dr. J.J. Irani Committee Report (**Irani Report**). The Irani report did not have any recommendation for a provision like Section 447 dealing with frauds. It seems the intervening major corporate scandals of 2007-08 led the Parliamentary Standing Committee to recommend two new legislative changes:

1. Separate definition of fraud under Section 447 of the Companies Act, 2013 (**the Act**) and
2. Creation of the Serious Fraud Investigation Office (**SFIO**) under Section 212 of the Act to investigate those frauds.

Section 447 of the Act is an amalgam of several sections of the IPC including Section 405 dealing with Criminal Breach of Trust, Section 415 dealing with Cheating, Section 463 dealing with Forgery, and Section 477A dealing with falsification of accounts.

Definition of Fraud under Section 447 of the Act:

Section 447 of the Act starts with the words "without prejudice to any liability including repayment of any debt under this Act or any other law" which means without affecting adversely any other legal proceedings. In the context of the said section, it signifies that the proceedings initiated under Section 447 of the Act will not be barred provided they do not adversely affect an action or a proceeding relating to any liability. This includes repayment of debt initiated under any other provision of the Act or any other law for the time being in force.

As per the explanation, the various elements of fraud include:

(a) Any act, or

(b) Omission, or

(c) Concealment of any factor

(d) Abuse of position

Committed by any person or any other person with the connivance in any matter, with the **intent to deceive**, or to gain undue advantage from, or to injure the interests of the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.

The term '**Intent to Deceive'** has been judicially examined from the perspective of Section 463 of IPC. It was held in the case of Vimla v. State that the idea of deceit is a necessary ingredient of fraud, but it does not exhaust it. The expression 'defraud' involves two elements, namely, deceit and injury to the person deceived. Injury is something other than the economic loss that is deprivation of property, whether movable or immovable or of money and it will include any over caused to any person in body, mind, reputation or, such others. A benefit or advantage to the deceiver will almost cause a loss or detriment to the deceived. Even in those rare cases where there is a benefit or advantage to the deceiver, but no corresponding loss to the deceived, the second condition is satisfied.

Section 447 of the Act has been invoked in a few recent corporate scandals which are still at different stages of the trial. Given that it is a relatively new provision, there are no direct pronouncements on this provision so far either by National Company Law Tribunal (NCLT) or the High Courts, or the Supreme Court (SC). This provision has been invoked by the Serious Fraud Investigation Office (SFIO) in a few recent corporate scandals.

The Act has introduced stringent punishment for persons who are found to be guilty of fraud. Fraud, if it involves an amount of at least INR 10 lakh or 1% of the turnover of the company, whichever is lower, is an offenseable by imprisonment not less than six months and can go up to a maximum of 10 years. The provision for a fine cannot be less than the amount of fraud and may extend up to three times the fraud amount. However, if the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

The offense under Section 447 of the Act is cognizable, non-bailable, and non-compoundable.

Section 446A of the Act lays down five factors to be considered by the Court while deciding the amount of fine or imprisonment under the Act: (a) size of the company; (b) nature of business carried on by the company; (c) injury to the public interest; (d) nature of the default; and (e) repetition of the default.

Standard of Proof:

Section 447 of the Act provides for maximum imprisonment for five years. The standard of proof is 'beyond reasonable doubt'. Recently, the SC in the matter of the Latest State of Maharashtra explained the term 'reasonable doubt' as "a mean between excessive caution and excessive indifference to a doubt, further it has been elaborated that reasonable doubt must be a practical one and not an abstract theoretical hypothesis…"

Reporting Duty of the Auditors:

Section 143(12) of the Act casts an obligation upon the auditors of companies to report to the Central Government about fraud or suspected fraud committed against a company by its officers or employees. Further, if the auditor does not report fraud as provided above wi receive the regulators, the auditor can be deemed to have committed fraud himself and be removed under the provisions of Section 140(5) of the Act.

Latest Developments:

SEBI has amended the SEBI (Listing Obligations and Disclosure Requirements-LODR) Regulations, 2015 with effect from October 08, 2020, to provide that in case of initiation of a forensic audit, (by whatever name called), the following disclosures shall be made to the stock exchanges by the listed entities:

1. The fact of initiation of forensic audit along-with name of entity initiating the audit and reasons for the same, if available;
2. Final forensic audit report (other than for forensic audit initiated by regulatory / enforcement agencies) on receipt by the listed entity along with comments of the management, if any.

This new requirement to report is without any materiality thresholds, which could cause a high level of anxiety to the Audit Committee and Boards as any such disclosure could have a profound impact on the stock price of the company. In addition, speculative reporting by the media may also create panic among the investor community.

Several recent corporate frauds seem to have alarmed lawmakers and the latest tightening of Sections 447 and 212 of the Act, coupled with the inclusion of fraud as an offence under the PMLA, has alarmed the Audit Committees and the Corporate Boards. Stringent conditions for the grant of bail, provisions for disgorgement of assets, claw-back of remuneration, and unlimited personal liability of directors have further damaged the frayed nerves of independent directors. Regulators and the enforcement agencies are increasingly becoming prosecuting new requirements for reporting to the stock exchange, even the commencement of a forensic audit may create further complications every time a whistle blower complaint is received by the Audit Committee. Independent directors now prefer to undertake comprehensive due diligence of compliance and the governance standards of a company before accepting new board positions. India Inc. is slowly adapting itself to the new normal.

Financial Forensics and Forensic Audit Techniques

17.3

Financial forensics is a field that combines accounting and investigation. One of the main purposes of financial forensics is discovering and gathering evidence of criminal activity involving money. They investigate individuals' and organisations' finances to determine the truth about how they manage them. Financial forensics professionals help prevent financial crime and recover lost assets.

Financial forensics professionals also work with investors to find investment opportunities.

The financial forensics professional, or forensics financial analyst, researches other businesses to determine their true value.

Examples of common cases a financial forensics professional might work on:

Financial theft: Financial theft occurs when a customer, an employee, or another individual steals money from an organisation. An employee, for example, might take money from a cash register. A financial forensics analyst studies the event, looking for evidence of theft in documents such as receipts, payments or profit-or-loss statements.

Securities fraud: Securities fraud is a type of white-collar crime that typically occurs when someone presents false information to an investor. For example, a stockbroker might give misleading advice to convince a client to invest in a certain company. Both individuals and organisations, such as investment banks and brokerage firms, can commit securities fraud. A financial forensics professional searches through documents such as stock transactions and communication records to determine if someone committed securities fraud.

Money laundering: Money laundering is the process of making money earned through illegal methods look legal. For example, someone might take stolen cash and invest it into a cash-based business, such as a restaurant. The restaurant deposits both its legal profits and the illegal cash into a financial institution, allowing it to use the illegal funds. To detect money laundering, a financial forensics analyst might research shell company documentation, significant changes in income at cash-based businesses, and inexplicable or suspicious transactions.

Corporate valuation disputes: A financial forensics professional might analyse a business to determine its value. For example, if one business is acquiring another, it might want to know the exact value of that organisation. Using a forensic analyst, they can learn more about that organisation's finances than what's available publicly. This helps ensure they're buying the business at a fair price and that it has no hidden financial issues.

Tax evasion: Tax evasion occurs when a person or organisation avoids paying their taxes. For example, a company might try to hide profits in a shell corporation so they don't have to pay taxes on it. A forensics analyst studies tax documents, profit-and-loss statements, and financial transactions to determine if someone committed tax evasion.

Forensic Audit Techniques:

In recent years, there have been considerable changes in the business landscape. The increasing globalization, free movement of people, easy communication, technological advancements, and the shrinking of the world have helped change the business environment. These factors have led to the rapid growth of established businesses and the sprouting of new ones. However, this growth of companies has also increased in financial crimes and frauds.

Many businesses keep a separate department of in-house accountants who keep an eye on all the business activities and strive to minimize any irregularities in the business's recordings. However, there are still cases of new and innovative fraudulent activities that can only be uncovered after an in-depth analysis of all the records and books of the business.

This situation has led to the growth of a niche field known as forensic accounting, which can be explained as the integration of accounting and investigative skills. To understand more about forensic accounting and the various techniques which help in uncovering any financial fraud.

Forensic Accounting/Auditing is a type of accounting that cross-checks a business's various financial records to find any indication of fraud being committed. It also provides an in-depth analysis of all of the business›s financial books, which could be presented in the court of law as evidence. Forensic accountants can be considered detectives in the economic and business field. These people go through every recorded transaction and try to find any fraudulent or illegal activity within the industry.

Forensic accounting not only helps the business minimize its losses but will also help improve the efficiency of the business, ultimately leading to greater profitability. Furthermore, it can help the management keep track of the various business activities and prevent any fraud from happening in the future.

Qualities a Forensic Accountant Should Have:

Here are some qualities which a forensic accountant should possess. These are only some of the traits and not an exhaustive list. More qualities can be added to this list.

- Have a Logical Mind.
- Give attention to detail.
- Give value to Moral Principles.
- Question Everything/Inquisitiveness
- Be Spontaneous.
- Good understanding of Accounting transactions and impacts.

Having these qualities will provide forensic accountants with an urge to dig deeper and will make them a very successful forensic accountant. With proper investigative techniques added to the mix, the accountants would be capable of digging out even the most minute discrepancy in the accounting records.

The investigative techniques for forensic accounting:

There are several techniques for conducting a forensic review of the business. The ones provided below are generic but effective. These are the forensic techniques that apply to almost all companies. These are:

Reviewing Public Documents and Conducting Background Checks:

The documents made available to the public are scrutinized as they are the easiest to obtain. Also, thorough background checks of a particular company are done to see the past dealings of the business. Public Documents would include any information in the public database, the corporate records, and any legally available information on the internet.

Conducting Detailed Interviews:

Conducting an interview is an essential technique that can transform an unwilling person into a source of valuable information. It helps in fully understanding all the facts. An interview should be conducted by accurately assessing the gravity of the situation and preparing the questions according to it. Discussions should take every detail into account and look at the greater picture to figure out the magnitude of the illegal activity and the culprit responsible.

Gathering Information from Trustworthy Sources:

Information provided by a confidential and trustworthy source can be precious to any case. When a piece of information is gained from a confidential source or a confidential informant, all the necessary precautions should be taken to hide the identity of the so-called cause. A forensic accountant should try to have as many confidential sources as possible because such sources can virtually guarantee a correct result.

Analysing Evidence Gathered:

Proper analysis of the obtained evidence can point to the guilty party and assist in understanding the extent of the fraud committed in the business. Furthermore, this analysis would also help understand how secure the company is against financial scams and installing various austerity measures to prevent any such future situation.

Conducting Surveillance:

This can be done physically or electronically and is one of the conventional measures to uncover any fraud. It can be done by monitoring and tracking all the official emails and messages.

Going Undercover:

This is an extreme measure and should be used only as a last resort. It is best left to the professionals as they know how and where to conduct the investigations. Even a small mistake while being undercover can signal the offender that something is wrong, and the person might vanish/disappear from the scene.

Analysing the Financial Statements:

This is a special tool for finding out the fraud committed. All the necessary details are summarised in the financial statement, and the analysis of these statements can help a forensic accountant figure out the scam.

Nowadays, the economic conditions are getting stricter, and each country's government is now implementing tighter laws regarding the governance of the businesses. As the companies are increasing the level of sophistication, so is fraud. This has led to a higher sensitivity to fraud which can be interpreted as massive demand for the services of forensic accountants by all the businesses.

Ethical Considerations and Code of Conduct in Forensic Audit

17.4

Ethical issues in business can be a difficult challenge to navigate for any business owner. Though some laws and statutes exist to hold workers and employers accountable, these alone do not entirely deter employees from behaving unethically.

Ethical Issues in Business

Ethical issues in business encompass a wide array of areas within an organisation's ethical standards. Fundamental ethical issues in business include promoting conduct based on integrity and trust, but more complex issues include accommodating diversity, empathetic decision-making, and compliance and governance that is consistent with the organisation's core values. According to the Global Business Ethics Survey of 2019, 25% of employees still feel that their senior managers do not have a good understanding of key ethical and compliance business risks across the organisation.

To manage the ethical issues in business that arise in an organisation, first need to develop a thorough understanding of what those issues can look like. Understanding how to detect and, most importantly, deter these issues before they become a problem can ensure to focus stays on business growth and success instead of remediation.

Harassment and Discrimination in the Workplace

Harassment and discrimination are arguably the largest ethical issues that impact business owners today. Should harassment or discrimination take place in the workplace, the result could be catastrophic for the organisation both financially and reputationally.

Every business needs to be aware of the anti-discrimination laws and regulations that exist to protect employees from unjust treatment. The U.S. Equal Employment Opportunity Commission (EEOC) defines many different types of discrimination and harassment statutes that can affect organisations, including but not limited to:

Age: Applies to those 40 and older, and to any ageist policies or treatment that takes place.

Disability: Accommodations and equal treatment are provided within reason for employees with physical or mental disabilities.

Equal Pay: Compensation for equal work regardless of sex, race, religion, etc.

Pregnancy: Accommodations and equal treatment are provided within reason for pregnant employees.

Race: Employee treatment is consistent regardless of race or ethnicity.

Religion: Accommodations and equal treatment are provided within reason regardless of employee religion.

Sex and Gender: Employee treatment is consistent regardless of sex or gender identity.

Health and Safety in the Workplace:

As outlined in the regulations stipulated by the Occupational Safety and Health Administration (OSHA), employees have a right to safe working conditions. According to their 2018 study, 5,250 workers in the United States died from occupational accidents or work-related diseases. On average, that is more than 100 a week, or more than 14 deaths every day. The top 10 most frequently cited violations of 2018 were:

Fall Protection, e.g., Unprotected sides and edges and leading edges.

Hazard Communication, e.g., Classifying harmful chemicals.

Scaffolding, e.g., Required resistance and maximum weight numbers.

Respiratory Protection, e.g., Emergency procedures and respiratory/filter equipment standards.

Lockout / Tagout, e.g., Controlling hazardous energy such as oil and gas.

Powered Industrial Trucks, e.g., Safety requirements for fire trucks.

Ladders, e.g., Standards for how much weight a ladder can sustain.

Electrical, Wiring Methods, e.g., Procedures for how to circuit to reduce electromagnetic interference.

Machine Guarding, e.g., Clarifying that guillotine cutters, shears, power presses, and other machines require a point of operation guarding.

Electrical, General Requirements, e.g., Not placing conductors or equipment in damp locations.

However, health and safety concerns should not be limited to physical harm. In a 2019 report conducted by the International Labour Organization (ILO), an emphasis was placed on the rise of "psychosocial risks" and work-related stress and mental health concerns. Factors such as job insecurity, high demands, effort-reward imbalance, and low autonomy, were all found to contribute to health-related behavioural risks, including sedentary lifestyles, heavy alcohol consumption, increased cigarette smoking, and eating disorders.

Whistle blowing or Social Media Rants

The widespread nature of social media has made employees' conduct online a factor in their employment status. The question of the ethics of firing or punishing employees for their online posts is complicated. However, the line is usually drawn when an employee's online behaviour is considered to be disloyal to their employer. This means that a Facebook post complaining about work is not punishable on its own but can be punishable if it does something to reduce business.

In the same vein, business owners must be able to respect and not penalize employees who are deemed whistle-blowers to either regulatory authorities or on social media. This means that employees should be encouraged, and cannot be penalized, for raising awareness of workplace violations online. For example, a Yelp employee published an article on the blogging website Medium, outlining what she claimed as the awful working conditions she was experiencing at the online review company. She was then fired for violating Yelp's terms of conduct. The ambiguity of her case, and whether her post was justifiable, or malicious and disloyal conduct, shows the importance of implementing clear social media policies within an organisation. To avoid this risk of ambiguity, a company should stipulate which online behaviours constitute an infringement.

Ethics in Accounting Practices

Any organisation must maintain accurate bookkeeping practices. "Cooking the books", and otherwise conducting unethical accounting practices, is a serious concern for organisations, especially publicly traded companies.

An infamous example of this was the 2001 scandal with American oil giant Enron, which was exposed for inaccurately reporting its financial statements for years, with its accounting firm Arthur Andersen signing off on statements despite them being incorrect. The deception affected stockholder prices, and public shareholders lost over $25 billion because of this ethics violation. Both companies eventually went out of business, and although the accounting firm only had a small portion of its employees working with Enron, the firm's closure resulted in 85,000 jobs lost.

In response to this case, as well as other major corporate scandals, the U.S. Federal Government established the Sarbanes-Oxley Act in 2002, which mandates new financial reporting requirements meant to protect consumers and shareholders. Even small privately held companies must keep accurate financial records to pay appropriate taxes and employee profit-sharing, or to attract business partners and investments.

Non-disclosure and Corporate Espionage

Many employers are at risk of current and former employees stealing information, including client data used by organisations in direct competition with the company. When intellectual property is stolen, or private client information is illegally distributed, this constitutes corporate espionage. Companies may put in place mandatory non-disclosure agreements, stipulating strict financial penalties in case of violation, to discourage these types of ethics violations.

Technology and Privacy Practices

Under the same umbrella as non-disclosure agreements, the developments in technological security capability pose privacy concerns for clients and employees alike. Employers now can monitor employee activity on their computers and other company-provided devices, and while electronic surveillance is meant to ensure efficiency and productivity, it often comes dangerously close to privacy violations.

2019 survey conducted by the American Management Association, 66% of organisations were found to monitor internet connections, with 45% tracking content, keystrokes, and time spent on the keyboard, and 43% storing and reviewing computer files as well as monitoring employee emails. The key to ethically using technological surveillance is transparency. According to the same survey, 84% of those companies tell their employees that they are reviewing computer activity. For employee surveillance does not turn into an ethical issue for business, both employees and employers should remain conscious of the actual benefits of being monitored, and whether it is a useful way of developing a record of their job performance.

Ethical Issues in Business

Avoiding ethical issues in business always starts with top management. Providing written policies and processes that ensure those policies are both acknowledged and adhered to, can ensure transparency and ethical business practices are applied.

To effectively detect and, most importantly, deter ethical issues in business from surfacing in an organisation, several everyday efforts take. Be sure to communicate and enforce a robust code of ethics when making decisions and ask the same of employees. Remain aware of the discrimination laws that exist in the region. Stay informed on the rules that impute and the story and ensure the organisation is acting in compliance with those regulations. Collaborate with accountants, maintaining transparency and honesty in financial the ports. Be presenting company, making sure organisation and employees alike are always doing the right and ethical thing.

Auditors

To bound auditors around the world to achieve objectives of engagement effectively and also provide users of financial statements with reasonable assurance and make responsible for other aspects of the professionals have to abide by the requirements of ethics. Principles laid out in the code of ethics are also known as fundamental ethical principles the auditor is required to assure all such principles are fulfilled. Fundamental principles include honesty or integrity, objectivity, professional competence, due care, and professional behaviour.

However, during the practice, while carrying requirements of engagement auditors may face or expect to face such situations when they will not be able to fulfil the requirements. Such obstructions are called threats to fundamental principles. Although threats can make many different shapes broadly, they can be classified into various categories:

Self-interest threat arises when the stake of the total stake of any immediate or close family member of the auditor is involved in the entity and thus, he might cause the auditor to violate multiple ethical requirements.

Advocacy threat arises when the auditor (most of the time unintentionally) supports the opinion or position (of the client most of the time) to the extent that it is not supported with relevant evidence or simply auditor supported the opinion beyond the degree of objectivity.

Intimidation threat arises when the auditor, directly or indirectly, is threatened physically or mentally to keep him from working objectively.

For example, Auditor is given a threat that if he reports objectively then the audit fee will not be paid or subsequent audits with the auditor will be cancelled. It might take the shape of physical threats like harming family members or the use of coercion on the auditor.

The company's good name and the trust of stakeholders are two of its most important assets. Protect the company's reputation and increase employee engagement by creating a workplace where ethical conduct is the norm.

Reduce ethics risk by taking these five key steps:

- Honestly assess needs and resources.
- Establish a strong foundation.
- Build a culture of integrity from the top down.
- Keep a "values focus" in moments big and small.
- Re-evaluate and revise as needed.

Honestly assess needs and resources

Successful businesses start with a good plan. So do successful ethics and compliance programs. To create a relevant and meaningful plan, have to know the law of the land. It's important to know:

- What ethics challenges are common in the work we do? In our workplace?
- Where are our greatest areas of risk? Which groups of employees, locations, business units, etc. are potential "hot spots"?
- What values are important to our company and its employees?
- What values are necessary for our business, our work in particular?
- What ethics and compliance resources will be most beneficial for employees? What vehicles of support (a phone line, an email, an individual or committee, an internal social network, etc.) are likely to be most utilized and helpful?
- In developing our code and values, which groups' input is necessary? Who would be helpful?

Plan/program will only make a difference if Management begins having an accurate picture of existing strengths and areas of vulnerability. Risk assessment should be the starting point of internal efforts, followed by gap analysis and program assessment. Audit reports are also an essential piece of the puzzle.

The company can gather information in a variety of ways. Focus groups allow representative samples of the larger population to share their opinions and experiences; they provide a deep, rich "snapshot" of the state of ethics in the organisation. Surveys (internal or conducted by a third party) provide the opportunity to gather information from a much larger group of employees see to compare results, and analyse by relevant subgroups (i.e., employee levels, departments, units, etc.).

Strong Foundation:

Written Standards of Ethical workplace conduct:

- Training on the standards.
- Company resources that provide advice about ethics and compliance issues.
- A means to report potential violations confidentially or anonymously.
- Performance evaluations of ethical conduct.
- Systems to discipline violators.

But just having these elements is not enough. When it comes to ethical conduct and compliance, it's not enough to "print, post, and pray". Implementation and integration matters.

Company ethics and compliance programs must be a vital, integrated element of work and the two way you it, ensuring that employees know how to and feel supported in their efforts to uphold ethics and compliance standards in their work. The hallmarks of an effective ethics and compliance program are:

- Freedom to question management without fear;
- Rewards for following ethics standards;
- Not rewarding questionable practices, even if they produce good results for the company;
- Positive feedback for ethical conduct;
- Employee preparedness to address misconduct; and
- Employees' willingness to seek ethics advice.

Develop a Culture of Integrity:

People have an innate desire to get along and (long-past high school) want to fit in and conform to the norms of those around them. It may not be pleasant to admit it, but most people's ethics standards are fairly malleable. Although most people retain a desire to "do the right thing," the definition of right is significantly influenced by the company they keep. Culture matters.

Fortunately, if the company has diligently built an ethics and compliance program and woven it into the daily operations of the organisation, a strong ethics culture is far more likely. Research proves that an effective ethics and compliance program helps build a culture of integrity in which everyone "walks the talk". In a strong ethics culture, employees at all levels are committed to doing what is right and upholding values and standards.

Leaders are powerful drivers of corporate culture; they set the tone in any organisation. They decide who gets attention, who gets promoted, and what merits rewards and recognition. They set the standard. There are several things' leaders should do to help promote a strong ethics culture:

- Talk about the importance of ethics.
- Keep employees adequately informed about issues that impact them.

- Uphold promises and commitments to employees and stakeholders.
- Acknowledge and reward ethical conduct.
- Hold accountable those who violate standards, especially leaders.
- Model ethical conduct both professionally and personally.

When it comes to ethical leadership, there are two key things to keep in mind:

Character is paramount: Ethical leaders show integrity not only in the way they conduct themselves at work but in their relationships as well. In a world of social media, private behaviour comes public knowledge, and shapes employees' beliefs about what kind of individuals their leaders are.

Leadership happens at all levels: While senior leaders set the tone for the entire organisation, supervisors shape the everyday environments in which employees work and make decisions. The actions of supervisors have a profound impact on employees and their workplace conduct.

Keep a "Values Focus":

Ethics is about choices-big and small. Organisations with integrity keep their values at the forefront in both mundane and extraordinary moments. Corporate values should come into play and be reflected in multiple processes that drive the everyday life of the company, including:

- HR policies and their implementation.
- Reward systems.
- Hiring and retention.
- Performance management and evaluation.
- Promotion decisions.

On those occasions when crises occur, leaders should recognize not only the ethical dimension of the moment at hand but the "teachable moment" it represents. Edgar Schein, the father of the study of organisational culture, noted that moments of crisis are particularly powerful culture-builders because of the intensity of emotion involved. Employees learn a great deal about leaders' priorities and character when they show their "True Colours." If leaders make values their touchstone in times of crisis, employees learn that ethics matters.

Re-evaluate and Revise:

Situations and needs will change. Employees need to know what is working, what isn't, what new vulnerabilities have emerged, what progress made, and where there's work yet to be done. Be disciplined about regularly revisiting the state of ethics and compliance in the organisation. Risk assessments, follow-up surveys, and periodic or ongoing focus groups will allow the program to relevant and regular assessments will demonstrate internally (and, if ever needed, externally) that the resources in ethics and compliance have made a difference.

Major Threats in Auditing Profession:

In the auditing profession, **major threats** may compromise an auditor's independence. Before an audit engagement, it is each member of the audit team must review five threats to independence. If an auditor is exposed to a certain threat, he or she should either develop safeguards to reduce the threat to an acceptable level or resign from the audit engagement.

The following are that can potentially compromise the independence of auditors:

Self-Interest Threat: A self-interest threat exists if the auditor holds a direct or indirect financial interest in the company or depends on the client for a major fee that is outstanding.

Example: The audit team is preparing to conduct its 2020 audit for ABC Company. However, the audit team has not received its audit fees from ABC Company for its 2019 audit.

Issue: The audit team might be tempted to issue a favourable report so that the company can secure a loan to settle the fees outstanding for their 2019 audit.

Self-Review Threat: A self-review threat exists if the auditor is auditing his work or work that is done by others in the same firm.

Example: The auditor prepares the financial statements for ABC Company while also serving as the auditor for ABC Company.

Issue: By having the auditor review his or her work, the auditor cannot be expected to form an unbiased opinion on the financial statements.

Advocacy Threat: An advocacy threat exists if the auditor is involved in promoting the client, to the point where their objectivity is potentially compromised.

Example: The auditor is assisting in selling ABC Company while also serving as the auditor for the company.

Issue: The auditor may issue a favourable report to increase the sale price of ABC Company.

Familiarity Threat: A familiarity threat exists if the auditor is too personally close to or familiar with employees, officers, or directors of the client company.

Example: ABC Company has been audited by the same auditor for over 10 years and the auditor regularly plays golf with the CEO and CFO of ABC Company.

Issue: The auditor may have become too familiar with the client and, thus, lack objectivity in their work.

Intimidation Threat: An intimidation threat exists if the auditor is intimidated by management or its directors to the point that they are deterred from acting objectively.

Example: ABC Company is unhappy with the conclusion of the audit report and threatens to switch auditors next year. ABC Company is the biggest client of the auditor.

Issue: The auditor's independence may be compromised, as ABC Company is their biggest client and they, quite naturally, do not want to lose such a client. Therefore, the auditor may issue a report that appeases ABC Company.

Most companies have some form of ethics policy in place. The name of the policy may vary. Some companies call them Code of Ethics, Code of Conduct, or just plain Ethics Policy, but they all have the same goal: to ensure all employees behave ethically.

Companies create this policy for good reasons. They want to make sure their employees behave ethically and have a clear outline of the expectations and consequences of violations, but having a policy in place doesn't mean it is effective. In most the companies, despite having a formal ethics policy in place that supposedly protected whistle-blowers, many employees were fired for calling the hotline to report the fraud they were being ordered to commit.

There are three primary challenges companies face when implementing an effective ethics policy:

Resistance from employees: The first challenge is resistance from employees. Not because employees are inherently unethical or immoral, but when they are facing a new ethics policy, they may be made to feel that way. Companies should offer as much communication as possible to let employees know why the policy is being implemented and how it affects them.

One way to ease the resistance is to make sure to implement a values-driven policy. A values-driven ethics policy will be more warmly welcomed by employees, thanks to its focus on the values and reasons behind the policy instead of the consequences of non-compliance.

Costs of training and other implementation fees can be high: The cost of creating an ethics policy is minimal. However, the cost of implementing and maintaining an effective ethics policy is much higher. An ethics policy is worthless if no one understands it. That's why companies must train their employees in ethics regularly. All employees should be subject to training, from the CEO to the newest hire, but not all training is equal.

Training programs should be tailored to employees as much as possible. Employees in one department may face very different ethical dilemmas than employees in another. Customize training whenever possible to ensure employees understand the full measure of the ethics policy.

Inability to determine ROI of the ethics policy: It is notoriously difficult for executives to demonstrate ROI in ethics programs, pointed out in Wall Street Journal article. "ROI is hard to measure for a couple of reasons: it's not easy to measure a lack of wrongdoing, and it's not obvious what success looks like for some of the outcomes. For example, is higher or lower call volume on integrity hotline more desirable?"

However, he goes on to mention that the connection of ethics and compliance programs to performance and corporate strategy is one way to increase the likelihood of having demonstrable ROI. That's why companies should focus on the long-term value of the ethics policy.

Of course, the real key to implementing an effective ethics policy has quality ethical leaders at the top. Most ethics experts agree that senior management must set the tone for integrity and ethical behaviour to establish a solid foundation for the rest of the company. Confidence in ethical leadership will encourage all employees to follow and abide by the ethics policy.

Code of Conduct in Forensic Audit:

The Association of Certified Fraud Examiners is an association of professionals committed to performing at the highest level of ethical conduct. Auditors of the Association pledge themselves to act with integrity and to perform their work professionally.

Auditors have a professional responsibility to their clients, to the public interest, and each other; a responsibility that requires subordinating self-interest to the interests of those served.

These standards express basic principles of ethical behaviour to guide Auditors in fulfilling of their duties and obligations. By following these standards, all Certified Fraud Examiners shall be expected, and all Associate Auditors shall strive to demonstrate their commitment to excellence in service and professional conduct.

Applicability of Code:

The CFE Code of Professional Standards shall apply to all Certified Auditors of the Association of Certified Fraud Examiners ("ACFE"). Associate Auditors of the ACFE should strive to adhere to the Standards but are not bound by them. The use of the terms "Certified Fraud Examiner" or "CFE" in this Code shall refer to certified Auditors.

Standards of Professional Conduct

A. Integrity and Objectivity:

1. Certified Fraud Examiners shall conduct themselves with integrity, knowing that public trust is founded on integrity. CFEs shall not sacrifice integrity to serve the client, their employer, or the public interest.
2. Before accepting the fraud examination, Certified Fraud Examiners shall investigate for actual or potential conflicts of interest. CFEs shall disclose any actual or potential conflicts of interest to prospective clients who retain them or to their employers.

3. Certified Fraud Examiners shall maintain objectivity in discharging their professional responsibilities within the scope of the engagement.
4. Certified Fraud Examiners shall not commit acts discreditable to the ACFE or its Auditor ship, and shall always conduct themselves in the best interests of the reputation of the profession.
5. Certified Fraud Examiners shall not knowingly make a false statement when testifying under oath in a court of law or another dispute resolution forum. CFEs shall comply with lawful orders of the courts or other dispute resolution bodies. CFEs shall not commit criminal acts or knowingly induce others to do so.

B. Professional Competence:

1. Certified Fraud Examiners shall be competent and shall not accept assignments where competence is lacking.

   In some circumstances, it may be possible to meet the requirement for professional competence by use of consultation or referral.
2. Certified Fraud Examiners shall maintain the minimum program of continuing professional education required by the Association of Certified Fraud Examiners. A commitment to professionalism combining education and experience shall continue throughout the CFE's professional career. CFEs shall continually strive to increase the competence and effectiveness of their professional services.

C. Due Professional Care:

1. Certified Fraud Examiners shall exercise due professional care in the performance of their services. Due professional care requires diligence, critical analysis, and professional skepticism in discharging professional responsibilities.
2. Conclusions shall be supported with evidence that is relevant, competent, and sufficient.
3. Fraud examinations shall be adequately planned. Planning controls the performance of a fraud examination from inception through completion and involves developing strategies and objectives for performing the services.
4. Work performed by assistants and other professionals operating under the Certified Fraud Examiner's direction on a fraud examination shall be adequately supervised. The extent of supervision required varies depending on the complexities of the work and the qualifications of the assistants or professionals.

D. Understanding with Client or Employer:

1. At the beginning of a fraud examination, Certified Fraud Examiners shall reach an understanding with those retaining them (client or employer) about the scope and limitations of the fraud examination and the responsibilities of all parties involved.
2. Whenever the scope or limitations of a fraud examination or the responsibilities of the parties change significantly, a new understanding shall be reached with the client or employer.

E. Communication with Client or Employer:

Certified Fraud Examiners shall communicate to those who retained them (client or employer) significant findings made during the normal course of the fraud examination.

F. Confidentiality:

Certified Fraud Examiners shall not disclose confidential or privileged information obtained during the fraud examination without the express permission of proper authority or the lawful order of a court. This requirement does not preclude professional practice or investigative body reviews as long as the reviewing organisation agrees to abide by the confidentiality restrictions.

Standards of Examination:

A. Fraud Examinations:

1. Fraud examinations shall be conducted in a legal, professional, and thorough manner. The Certified Fraud Examiner's objective shall be to obtain evidence and information that is complete, reliable and relevant.

2. Certified Fraud Examiners shall establish prediction and scope priorities at the outset of a fraud examination and continuously re-evaluate them as the examination proceeds. CFEs shall strive for efficiency in their examination.

3. Certified Fraud Examiners shall be alert to the possibility of conjecture, unsubstantiated opinion, and bias of witnesses and others. CFEs shall consider both exculpatory and inculpatory evidence.

B. Evidence:

1. Certified Fraud Examiners shall endeavour to establish effective control and management procedures for documents, data, and other evidence obtained during an examination. CFEs shall be cognizant of the chain of custody including origin, possession, and disposition of relevant evidence and material. CFEs shall strive to preserve the integrity of relevant evidence and material.

2. Certified Fraud Examiners' work may vary with the circumstances of each fraud examination. The extent of documentation shall be subject to the needs and objectives of the client or employer.

Standards of Reporting:

A. General:

1. Certified Fraud Examiners' reports may be oral or written, including fact witness and/or expert witness testimony, and may take many different forms. There is no single structure or format that is prescribed for a CFE's report; however, the report should not be misleading.

B. Report Content:

1. Certified Fraud Examiners' reports shall be based on evidence that is sufficient and relevant to support the facts, conclusions, opinions, and/or recommendations related to the fraud examination. The report shall be confined to subject matter, principles, and methodologies within the member's area of knowledge, skill, experience, training or education.

2. No opinion shall be expressed regarding the legal guilt or innocence of any person or party.

Code of Ethics for Certified Fraud Examiners:

1. A Certified Fraud Examiner shall, at all times, demonstrate a commitment to professionalism and diligence in the performance of his or her duties.

2. A Certified Fraud Examiner shall not engage in any illegal or unethical conduct or any activity which would constitute a conflict of interest.

3. A Certified Fraud Examiner shall, at all times, exhibit the highest level of integrity in the performance of all professional assignments, and will accept only assignments for which there is a reasonable expectation that the assignment will be completed with professional competence.

4. A Certified Fraud Examiner will comply with lawful orders of the courts, and will testify to matters truthfully and without bias or prejudice.
5. A Certified Fraud Examiner, in conducting examinations, will obtain evidence or other documentation to establish a reasonable basis for any opinion rendered. No opinion shall be expressed regarding the guilt or innocence of any person or party.
6. A Certified Fraud Examiner shall not reveal any confidential information obtained during a professional engagement without proper authorization.
7. A Certified Fraud Examiner shall reveal all material matters discovered during an examination, which, if omitted, could cause a disorder.
8. A Certified Fraud Examiner shall continually strive to increase the competence and effectiveness of professional services performed under his or her direction.

Fraud is a deceptive action intended for personal or financial gain and a certified fraud examiner is a highly qualified professional who investigates cases of criminal and civil fraud. Fraud comes in all forms, such as embezzlement, payroll frauds, skimming, and expense report frauds. The majority of entities, from small businesses to large corporations have dealt with fraud in some way, shape, or form, which decreases gross revenue every year. A certified fraud examiner uses his or her knowledge of multifaceted financial transactions with their understanding of law, techniques, and ways to resolve fraud allegations. He or she has a solid understanding of how and why fraud occurs.

A certified fraud examiner plays three essential roles:

- Identifying evidence of fraud.
- Conducting interviews and writing reports, and
- Proactively evaluating the fraud risk of a business or organisation.

He or she identifies and gathers the evidence of fraud incidences to form a case, such as billing trends, financial relationships, and financial data. He/She also interviews witnesses and documents statements to include in the report. A certified fraud examiner often testifies his or her findings in cases of fraud allegations to resolve the issues. He/She commonly works with attorneys and law enforcement officers and assists in the arrest of individuals charged with fraud. Many certified fraud examiners help organisation's fraud detection and prevention efforts.

A certified fraud examiner may design, apply, and maintain fraud detection procedures and tools. Some also train others in fraud detection and prevention methods.

Professional Opportunities 17.5

Growing cyber-crimes, failure of regulators to track the security scams, series of cooperative banks bursting all are pinpointing the need for forensic accounting, irrespective of whether we understand the need or not.

Forensic accounting seeks to uncover the what, why, and how behind the computation and reporting of figures. The aim is to ascertain or confirm the substance of those purported transactions.

In the Indian context, Forensic Accountants are the most required in the wake of the growing fraud. The law enforcement officers are the experts in analysing fingerprints and the optics but what about the digital evidence analysis.

Why there is a need for Forensic Accountants?

Forensic Accounting is the specialty practice area that describes engagements that result from actual or anticipated frauds, disputes, or litigations. Forensic Accounting, Fraud Detection & Prevention specialization is in increasing demand considering increasing incidents of cyber-crimes and frauds. It is the practice of utilizing accounting, auditing, CAATs/ Data Mining Tools, and investigative skills to detect frauds/ mistakes. The Government bodies, PSUs, in the insurance sector, Banks and, and Investigating agencies as well as many medium-sized and boutique firms have specialist forensic accounting departments engaging Forensic Auditors.

Very few know about it – Maurice E. Peloubet who coined the term Forensic Accountant in 1946 said that the preparation of financial statements has some but not all of the characteristics of forensic accounting. This statement is enough for the chartered accountants in India to foray into this field. It is s a new child on the block. Central Investigating Agencies like CBI do the forensic accounting work.

The growing number of regulators, the administrative agencies will demand the services like forensic reviews. Cost Accountants are going to find themselves more involved in what is essentially a type of forensic practice. The changing nature of the Accounting and Auditing & assurance standards also confirms this.

Nearly 40 percent of the top 100 American accounting firms are expanding their forensics and fraud services, according to Accounting Today. If this data is of some sense to the Indian scenario, then the day is not far away when forensic practice will contribute to the total revenue of the Indian CMA firm.

According to the '2018 Report to the nation' by the Association of Certified Fraud Examiners (ACFE), there were 2690 cases of occupational fraud from 125 countries printing into loss of more than $7 billion which causes a huge demand for those who can identify and put-up relevant control to prevent such mishap. Out of these 72 cases were from India. Against a backdrop of tough economic conditions and growing corporate governance, demand for forensic accountants is increasing. Practitioners believe that the demand for the services of forensic accountants is growing because of the tightening economic conditions and the increasing scrutiny of how companies are governed.

In such circumstances, there is heightened sensitivity to fraud, and that translates into more efforts to detect and prevent it, as well as to take legal action against the wrongdoers.

Nothing is surprising too that, as this the 'Forensic Audit' has become so familiar these days, and special credit for this goes to Mr. Vijay Mallya and Mr. Nirav Modi and a huge pile of NPA's build-up by state-owned banks.

Pre-requisite of a skilful Forensic Accountant:

(a) Dave Cotton, a qualified CFE has greatly defined the attitude the person should maintain while investigating Fraud and Forensic Cases. He said: 'Many fraud perpetrators aren't as clever at concealing fraud as most people probably think. If CFEs simply remain alert and maintain a high degree of professional skepticism many potential frauds are easy to find'.

(b) A good Forensic Auditor requires immense knowledge of the finance aspects along with a good understanding of internal financial controls as identification of weak control can help to easily catch out the areas where fraud can be carried out.

Professional Qualifications that can give you an extra edge: The Institute of Cost Accountants of India, Kolkata conducting Advanced Diploma in Forensic Audit which gives some insights on the subject and helps to improve the skills and knowledge in Forensic Audit.

Sum Up:

Forensic Audit is a much-required tool in the recent era of Frauds & Misappropriations

"If you see a fraud and do not say fraud, then you are a fraud" … Naasim Nicholas Taleb

The relevance of the concept has been highlighted- especially in the emerging scenario of continuous development in the fields of accounting and auditing. The article also touches upon the various inter-related concepts and the vital areas where the technique of Forensic Auditing can be best used in detecting the misappropriations and manipulations in the financial as well as operational matters.

The manipulations and misappropriations in the corporate world relate back to September, 1720 when after the War of Spanish Succession, the Great Britain signed the Treaty of Utrecht, 1713 with Spain, ostensibly allowing it to trade in the seas near South America. In fact, barely any trade took place as Spain renounced the treaty; however, this was concealed on the Great Britain stock market. A speculative bubble saw the share price reach over £1000 in August 1720, but then crash in September. A Parliamentary inquiry revealed fraud among members of the government, including the Tory Chancellor of the Exchequer- John Aislabie, who was sent to prison and since then there has been a steep rise in such manipulations being continuously occurring all over the world, such as Quintex-Real Estate (1989); Poly Peck-Electronics, Food, Textiles (1990); Bre-X-Mining (1997); Equitable Life Assurance Society-Insurance (2000); WorldCom-Telecommunication (2001); Enron-Energy (2001); Arthur Anderson-Accounting (2002); Parmalat-Food (2003); Refco-Brokering (2005) and of course the securities scam by Harshad Mehta and Ketan Parekh, C.R. Bhansali, Home Trade fraud, M/s Satyam Computer Services Ltd and many more. Some of the Companies which were in news in recent past for the wrong reasons:

1. Vakrangee – No one knows what's wrong with the Company, but still the stock prices kept on falling.
2. Manpasand – Alleged Tax credit claim fraud (Fake invoices exchanged in grey market).
3. LEEL – It is alleged that Promoters just took out the money after selling a business unit.
4. Gitanjali – Fake letter of credit.
5. Eros, Cox and kings – It was alleged that Despite having cash, company defaulted on NCD.

6. DHFL – It is alleged that borrowed funds were used to lend to shell companies owned by operator.
7. IL&FS– Huge bonuses and dividend pay-outs to promoters were alleged.
8. Yes Bank – Alleged Non-disclosure of provisions is been the issue and power of cantered in the hand of one man knew and he was asked by regulators to leave.
9. HEG– A 20 million USD bonus was given to the CEO when shareholders lost more than 80% of value.
10. CG Power – It is alleged that billion dollars taken out via transactions.
11. TATA Sons- The Board aligned to the majority shareholder, gave Cyrus Mistry a glowing performance review only to sack him a few months later.
12. Infosys– The Board first played supplicant to Chief Executive Officer Vishal Sikka, then to former promoter NR Narayan Murthy. Investors paid the price for unstable leadership, and even today, investigations into acquisitions have not been shared with all the stakeholders.
13. Axis Bank– The Board seemed unquestioning of Managing Director and Chief Executive Officer Shikha Sharma, but the regulator wanted her go.
14. ICICI Bank– The Board appeared like a deer in the headlights, dazed by the celebrity of MD & CEO Chanda Kochhar, allowing her continued presence in the company, even as she was being investigated for alleged nepotism.
15. Fortis– Promoters held sway, the board turned a blind eye to many suspicious transactions, and finally shareholders booted them out.

Constituents of Forensic Audits:

1. Assessment of fraud risk factors and evaluating internal controls and standards.
2. Comparison and contrast of various fraud schemes to devise the appropriate internal controls.
3. Developing off-setting internal controls that would limit or prevent these fraud schemes.
4. Using data analysis techniques to identify high-risk transactions for further review and investigation.
5. Evaluating internal controls and identifying ways to plan audits to take advantage of available information systems resources.
6. Evaluating financial and program risk for potential fraud.
7. Applying various evidence-gathering techniques used to detect fraud.
8. Justifying the auditor's conclusion of fraud by providing the evidence needed to support legal and investigative staff.
9. Documenting the evidence and data-gathering process.
10. Sharing the findings with the agency and advise them on how to avoid the fraud in the future.

In the present scenario of revival of corporate law and norms being made stringent, there is an ample space for the overall recognition of such an important technique for identifying frauds. The technique altogether different from the traditional auditing approach has also got its significance where the concept of due diligence has to be applied. Forensic Auditing not only identifies the factors/ reasons adversely affecting the trust in mechanism of trade, finance and investment but also helps in recognizing the destabilizing effect on commercial institutions and corporate houses directly affecting the national progress and putting strain on national resources.

Solved Cases

Case Study: 1

Harshad Mehta and the Stock Market Scam

Who is this Stockbroker from Gujarat?

What happened: During the early 1990s he started facilitating transactions of ready-forward deals among the Indian banks, acting as an intermediary. In this process, he used to raise funds from the banks and subsequently illegally invest the same in the stocks listed on the Bombay Stock Exchange to inflate the stock prices artificially. Mehta again raised a furore on 16 June 1993 when he made a public announcement that he had paid Rupees 1 Crore to the then Congress President and Prime Minister as a donation to the party, for getting him off the case.

How did this happen: Mehta siphoned off around ₹1,000 crore from the banking system to buy stocks on the Bombay Stock Exchange. As he pumped in money, the markets continued to achieve new highs. Retail investors took cues from what Mehta was buying and followed in the footsteps of the 'Big Bull'.

In the period between April 1991 and April 1992, the Sensex went into a frenzy and returned 274 percent, moving from 1,194 points to 4,467. That is the highest annual return for the index.

He also promised the banks higher rates of interest, while asking them to transfer the money into his account, under the guise of buying securities for them from other banks. At that time, a bank had to go through a broker to buy securities and forward bonds from other banks. Mehta used this money temporarily in his account to buy shares, thus hiking up the demand for certain shares (of well-established companies like Associated Cement Companies Limited- ACC, Sterlite Industries, and Videocon) dramatically, selling them off, passing on a part of the proceeds to the bank and keeping the rest for himself. This resulted in stocks like ACC (which was trading in 1991 for ₹ 200/ share) to nearly ₹ 9,000 in just 3 months.

The scam came to light when the State Bank of India reported a shortfall in government securities. That led to an investigation that later showed that Mehta had manipulated around ₹ 3,500 crore in the system. On August 6, 1992, after the scam was exposed, the markets crashed by 72 percent leading to one of the biggest falls and a bearish phase that lasted for two years.

On 23 April 1992, journalist Sucheta Dalal exposed Mehta's illegal methods in a column in The Times of India. Mehta was dipping illegally into the banking system to finance his buying.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Forensic Accounting is defined as:

   (a) The practice of applying defined financial ratios to investigate a company's financial health.

   (b) The use of law enforcement to subpoena financial records to determine unlawful actions.

   (c) The application of investigative and analytical skills to resolve financial issues in a manner that meets standards required by courts of law.

   (d) The investigatory arm of the Securities and Exchange Commission.

2. If your actions are the result of misleading, intentional actions or inaction (including misleading statements and the omission of relevant information to gain an advantage, then you have committed:

   (a) Perjury.

   (b) Contempt.

   (c) Treason.

   (d) Fraud.

3. When the auditor tests the documents by keeping them side by side then it is known as ______.

   (a) Test of impossibility.

   (b) Test of absurdity.

   (c) Juxtaposition test.

   (d) None of the above.

4. As per the study of ACFE, the following category of individuals commit the highest frauds (in monetary terms)______.

   (a) Low-level management.

   (b) Mid-level management.

   (c) Senior level management.

   (d) All of the above.

5. ______ are the elements of fraud.

   (a) The individual must know that the statement is untrue.

   (b) There is an intent to deceive the victim.

   (c) The victim relied on the statement & The victim is injured financially or otherwise.

   (d) All of the above.

6. A type of fraud where forged emails, forged websites are used to defraud the user is known as ______.
   (a) E-frauds.
   (b) Forgery.
   (c) Phishing.
   (d) None of the above.

7. ______ happens when the fraudster avails multiple loans for the same property simultaneously for a total amount over the actual value of the property.
   (a) Phishing.
   (b) Window dressing.
   (c) Shot gunning.
   (d) Skimming.

8. Pressure, opportunity & ______ are the aspects of a fraud triangle.
   (a) Rationalization.
   (b) Creation.
   (c) Commitment.
   (d) None of the above.

9. A ______ is termed as an indication of a danger or a warning signal.
   (a) Red flag.
   (b) Green flag.
   (c) Amber flag.
   (d) White flag.

10. A ______ is a flag that denotes a “too good to be true scenario”.
   (a) Red flag.
   (b) Green flag.
   (c) Amber flag.
   (d) White flag.

11. Significant increase in working capital borrowing as a percentage of turnover is a______.
   (a) Red flag.
   (b) Green flag.
   (c) Amber flag.
   (d) White flag.

12. A case where an employee doesn't take travel advance but always pays from his pocket is a ______.
    (a) Red flag.
    (b) Green flag.
    (c) Amber flag.
    (d) White flag.

13. Analysing non-verbal cues is important for a forensic auditor while ______.
    (a) Interviewing a suspect.
    (b) Interrogating a suspect.
    (c) (a) & (b) both.
    (d) None of the above.

14. A model categorizing known frauds which lists about 49 different individual fraud schemes grouped by categories and subcategories is known as ______.
    (a) Fraud triangle.
    (b) Fraud square.
    (c) Fraud model.
    (d) Fraud tree.

15. When the fraudster can give a personal justification for fraudulent actions, it is known as ______.
    (a) Pressure.
    (b) Opportunity.
    (c) Rationalization.
    (d) All of the above.

16. Various frauds in the banking sector are:
    (a) Appraisal fraud.
    (b) Mortgage fraud.
    (c) Shot gunning.
    (d) All of the above.

17. Fraudsters may alter cheques to change the name or the amount on the face of cheques. This is called ______.
    (a) Phishing.
    (b) Forgery.

(c) Disbursement fraud.

(d) Skimming.

18. Ratio analysis is one of the key aspects that a forensic auditor has to look ______ at.

    (a) Correct.

    (b) Incorrect.

    (c) Partially Correct.

    (d) Cannot be determined.

19. The principle of 3D vision includes ______.

    (a) Time dimension analysis.

    (b) Space dimension analysis.

    (c) Both (a) & (b).

    (d) None of the above.

20. "Fraud is a deliberate act of omission or commission by any person, carried out in the course of a banking transaction or the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank" is a definition given by:

    (a) SEBI.

    (b) RBI.

    (c) ICAI.

    (d) ACFE.

Essay Type Questions

1. Write a note explaining the Meaning and Definition of Fraud under the Companies Act, 2013 as well as the Criminal Procedure Code, 1973.
2. What do you mean by Forensic Audit? Discuss its need and significance in detail.
3. Write down the similarities and differences between Audit and Forensic Audit.
4. Discuss the elements of Fraud and Civil, Criminal Remedies available against it.
5. Discuss the fundamentals of Forensic Audit.
6. What is the contemporary scenario of Corporate Fraud in India and How Forensic Audit is significant in preventing the same?
7. What are the various kinds of Fraud? Discuss.

8. What are the different methods of Investigation in Forensic Audit?

9. What are Red Flags and Green Flags? Discuss.

10. Write a Note on Field Investigations.

Answer:

⦿ **Multiple Choice Questions (MCQ)**

1.	(c)	The application of investigative and analytical skills to resolve financial issues in a manner that meets standards required by courts of law.
2.	(d)	Fraud.
3.	(c)	Juxtaposition test.
4.	(c)	Senior level management.
5.	(d)	All of the above.
6.	(c)	Phishing.
7.	(c)	Shot gunning.
8.	(a)	Rationalization.
9.	(a)	Red flag.
10.	(b)	Green flag.
11.	(a)	Red flag.
12.	(b)	Green flag.
13.	(c)	(a) & (b) both.
14.	(d)	Fraud tree.
15.	(c)	Rationalization.
16.	(d)	All of the above.
17.	(b)	Forgery.
18.	(a)	Correct.
19.	(c)	Both (a) & (b).
20.	(b)	RBI.

Anti-Money Laundering 18

This Module includes:

Anti-Money Laundering

SLOB Mapped against the Module

To understand international standards on combating money laundering and provide guidance to prevent and control money laundering transactions in the business operations. (CMLO 2c)

Module Learning Objectives:

To prevent criminal activity, nearly all countries in the world have committed themselves to extremely tough laws against money laundering and terrorist financing. Money laundering is defined as criminal proceeds finding their way into the formal economy via transactions that conceal their true origins. Terrorist financing can come from rogue regimes or terrorist organisations that feed their cells worldwide under trade payments, investments, remittances, and money for education. After studying this module, the students will be able to –

- Understand Money Laundering / Terrorism Financing methods and typologies that are relevant to the organisation
- Analyse the AML policies, procedures systems & controls adopted by the Organisations
- Acquire the skill to identify suspicious activities & unusual behaviour of customers and report them to the AML compliance officer
- Understand the responsibilities and role of individuals in the organisation towards countering money laundering and financing of terrorism.

Introduction 18

Money laundering is a type of financial crime. It involves taking criminally obtained proceeds (dirty money) and disguising their origins so they'll appear to be from a legitimate source. Anti-money laundering (AML) refers to the activities financial institutions perform to achieve compliance with legal requirements to actively monitor for and report suspicious activities.

The United States was one of the first nations to enact anti-money laundering legislation when it established the Bank Secrecy Act (BSA) in 1970. In an early effort to detect and prevent money laundering, the BSA has since been amended and strengthened by additional anti-money laundering laws. The Financial Crimes Enforcement Network is now the designated administrator of the BSA with a mission to "safeguard the financial system from the abuses of financial crime, including terrorist financing, money laundering, and other illicit activity."

In 1989, multiple countries and organisations formed the global Financial Action Task Force (FATF). Its mission is to devise and promote international standards to prevent money laundering. Shortly after the 9/11 attacks on the US, FATF expanded its mandate to include AML and combating terrorist financing. The International Monetary Fund (IMF) is another important organisation. With 189 member countries, its primary purpose is to ensure the stability of the international monetary system. The IMF is concerned about the consequences money laundering and related crimes can have on the integrity and stability of the financial sector and the broader economy.

Importance of understanding Anti-money laundering

The estimated amount of **money laundered globally in one year is 2% to 5% of global GDP, or US$800 billion to US$2 trillion** – and that's a low estimate. Money laundering often accompanies activities like smuggling, illegal arms sales, embezzlement, insider trading, bribery, and computer fraud schemes. It's also common with organized crime including human, arms or drug trafficking, and prostitution rings.

Anti-money laundering is closely related to counter-financing of terrorism (CFT), which financial institutions use to combat terrorist financing. AML regulations combine money laundering (source of funds) with terrorism financing (destination of funds).

Beyond the moral imperative to fight money laundering and terrorist financing, financial institutions also use AML tactics for:

- **Compliance with regulations** that require them to monitor customers and transactions and report suspicious activity.
- **Protection of their brand reputation** and shareholder value.
- **Avoidance of consent orders** as well as civil and criminal penalties that could be levied because of non-compliance or negligence.
- **Reduction of costs** related to fines, employee and IT costs, and capital reserved for risk exposure.

How Money Laundering Works

To identify and report potential money laundering and address compliance requirements, financial institutions must have a deep understanding of how the crime works. Money laundering involves three stages:

- Placement,
- Layering, and
- Integration.

These are a complex series of transactions that start with depositing funds, then gradually moving them into what appear to be legitimate assets.

Placement refers to how and where illegally obtained funds are placed. Money is often placed via Payments to cash-based businesses; payments for false invoices; "smurfing," which means putting small amounts of money (below the AML threshold) into bank accounts or credit cards; moving money into trusts and offshore companies that hide beneficial owners' identities; using foreign bank accounts, and aborting transactions shortly after funds are lodged with a lawyer or accountant.

Layering refers to separating criminal funds from their source. It involves converting the illicit proceeds into another form and creating complex layers of financial transactions to disguise the funds' origin and ownership. Criminals do this to obfuscate the trail of their illicit funds so it will be hard for AML investigators to trace the transactions.

Integration refers to the re-entry of the laundered funds into the economy in what appears to be normal, legitimate business or personal transactions. This is sometimes done by investing in real estate or luxury assets. It allows launderers and criminals to increase their wealth.

Regulations & Compliance for AML

The FATF helps countries create a financial intelligence unit (FIU) that's responsible for managing the flow of information between their institutions and law enforcement agencies. Government legislation and regulation by each country's FIU make financial institutions the first line of defence against money laundering and terrorist financing.

By reporting suspicious activities to the government via suspicious transaction reports (STRs) and suspicious activity reports (SARs), banks alert law enforcement to possible criminal activities. Many regulatory bodies have enacted critical AML legislation with compliance requirements banks follow to enforce anti-money laundering, such as:

US: US Patriot Act, Bank Secrecy Act.

Europe: EU Fourth Anti-Money Laundering Directive (4AMLD).

Canada: Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA).

Australia: Anti-Money Laundering and Counter-Terrorism Financing Act of 2006.

AML regulations vary by jurisdiction, but in general, financial institutions undertake the following measures to meet compliance requirements:

- **Customer identification program/know your customer (KYC)**: Financial institutions must require proper customer identification and verification to ensure legitimacy. Higher-risk products and services (e.g., private banking) require more in-depth documentation.
- **Large currency transaction reporting**: Requirements call for institutions to file a regulatory report (known as a "CTR" in the US) for transactions above a certain threshold made by a single customer during a business day.

- **Suspicious activities monitoring and reporting**: Regulatory agencies publish AML guidelines about behaviour that should be monitored (e.g., making numerous cash deposits or withdrawals over several days to avoid a reporting threshold). If an AML investigator uncovers behaviour that exceeds reporting thresholds and has no apparent business purpose, they file a SAR/STR with the FIU to fulfil Regulatory requirements.

Sanctions compliance: Regulatory bodies such as the US Treasury Department, US Office of Foreign Assets Control, the United Nations, the European Union, His Majesty's Treasury, and the Financial Action Task Force on Money Laundering have requirements for financial institutions to check transaction parties against lists of sanctioned individuals, companies, institutions and countries.

Technology & Anti-Money Laundering:

A successful anti-money laundering program involves using data and analytics to detect unusual activities. This is done by monitoring transactions, customers, and entire networks of behaviours.

As Artificial Intelligence technologies like Machine Learning become more prevalent, these next-gen AML technologies will automate many manual processes- helping to effectively identify financial crimes risks.

These techniques can be used for:

Suspicious activity monitoring- to uncover new schemes and detect increasingly sophisticated financial crimes tactics.

Intelligent alert prioritization- triage alerts that warrant investigation and hibernate low- value alerts.

Alert/case enrichment- to show AML investigators relevant images, prior cases, SARs, third- party data, maps, transaction history, and more.

Automated SAR filings- via natural language generation and processing to transform data into language and stories.

A holistic entity view- built from network analytics to help you visualize and explore relationships in data.

Alert scoring- with Bayesian algorithms to relatively scores all subjects of AML investigations.

Client risk rating- for empirical scoring of money laundering risk exposure.

Intelligent customer segmentation- that builds smart peer groupings to improve coverage across customers and/ or accounts.

Peer-based anomaly detection- to identify abnormal behaviour for a subject relative to peers.

Rare-event detection- to identify those similar to a subject of interest (such as a law enforcement inquiry).

Automated manual processes- across the trade transaction life cycle to detect patterns of illicit trade finance activity through optical character recognition.

Prevention of Money-Laundering Act (PMLA), 2002:

In India, The Prevention of Money-Laundering Act (PMLA), 2002 is an Act to prevent money laundering and to provide for confiscation of property derived from, or involved in, money laundering and for matters connected therewith or incidental thereto. Illegally obtained funds are laundered and moved around the globe using shell companies, and intermediaries. In this way, the illegal funds are given the colour of legitimacy, and it finds their way into the economy.

The offence of Money-Laundering:

The definition of "Money-Laundering" is comprehensive enough to cover most of the instances of converting black money into white.

Money-laundering has been defined in PMLA under section 3, wherein a person shall be guilty of the offence of money-laundering if such person is found to have directly or indirectly:

- Attempted to indulge or
- Knowingly assisted or
- Knowingly is a party or

Is involved in one or more of the following processes or activities connected with proceeds of crime, namely:

- Concealment; or
- Possession; or
- Acquisition; or
- Use; or
- Projecting as untainted property; or
- Claiming as untainted property.

Section 2(u) of PMLA defines "Proceeds of Crime" as any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offense or the value of any such property, or where such property is taken or held outside the country, then the property equivalent in value held within the country or abroad.

"Proceeds of Crime" include property not only derived or obtained from a scheduled offense but also any property which may directly or indirectly be derived or obtained as a result of any criminal activity relatable to the scheduled offense.

The Schedule to PMLA lists all offenses which have been defined as scheduled offences. As per Section 2(1)(y) of PMLA, Scheduled offence means:

- The offences specified under Part A of the Schedule; or
- The offences specified under Part B of the Schedule if the total value involved in such offences is one crore rupees or more; or
- The offenses are specified under Part C of the Schedule.

An offense of money laundering cannot exist independently. It is evident that money laundering comprises a predicate offence well and is usually the result of the commission of a predicate offence is the sine qua non for the existence of an offence under PMLA that the money in question is 'proceeds of crime' derived from the commission of a predicate offence. In the absence of a predicate offense, there can be no offence of money laundering. The predicate offences are mentioned in the Schedule to PMLA.

Attachment of Property under PMLA:

Under Section 2(v) of PMLA, the term "property" has been defined as any property or assets of every description, whether corporeal or incorporeal, movable or immovable, tangible or intangible, and includes deeds and instruments evidencing title to, or interest in, such property or assets, wherever located.

It is often seen that the assets that may constitute "Proceeds of Crime" may be situated outside India, and it becomes difficult for the authorities to attach such property, which is in a foreign jurisdiction. Therefore, to overcome this hurdle, an amendment to the definition of "Proceeds of Crime" was made by the Finance act 2015, which enables the attachment and confiscation of equivalent assets in India where the asset located abroad cannot be forfeited.

The Finance Act 2018, has further amended the definition of 'proceeds of crime' to include the right of attachment of such property held, which is equivalent to the proceeds of crime.

Section 2(d) of PMLA defines the word "attachment" to mean the prohibition of transfer, conversion, disposition, or movement of property by an order under PMLA.

The power of attachments granted, under section 5 of PMLA to a Director or any other officer not below the rank of Deputy Director authorized by the Director appointed by the Central Government to be authorities under the Act for attachment of property involved in money-laundering. It is important that to exercise the right of attachment; the concerned officer has to show that based on material in his possession, has reason to believe,, which has to be recorded in writing, that has possession of any proceeds of crime that are likely to be concealed, transferred, or dealt with in a way which might interfere with proceedings, investigations which relates to the confiscation of such proceeds linked with a crime, he may in such a case order the prohibition of transfer, conversion, disposition, or the movement of any such proceeds or property. The attachment is valid for 180 days from the date of the order and following the attachment, the officer must forward the attachment order along with the material in his possession to the Adjudicating Authority of the matter. He must also explain the facts of the case and also the reasons for such attachment to the Adjudicating Authority. The aggrieved person also has the right to present his defence before the Adjudicating Authority records that the attached property forms part of the money-laundering ring and is considered as a proceed of the crime.

Nevertheless, the aggrieved person can challenge the attachment order and the validity of the Reasons to Believe formed by the authorized officer, for attaching the property of the aggrieved person, at the appropriate forum, and then it will be open to the Court or forum to examine whether the reasons for the believe have any rational connection with the material in possession, or the officer has any basis for forming such belief. On examination, if the Court or forum concludes that the belief formed by the officer is not able to satisfy the statutory requirement as enumerated u/s.5(1) of PMLA, then the whole proceedings for attachment of property of the aggrieved person will get vitiated. The attachment shall continue while the proceedings for the crime go on for the scheduled offence and will become final only after the guilty judgment from the Court has been passed.

Arrest Under PMLA:

Under Section 19 of PMLA, the Director, Deputy Director, Assistant Director, or any other officer authorized on this behalf by the Central Government by general or special order, has the power to arrest a person. A person can be arrested by the concerned authority, if such authority, is based on material in his possession,

- Has reason to believe that such a person has been guilty of an offence punishable under PMLA, and
- The reason for such belief has been duly recorded in writing.

After arresting such a person, the authority is bound to:

- Inform the arrested person about the grounds for his arrest.
- Forward a copy of the arrest order along with the material in his possession to the Adjudicating Authority.
- Produce such person, within twenty-four hours, before the Special Court or Judicial Magistrate or a Metropolitan Magistrate, as the case may be, having jurisdiction.

From the bare perusal of Section 19 of PMLA, it is apparent that there is no requirement under the section to obtain an arrest warrant from the Court before arresting a person. If the conditions mentioned in Section 19 of PMLA are fulfilled, the relevant authority under PMLA can arrest such a person.

The question of whether the offences under PMLA are cognizable or non-cognizable is irrelevant under PMLA. However, there are contradictory judgments of High Courts on the point of whether the offences under PMLA are cognizable or non-cognizable. The matter is now sub-judice before the Hon'ble Supreme Court.

Bail under PMLA:

Section 45 of PMLA deals with the provisions relating to bail under the Act. Under section 45, an offence under PMLA shall be cognizable and non-bailable. A cognizable offence means an offence in which a police officer has the authority to make an arrest without a warrant and to start an investigation with or without the permission of a court. Bail for an offence under PMLA cannot be given as of right but only after the accused has been presented before a judge in this case, before the relevant Special Court. It may be noted that the provisions of PMLA do not provide for any right of seeking anticipatory bail. The said right is derived from section 65 of PMLA, and as a result, the accused can seek the relief of anticipatory bail given under the provisions of the Code of Criminal Procedure, 1973 CrPC). The privilege of the pre-arrest bail is not a matter of right and is generally granted only in exceptional cases under section 438 of CrPC.

Summon, Survey & Search:

Section 16 of PMLA deals with the Power of Survey. An officer under PMLA has the power to enter and survey a property or premises, if such officer believes that the survey will allow him the opportunity to inspect necessary records which might be available on the premises in question, help verify proceeds of a crime or any transactions related to the proceeds which might be found on the premises, or might assist them with any other proceedings being conducted under the Act. The officer is under an obligation to record the reasons for choosing to survey the premises as well as the findings.

Section 17 of PMLA deals with the power of search and seizure by the authority. A Director or any person authorised by the Director released reason on based information provided to him or already in his possession, which needs to be put in writing money laundering has indulged in monetizing possession of any proceeds of crime, and such records evidencing such a crime, or has property related to the crime, in such a case he will be within his powers to authorize an officer to:

- Enter and search any building, place, vessel, vehicle, or aircraft where he has reason to suspect that such records or proceeds of crime are kept;
- Break open the lock of any door, box, locker, safe, almirah, or other receptacles where the keys thereof are not available;
- Seize any record or property found as a result of such search;
- Placemarks of identification on such record or make or cause to be made extracts or copies therefrom;
- Make a note or an inventory of such record or property;
- Examine on oath any person who is found to be in possession or control of any record or property, in respect of all matters relevant to any investigation under PMLA.

Section 18 of PMLA deals with the power to search a person. If an authority, has reason to believe (the reason for such belief to be recorded in writing) that any person has secreted about his person or in anything under his possession, ownership, or control, any record or proceeds of crime which may be useful for or relevant to any proceedings under this Act, the authority may search that person and seize such record or property which may be useful for or relevant to any proceedings under this Act.

Retention of Records under PMLA:

Section 21 of PMLA deals with the retention of records. As per the aforesaid section, where any records have been seized under section 17 or section 18 or frozen under sub-section (1A) of section 17 and the officer authorized by based on his behalf has based on material in his possession, the reason to believe, which shall be recorded in writing, that such records are required to for purposes of adjudication under section 8, such records may, if seized, be retained or if frozen, may continue to remain frozen, for a period not exceeding one hundred and eighty days from the day on which such records were seized or frozen, as the case may be. On the expiry of the period of one hundred and eighty days, the records shall be returned to the person from whom such records were seized or whose records were ordered to be frozen unless the Adjudicating Authority permits retention or continuation of freezing of such records beyond the said period. The Adjudicating Authority, before authorizing the retention or continuation of freezing of such records beyond the period of one hundred and eighty days, shall satisfy himself that the records are prima facie involved in money-laundering and the records are required for the detection under section 8. The person from whom records are seized or frozen shall be entitled to obtain copies of records.

Interconnected Transactions:

Section 23 of PMLA deals with presumption relating to interconnected transactions. As per the aforesaid section, here money-laundering involves two or more inter-connected transactions and one or more such transactions is or are proved to be involved in money-laundering, then for adjudication or confiscation under Section 8 or the trial of the money-laundering offence, it shall unless otherwise proved, be presumed that the remaining transactions form part of such inter-connected transactions associated with money-laundering.

Presumptions & Onus of Proof:

Under section 24 of PMLA, the burden of proof lies on the person who claims that the proceeds of the crime alleged to be involved in money-laundering, are not so involved. The presumption against the accused or any 3rd party is good enough to discharge the onus of the authorities under PMLA. Even in the case of records and properties which are found in the possession or control of any person in the course of a survey or search under PMLA (Section 16, Section 17, and Section 18), under section 22 of PMLA, a presumption is raised that such records or property belongs to such person, and the contents of such records are true, and further that signatures and any part of such records is in hand-writing of a particular person or the hand-writing of such person.

Where any records have been received from any place outside India, duly authenticated by such authority or person and in such manner, as may be prescribed, in the course of proceedings under PMLA, the Special Court, the Appellate Tribunal, or the Adjudicating Authority, as the case may be, shall presume, that the signature and every other part of such record which purports to be in the hand-writing of any particular person or which the Court may reasonably assume to have been signed by, or to be in the hand-writing of, any particular person, is in that person’s hand-writing; and in the case of a record executed or attested, that it was executed or attested by the person by whom it purports to have been so executed or attested.

The presumptions are absolute, and the onus to prove the same otherwise lies on such a person.

It is clear that a person accused of an offence under Section 3 of PMLA, whose property is attached and proceeded against for confiscation, shall discharge the onus of proof (Section 24) vested in him by disclosing the sources of his income, earnings, or assets, out of which or means by which he has acquired the property attached, to discharge the burden that the property does not constitute proceeds of crime. Where a transaction of acquisition of property is part of inter-connected transactions, the onus of establishing that the property acquired is not connected to the activity of money-laundering, is on the person in ownership, control, or possession of the property, even if such person is not accused of a Section 3 offence under the Act, provided one or more of the interconnected transactions is or are proved to be involved in money-laundering.

Under the Act, a person accused or being investigated for money laundering is required to give a truthful statement if such person is summoned by the Director. This power to the Director is given under section 50(2) of PMLA, which provides that the Director (or Additional Director, Joint Director, Deputy Director, or Assistant Director) has the power to summon any person whose attendance he considers necessary whether to give evidence or to produce any records during any investigation or proceeding. All such summoned persons are bound to state the truth or make statements and produce such documents as may be required under section 50(3) of the Act.

A person called upon to make a statement before the authorities under section 50 of PMLA during an investigation cannot be said to be accused of an offence. The investigation is only to collect evidence about the proceeds of crime in the hands of the persons suspected and their involvement in the offence of money laundering. It is only at the stage of filing the complaint about prosecution under PMLA envisaged under Section 44, that such persons or suspects be termed as accused. Accordingly, all such statements can be used against the accused during prosecution.

Offences of Cross-Border Implications:

Offenses with cross-border implications are offences under Part C of the Schedule to PMLA and, accordingly, PMLA may apply offences of willful attempt to evade tax under section 51 of the Black Money Act has also been included in the list of offences under PMLA, and accordingly, PMLA may apply to such offences. Further, the UN Security Council Resolution 1373 obliges countries to freeze without delay the funds or other assets of persons who commit, or attempt to commit, terrorist acts, or participate in or facilitate the commission of terrorist acts; entities owned or controlled directly or indirectly by such persons; and persons and entities acting on behalf of or at the direction of, such persons and entities, including funds or other assets derived or generated from property owned or controlled, directly or indirectly, by such persons and associated persons and entities.

Each country has the authority to designate the persons and entities that should have their funds or other assets frozen. Additionally, to ensure that effective cooperation is developed among countries, countries should examine and give effect to, if appropriate, the actions initiated under the freezing mechanisms of other countries. To give effect to the requests of foreign countries under UN Security Council Resolution 1373, the Ministry of External Affairs examines the requests made by the foreign countries and forwards them electronically, with their comments, to a designated officer for freezing of funds or other assets. The freezing orders shall take place without prior notice to the designated persons involved.

International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation

18.1

Note: For detailed information on 18.1 and 18.2 Concepts, please go through the Documents on The FATF Recommendations (International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation) – Updated March 2022 and Guidance for a Risk-Based Approach (Accounting Profession) – Updated 2019 of Financial Action Task Force (FATF) - www.fatf-gafi.org

Acronyms:

AML/CFT: Anti-Money Laundering / Countering the Financing of Terrorism (also used for Combating the financing of terrorism)

BNI: Bearer-Negotiable Instrument

CDD: Customer Due Diligence

DNFBP: Designated Non-Financial Business or Profession

FATF: Financial Action Task Force

FIU: Financial Intelligence Unit

IN: Interpretive Note

ML: Money Laundering

MVTS: Money or Value Transfer Service(s) NPO: Non-Profit Organisation

Palermo Convention: The United Nations Convention against Transnational Organized Crime 2000

PEP: Politically Exposed Person

R.: Recommendation

RBA: Risk-Based Approach SR.: Special Recommendation SRB: Self-Regulatory Bodies

STR: Suspicious Transaction Report

TCSP: Trust and Company Service Provider

Terrorist Financing Convention: The International Convention for the Suppression of the Financing of Terrorism 1999

UN: United Nations

Vienna Convention: The United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances 1988

The FATF Recommendations:

A. AML/CFT POLICIES AND COORDINATION

1. **Assessing risks and applying a risk-based approach:**

Countries should identify, assess, and understand the money laundering and terrorist financing risks for the country, and should take action, including designating an authority or mechanism to coordinate actions to assess risks and apply resources, aimed at ensuring the risks are mitigated effectively. Based on that assessment, countries should apply a risk-based approach (RBA) to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified. This approach should be an essential foundation for the efficient allocation of resources across the anti-money laundering and countering the financing of terrorism (AML/CFT) regime and the implementation of risk-based measures throughout the FATF Recommendations. Where countries identify higher risks, they should ensure that their AML/CFT regime adequately addresses such risks. Where countries identify lower risks, they may decide to allow simplified measures for some of the FATF Recommendations under certain conditions.

Countries should also identify, assess, and understand the proliferation financing risks for the country. In the context of Recommendation 1, "proliferation financing risk" refers strictly and only to the potential breach, non-implementation, or evasion of the targeted financial sanctions obligations referred to in Recommendation 7. Countries should take commensurate action aimed at ensuring that these risks are mitigated effectively, including designating an authority or mechanism to coordinate actions to assess risks and allocate resources efficiently for this purpose. Where countries identify higher risks, they should ensure that they adequately address such risks. Where countries identify lower risks, they should ensure that the measures applied are commensurate with the level of proliferation financing risk, while still ensuring full implementation of the targeted financial sanctions as required in Recommendation 7.

Countries should require financial institutions and designated non-financial businesses and professions (DNFBPs) to identify, assess and take effective action to mitigate their money laundering, terrorist financing, and proliferation financing risks.

2. National cooperation and coordination:

Countries should have national AML/CFT/CPF policies, informed by the risks (Proliferation financing risk refers strictly and only to the potential breach, non-implementation, or evasion of the targeted financial sanctions obligations referred to in Recommendation 7) identified, which should be regularly reviewed and should designate an authority or have the coordination or another mechanism that is responsible for such policies.

Countries should ensure that policy-makers, the financial intelligence unit (FIU), law enforcement authorities, supervisors, and other relevant competent authorities, at the policymaking and operational levels, have effective mechanisms in place which enable them to cooperate, and, where appropriate, coordinate and exchange information domestically with each other concerning the development and implementation of policies and activities to combat money laundering, terrorist financing and the financing of proliferation of weapons of mass destruction. This should include cooperation and coordination between relevant authorities to ensure the compatibility of AML/CFT/CPF requirements with Data Protection and Privacy rules and other similar provisions (e.g., data security/localization).

B. MONEY LAUNDERING AND CONFISCATION

3. Money laundering offence:

Countries should criminalize money laundering based on the Vienna Convention and the Palermo Convention. Countries should apply the crime of money laundering to all serious offences, including the widest range of predicate offences.

4. Confiscation and provisional measures:

Countries should adopt measures similar to those outlined in the Vienna Convention, the Palermo Convention, and the Terrorist Financing Convention, including legislative measures, to enable their competent authorities to freeze or seize and confiscate the following, without prejudicing the rights of bona fide third parties: (a) property laundered, (b) proceeds from, or instrumentalities used in or intended for use in money laundering or predicate offences, (c) property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts or terrorist organisations, or (d) property of corresponding value.

Such measures should include the authority to (a) identity, trace, and evaluate the property that is subject to confiscation; (b) carry out provisional measures, such as freezing and seizing, to prevent any dealing, transfer, or disposal of such property; (c) take steps that will prevent or void actions that prejudice the country's ability to freeze or seize or recover property that is subject to confiscation; and (d) take any appropriate investigative measures.

Countries should consider adopting measures that allow such proceeds or instrumentalities to be confiscated without requiring a criminal conviction (non-conviction-based confiscation), or which require an offender to demonstrate the lawful origin of the property alleged to be liable to confiscation, to the extent that such a requirement is consistent with the principles of their domestic law.

C. TERRORIST FINANCING AND FINANCING OF PROLIFERATION

5. Terrorist financing offence:

Countries should criminalize terrorist financing based on the Terrorist Financing Convention and should criminalize not only the financing of terrorist acts but also the financing of terrorist organisations and individual terrorists even in the absence of a link to a specific terrorist act or acts. Countries should ensure that such offences are designated as money laundering predicate offences.

6. Targeted financial sanctions related to terrorism and terrorist financing:

Countries should implement targeted financial sanctions regimes to comply with United Nations Security Council resolutions relating to the prevention and suppression of terrorism and terrorist financing. The resolutions require countries to freeze without delay the funds or other assets of and to ensure that no funds or other assets are made available, directly or indirectly, to or for the benefit of, any person or entity either (i) designated by, or under the authority of, the United Nations Security Council under Chapter VII of the Charter of the United Nations, including by resolution 1267 (1999) and its successor resolutions; or (ii) designated by that country under resolution 1373 (2001).

7. Targeted financial sanctions related to proliferation:

Countries should implement targeted financial sanctions to comply with United Nations Security Council resolutions relating to the prevention, suppression, and disruption of the proliferation of weapons of mass destruction and its financing. These resolutions require countries to freeze without delay the funds or other assets of and to ensure that no funds and other assets are made available, directly or indirectly, to or for the benefit of, any person or entity designated by, or under the authority of, the United Nations Security Council under Chapter VII of the Charter of the United Nations.

8. Non-profit organisations:

Countries should review the adequacy of laws and regulations that relate to non-profit organisations that the country has identified as being vulnerable to terrorist financing abuse. Countries should apply focused and proportionate measures, in line with the risk-based approach, to such non-profit organisations to protect them from terrorist financing abuse, including:

(a) By terrorist organisations posing as legitimate entities;

(b) By exploiting legitimate entities as conduits for terrorist financing, including to escape asset-freezing measures; and

(c) By concealing or obscuring the clandestine diversion of funds intended for legitimate purposes to terrorist organisations.

D. PREVENTIVE MEASURES:

9. Financial institution secrecy laws:

Countries should ensure that financial institution secrecy laws do not inhibit the implementation of the FATF Recommendations.

CUSTOMER DUE DILIGENCE AND RECORD-KEEPING:

10. Customer due diligence:

Financial institutions should be prohibited from keeping anonymous accounts or accounts in fictitious names. Financial institutions should be required to undertake customer due diligence (CDD) measures when:

(i) Establishing business relations;

(ii) Carrying out occasional transactions: above the applicable designated threshold (USD/EUR 15,000); or

(ii) that are wire transfers in the circumstances covered by the Interpretive Note to Recommendation 16;

(iii) There is a suspicion of money laundering or terrorist financing; or

(iv) The financial institution has doubts about the veracity or adequacy of previously obtained customer identification data.

The principle that financial institutions should conduct CDD should be set out in law. Each country may determine how it imposes specific CDD obligations, either through law or enforceable means.

The CDD measures to be taken are as follows:

(a) Identifying the customer and verifying that customer's identity using reliable, independent source documents, data, or information.

(b) Identifying the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner, such that the financial institution is satisfied that it knows who the beneficial owner is. For legal persons and arrangements, this should include financial institutions understanding the ownership and control structure of the customer.

(c) Understanding and, as appropriate, obtaining information on the purpose and intended nature of the business relationship.

(d) Conducting ongoing due diligence on the business relationship and scrutiny of transactions are undertaken throughout that relationship to ensure that the transactions being conducted are consistent with the institution's knowledge of the customer, their business, and risk profile, including, where necessary, the source of funds.

Financial institutions should be required to apply each of the CDD measures under (a) to (d) above but should determine the extent of such measures using a risk-based approach (RBA) by the Interpretive Notes to this Recommendation and Recommendation 1.

Financial institutions should be required to verify the identity of the customer and beneficial owner before or during establishing a business relationship or conducting transactions for occasional customers. Countries may permit financial institutions to complete the verification as soon as reasonably practicable following the establishment of the relationship, where the money laundering and terrorist financing risks are effectively managed, and where this is essential not to interrupt the normal conduct of business.

Where the financial institution is unable to comply with the applicable requirements under paragraphs (a) to (d) above (subject to appropriate modification of the extent of the measures on a risk-based approach), it should be required not to open the account, commence business relations or perform the transaction; or should be required to terminate the business relationship; and should consider making a suspicious transactions report about the customer.

These requirements should apply to all new customers, although financial institutions should also apply this Recommendation to existing customers based on materiality and risk, and should conduct due diligence on such existing relationships at appropriate times.

11. Record-keeping:

Financial institutions should be required to maintain, for at least five years, all necessary records on transactions, both domestic and international, to enable them to comply swiftly with information requests from competent authorities. Such records must be sufficient to permit the reconstruction of individual transactions (including the amounts and types of currency involved, if any) to provide, if necessary, evidence for the prosecution of criminal activity.

Financial institutions should be required to keep all records obtained through CDD measures (e.g., copies or records of official identification documents like passports, identity cards, driving licenses, or similar documents), account files, and business correspondence, including the results of any analysis undertaken (e.g., inquiries to establish the background and purpose of complex, unusual large transactions), for at least five years after the business relationship is ended, or after the date of the occasional transaction.

Financial institutions should be required by law to maintain records on transactions and information obtained through the CDD measures.

The CDD information and the transaction records should be available to domestic competent authorities upon appropriate authority.

ADDITIONAL MEASURES FOR SPECIFIC CUSTOMERS AND ACTIVITIES

12. Politically exposed persons:

Financial institutions should be required, about foreign politically exposed persons (PEPs) (whether a customer or beneficial owner), in addition to performing normal customer diligence measures, to:

(a) have appropriate risk-management systems to determine whether the customer or the beneficial owner is a politically exposed person;

(b) obtain senior management approval for establishing (or continuing, for existing customers) such business relationships;

(c) take reasonable measures to establish the source of wealth and source of funds; and conduct enhanced ongoing monitoring of the business relationship.

Financial institutions should be required to take reasonable measures to determine whether a customer or beneficial owner is a domestic PEP or a person who is or has been entrusted with a prominent function by an international organisation. In cases of a higher-risk business relationship with such persons, financial institutions should be required to apply the measures referred to in paragraphs B, C and D.

The requirements for all types of PEP should also apply to family members or close associates of such PEPs.

13. Correspondent banking:

Financial institutions should be required, about cross-border correspondent banking and other similar relationships, in addition to performing normal customer due diligence measures, to:

(a) Gather sufficient information about a respondent institution to understand fully the nature of the respondent's business and to determine from publicly available information the reputation of the institution and the quality of supervision, including whether it has been subject to a money laundering or terrorist financing investigation or regulatory action;

(b) Assess the respondent institution's AML/CFT controls;

(c) Obtain approval from senior management before establishing a news correspondent relationship;

(d) Clearly understand the respective responsibilities of each institution; and

(e) Concerning "payable-through accounts", be satisfied that the respondent bank has conducted CDD on the customers having direct access to accounts of the correspondent bank and that it can provide relevant CDD information upon request to the correspondent bank.

Financial institutions should be prohibited from entering into, or continuing, a correspondent banking relationship with shell banks. Financial institutions should be required to satisfy themselves that respondent institutions do not permit their accounts to be used by shell banks.

14. Money or value transfer services:

Countries should take measures to ensure that natural or legal persons that provide money or value transfer services (MVTS) are licensed or registered and subject to effective systems for monitoring and ensuring compliance with the relevant measures called for in the FATF Recommendations. Countries should take action to identify natural or legal persons that carry out MVTS without a license or registration and to apply appropriate sanctions.

Any natural or legal person working as an agent should also be licensed or registered by a competent authority or the MVTS provider should maintain a current list of its agents accessible by competent authorities in the countries in which the MVTS provider and its agents operate. Countries should take measures to ensure that MVTS providers that use agents include them in their AML/CFT programs and monitor them for compliance with these programs.

15. New technologies:

Countries and financial institutions should identify and assess the money laundering or terrorist financing risks that may arise about: (a) the development of new products and new business practices, including new delivery mechanisms, and (b) the use of new or developing technologies for both new and pre-existing products. In the case of financial institutions, such a risk assessment should take place before the launch of new products, business practices, or the use of new or developing technologies. They should take appropriate measures to manage and mitigate those risks.

To manage and mitigate the risks emerging from virtual assets, countries should ensure that virtual asset service providers are regulated for AML/CFT purposes and licensed or registered and subject to effective systems for monitoring and ensuring compliance with the relevant measures called for in the FATF Recommendations.

16. Wire transfers:

Countries should ensure that financial institutions include required and accurate originator information, and required beneficiary information, on wire transfers and related messages, and that the information remains with the wire transfer or related message throughout the payment chain.

Countries should ensure that financial institutions monitor wire transfers for detecting those that lack required originator and/or beneficiary information, and take appropriate measures.

Countries should ensure that, in the context of processing wire transfers, financial institutions take freezing action and should prohibit conducting transactions with designated persons and entities, as per the obligations set out in the relevant United Nations Security Council resolutions, such as resolution 1267 (1999) and its successor resolutions, and resolution 1373 (2001), relating to the prevention and suppression of terrorism and terrorist financing.

RELIANCE, CONTROLS, AND FINANCIAL GROUPS

17. Reliance on third parties:

Countries may permit financial institutions to rely on third parties to perform elements (a)-(c) of the CDD measures set out in Recommendation 10 or to introduce business, provided that the criteria set out below are met. Where such reliance is permitted, the ultimate responsibility for CDD measures remains with the financial institution relying on the third party.

The criteria that should be met are as follows:

(a) A financial institution relying upon a third party should immediately obtain the necessary information concerning elements (a)-(c) of the CDD measures set out in Recommendation 10.

(b) Financial institutions should take adequate steps to satisfy themselves that copies of identification data and other relevant documentation relating to the CDD requirements will be made available from the third party upon request without delay.

(c) The financial institution should satisfy itself that the third party is regulated, supervised, or monitored, and has measures in place for compliance with, CDD and recordkeeping requirements in line with Recommendations 10 and 11.

(d) When determining in which countries the third party that meets the conditions can be based, countries should have regard to information available on the level of country risk.

When a financial institution relies on a third party that is part of the same financial group, and (i) that group applies CDD and record-keeping requirements, in line with Recommendations 10, 11, and 12, and programs against money laundering and terrorist financing, by Recommendation 18; and (ii) where the effective implementation of those CDD and record-keeping requirements and AML/CFT programs are supervised at a group level by a competent authority, then relevant competent authorities may consider that the financial institution applies measures under (b) and (c) above through its group program, and may decide that (d) is not a necessary precondition to reliance when higher country risk is adequately mitigated by the group AML/CFT policies.

18. Internal controls and foreign branches and subsidiaries:

Financial institutions should be required to implement programs against money laundering and terrorist financing. Financial groups should be required to implement group-wide programs against money laundering and terrorist financing, including policies and procedures for sharing information within the group for AML/CFT purposes.

Financial institutions should be required to ensure that their foreign branches and majority-owned subsidiaries apply AML/CFT measures consistent with the home country's requirements in implementing the FATF Recommendations through the financial groups' programs against money laundering and terrorist financing.

19. Higher-risk countries:

Financial institutions should be required to apply enhanced due diligence measures to business relationships and transactions with natural and legal persons, and financial institutions, from countries for which this is called for by the FATF. The type of enhanced due diligence measures applied should be effective and proportionate to the risks.

Countries should be able to apply appropriate countermeasures when called upon to do so by the FATF. Countries should also be able to apply countermeasures independently of any call by the FATF to do so. Such countermeasures should be effective and proportionate to the risks.

REPORTING OF SUSPICIOUS TRANSACTIONS

20. Reporting of suspicious transactions:

If a financial institution suspects or has reasonable grounds to suspect that funds are the proceeds of criminal activity, or are related to terrorist financing, it should be required, by law, to report promptly its suspicions to the financial intelligence unit (FIU).

21. Tipping-off and confidentiality:

Financial institutions, their directors, officers, and employees should be:

(a) protected by law from criminal and civil liability for breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision, if they report their suspicions in good faith to the FIU, even if they did not know precisely what the underlying criminal activity was, and regardless of whether the illegal activity occurred; and

(b) prohibited by law from disclosing ("tipping-off") the fact that a suspicious transaction report (STR) or related information is being filed with the FIU. These provisions are not intended to inhibit information sharing under Recommendation 18.

DESIGNATED NON-FINANCIAL BUSINESSES AND PROFESSIONS

22. DNFBPs: customer due diligence:

The customer due diligence and record-keeping requirements set out in Recommendations 10, 11, 12, 15, and 17, apply to designated non-financial businesses and professions (DNFBPs) in the following situations:

(a) Casinos- when customers engage in financial transactions equal to or above the applicable designated threshold.

(b) Real estate agents- when they are involved in transactions for their clients concerning the buying and selling of real estate.

(c) Dealers in precious metals and dealers in precious stones- when they engage in any cash transaction with a customer equal to or above the applicable designated threshold.

(d) Lawyers, notaries, other independent legal professionals, and accountants – when they prepare for or carry out transactions for their clients concerning the following activities:

- Buying and selling of real estate;
- Managing client money, securities, or other assets;
- Management of the bank, savings, or securities accounts;
- The organisation of contributions for the creation, operation, or management of companies;
- Creation, operation, or management of legal persons or arrangements, and buying and selling of business entities.

(e) Trust and company service providers – when they prepare for or carry out transactions for a client concerning the following activities:

- Acting as a formation agent of legal persons;
- Acting as (or arranging for another person to act as) a director or secretary of a company, a partner of a partnership, or a similar position to other legal persons;
- Providing a registered office, business address, accommodation, correspondence, or administrative address for a company, a partnership, or any other legal person or arrangement;
- Acting as (or arranging for another person to act as) a trustee of an express trust or performing the equivalent function for another form of legal arrangement;
- Acting as (or arranging for another person to act as) a nominee shareholder for another person.

23. DNFBPs: Other measures:

The requirements set out in Recommendations 18 to 21 apply to all designated non-financial businesses and professions, subject to the following qualifications:

(a) Lawyers, notaries, other independent legal professionals, and accountants should be required to report suspicious transactions when, on behalf of or for a client, they engage in a financial transaction about the activities described in paragraph (d) of recommendation 22. Countries are strongly encouraged to extend the reporting requirement for the rest of the professional activities of accountants, including auditing.

(b) Dealers in precious metals and dealers in precious stones should be required to report suspicious transactions when they engage in any cash transaction with a customer equal to or above the applicable designated threshold.

(c) Trust and company service providers should be required to report suspicious transactions for a client when, on behalf of or for a client, they engage in a transaction about the activities referred to in paragraph (e) of Recommendation 22.

E. TRANSPARENCY AND BENEFICIAL OWNERSHIP OF LEGAL PERSONS AND ARRANGEMENTS

24. Transparency and beneficial ownership of legal persons:

Countries should assess the risks of misuse of legal persons for money laundering or terrorist financing, and take measures to prevent their misuse. Countries should ensure that there is adequate, accurate, and up-to-date information on the beneficial ownership and control of legal persons that can be obtained or accessed rapidly and efficiently by competent authorities, through either a register of beneficial ownership or an alternative mechanism. Countries should not permit legal persons to issue new bearer shares or bearer share warrants and take measures to prevent the misuse of existing bearer shares and bearer share warrants. Countries should take effective measures to ensure that nominee shareholders and directors are not misused for money laundering or terrorist financing. Countries should consider facilitating access to beneficial ownership and control information by financial institutions and DNFBPs undertaking the requirements set out in Recommendations 10 and 22.

25. Transparency and beneficial ownership of legal arrangements:

Countries should take measures to prevent the misuse of legal arrangements for money laundering or terrorist financing. In particular, countries should ensure that it is adequate, accurate, and timely information on express trusts, including information on the settlor, trustee and beneficiaries, that can be obtained or accessed in a timely fashion by competent authorities.

Countries should consider measures to facilitate access to beneficial ownership and control information by financial institutions and DNFBPs undertaking the requirements set out in Recommendations 10 and 22.

F. POWERS AND RESPONSIBILITIES OF COMPETENT AUTHORITIES, AND OTHER INSTITUTIONAL MEASURES REGULATION AND SUPERVISION

26. Regulation and supervision of financial institutions:

Countries should ensure that financial institutions are subject to adequate regulation and supervision and are effectively implementing the FATF Recommendations. Competent authorities or financial supervisors should take the necessary legal or regulatory measures to prevent criminals or their associates from holding, or being the beneficial owner of, a significant or controlling interest, or holding a management function in, a financial institution. Countries should not approve the establishment, or continued operation, of shell banks.

For financial institutions subject to the Core Principles, the regulatory and supervisory measures that apply for prudential purposes, and which are also relevant to money laundering and terrorist financing, should apply similarly for AML/CFT purposes. This should include applying consolidated group supervision for AML/CFT purposes.

Other financial institutions should be licensed or registered and adequately regulated, and subject to supervision or monitoring for AML/CFT purposes, having regard to the risk of money laundering or terrorist financing in that sector. At a minimum, where financial institutions provide a service of money or value transfer, or of money or currency changing, they should be licensed or registered, and subject to effective systems for monitoring and ensuring compliance with national AML/CFT requirements.

27. Powers of supervisors:

Supervisors should have adequate powers to supervise or monitor, and ensure compliance by, financial institutions with requirements to combat money laundering and terrorist financing, including the authority to conduct inspections. They should be authorized to compel the production of any information from financial institutions that is relevant to monitoring such compliance and to impose sanctions, in line with Recommendation 35, for failure to comply with such requirements. Supervisors should have powers to impose a range of disciplinary and financial sanctions, including the power to withdraw, restrict or suspend the financial institution's license, where applicable.

28. Regulation and supervision of DNFBPs:

Designated non-financial businesses and professions should be subject to regulatory and supervisory measures as set out below.

(a) Casinos should be subject to a comprehensive regulatory and supervisory regime that ensures that they have effectively implemented the necessary AML/CFT measures. At a minimum:

- Casinos should be licensed;
- Competent authorities should take the necessary legal or regulatory measures to prevent criminals or their associates from holding, or being the beneficial owner of, a significant or controlling interest, holding a management function in, or being an operator of, a casino; and
- Competent authorities should ensure that casinos are effectively supervised for compliance with AML/CFT requirements.

(b) Countries should ensure that the other categories of DNFBPs are subject to effective systems for monitoring and ensuring compliance with AML/CFT requirements. This should be performed on a risk-sensitive basis. This may be performed by: (a) a supervisor or (b) by an appropriate self-regulatory body (SRB), provided that such a body can ensure that its members comply with their obligations to combat money laundering and terrorist financing.

The supervisor or SRB should also: (a) take the necessary measures to prevent criminals or their associates from being professionally accredited, holding or being the beneficial owner of a significant or controlling interest, or holding a management function, e.g., through evaluating persons based on a "fit and proper" test; and (b) have effective, proportionate, and dissuasive sanctions in line with Recommendation 35 available to deal with failure to comply with AML/CFT requirements.

OPERATIONAL AND LAW ENFORCEMENT

29. Financial intelligence units:

Countries should establish a financial intelligence unit (FIU) that serves as a national center for the receipt and analysis of: (a) suspicious transaction reports; and (b) other information relevant to money laundering, associated predicate offences, terrorist financing, and for the dissemination of the results of that analysis. The FIU should be able to obtain additional information from reporting entities and should have access on a timely basis to the financial, administrative, and law enforcement information that it requires to undertake its functions properly.

30. Responsibilities of law enforcement and investigative authorities:

Countries should ensure that designated law enforcement authorities have responsibility for money laundering and terrorist financing investigations within the framework of national AML/CFT policies. At least in all cases related to major proceeds-generating offences, these designated law enforcement authorities should develop a pro-active parallel financial investigation when pursuing money laundering, associated predicate offences, and terrorist financing. This should include cases where the associated predicate offence occurs outside their jurisdictions. Countries should ensure that competent authorities have responsibility for expeditiously identifying, tracing, and initiating actions to freeze and seize property that is, or may become, subject to confiscation, or is suspected of being proceeds of crime. Countries should also make use, when necessary, of permanent or temporary multi-disciplinary groups specialized in financial or asset investigations. Countries should ensure that, when necessary, cooperative investigations with appropriate competent authorities in other countries take place.

31. Powers of law enforcement and investigative authorities:

When conducting investigations of money laundering, associated predicate offences, and terrorist financing, competent authorities should be able to obtain access to all necessary documents and information for use in those investigations, prosecutions, and, related actions. This should include powers to use compulsory measures for the production of records held by financial institutions, DNFBPs, and other natural or legal persons, for the search of persons and premises, for taking witness statements, and for the seizure and obtaining of evidence.

Countries should ensure that competent authorities conducting investigations can use a wide range of investigative techniques suitable for the investigation of money laundering, associated predicate offences, and terrorist financing. These investigative techniques include undercover operations, intercepting communications, accessing computer systems, and controlled delivery. In addition, countries should have effective mechanisms in place to identify, promptly, whether natural or legal persons hold or control accounts. They should also have mechanisms to ensure that competent authorities have a process to identify assets without prior notification to the owner. When conducting investigations of money laundering, associated predicate offences, and terrorist financing, competent authorities should be able to ask for all relevant information held by the FIU.

32. Cash couriers:

Countries should have measures in place to detect the physical cross-border transportation of currency and bearer negotiable instruments, including through a declaration system and/or disclosure system.

Countries should ensure that their competent authorities have the legal authority to stop or restrain currency or bearer negotiable instruments that are suspected to be related to terrorist financing, money laundering, or predicate offences, or that are falsely declared or disclosed. Countries should ensure that effective, proportionate, and dissuasive sanctions are available to deal with persons who make a false declaration(s) or disclosure(s). In cases where the currency or bearer negotiable instruments are related to terrorist financing, money laundering, or predicate offences, countries should also adopt measures, including legislative ones consistent with Recommendation 4, which would enable the confiscation of such currency or instruments.

GENERAL REQUIREMENTS:

33. Statistics:

Countries should maintain comprehensive statistics on matters relevant to the effectiveness and efficiency of their AML/CFT systems. This should include statistics on the STRs received and disseminated; on money laundering and terrorist financing investigations, prosecutions, and convictions; on property frozen, seized, and confiscated; and on mutual legal assistance or other international requests for cooperation.

34. Guidance and feedback:

The competent authorities, supervisors, and SRBs should establish guidelines, and provide feedback, which will assist financial institutions and designated non-financial businesses and professions in applying national measures to combat money laundering and terrorist financing, and, in particular, in detecting and reporting suspicious transactions.

SANCTIONS:

35. Sanctions:

Countries should ensure that there is a range of effective, proportionate, and dissuasive sanctions, whether criminal, civil, or administrative, available to deal with natural or legal persons covered by Recommendations 6, and 8 to 23, that fail to comply with AML/CFT requirements. Sanctions should apply not only to financial institutions and DNFBPs but also, to their directors and senior management.

G. INTERNATIONAL COOPERATION:

36. International instruments:

Countries should take immediate steps to become a party to and implement fully the Vienna Convention, 1988; the Palermo Convention, 2000; the United Nations Convention against Corruption, 2003; and the Terrorist Financing Convention, 1999. Where applicable, countries are also encouraged to ratify and implement other relevant international conventions, such as the Council of Europe Convention on Cybercrime, 2001; the Inter-American Convention against Terrorism, 2002; and the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism, 2005.

37. Mutual legal assistance:

Countries should rapidly, constructively, and effectively provide the widest possible range of mutual legal assistance regarding money laundering, associated predicate offences, and terrorist financing investigations, prosecutions, and related proceedings. Countries should have an adequate legal basis for assisting and, where appropriate, should have in place treaties, arrangements, or other mechanisms to enhance cooperation. In particular, countries should:

(a) Not prohibit, or place unreasonable or unduly restrictive conditions on, the provision of mutual legal assistance.

(b) Ensure that they have clear and efficient processes for the timely prioritization and execution of mutual legal assistance requests. Countries should use a central authority, or another established official mechanism, for effective transmission and execution of requests. To monitor progress on requests, a case management system should be maintained.

(c) Not refuse to execute a request for mutual legal assistance on the sole ground that the offecse is also considered to involve fiscal matters. Do not refuse to execute a request for mutual legal assistance because laws require financial institutions or DNFBPs to maintain secrecy or confidentiality (except where the relevant information that is sought is held in circumstances where legal, a professional privilege or legal professional secrecy applies).

(d) Maintain the confidentiality of mutual legal assistance requests they receive and the information contained in them, subject to fundamental principles of domestic law, to protect the integrity of the investigation or inquiry. If the requested country cannot comply with the requirement of confidentiality, it should promptly inform the requesting country.

Countries should render mutual legal assistance, not withstanding the absence of dual criminality, if the assistance does not involve coercive actions. Countries should consider adopting such measures as may be necessary to enable them to provide a wide scope of assistance in the absence of dual criminality.

Where dual criminality is required for mutual legal assistance, that requirement should be deemed to be satisfied regardless of whether both countries place the offence within the same category of offence, or denominate the offence by the same terminology, provided that both countries criminalize the conduct underlying the offence. Countries should ensure that the powers and investigative techniques required under Recommendation 31, and any other powers and investigative techniques available to their competent authorities:

(a) All those relating to the production, search, and seizure of information, documents, or evidence (including financial records) from financial institutions or other persons, and the taking of witness statements; and

(b) A broad range of other powers and investigative techniques;

are also available for use in response to requests for mutual legal assistance, and, if consistent with their domestic framework, in response to direct requests from foreign judicial or law enforcement authorities to domestic counterparts.

To avoid conflicts of jurisdiction, consideration should be given to devising and applying mechanisms for determining the best venue for prosecution of defendants in the interests of justice in cases that are subject to prosecution in more than one country.

Countries should, when making mutual legal assistance requests, make their best efforts to provide complete factual and legal information that will allow for timely and efficient execution of requests, including any need for urgency, and should send requests using expeditious means.

Countries should, before sending requests, make their best efforts to ascertain the legal requirements and formalities to obtain assistance.

The authorities responsible for mutual legal assistance (e.g. a Central Authority) should be provided with adequate financial, human, and technical resources. Countries should have in place processes to ensure that the staff of such authorities maintain high professional standards, including standards concerning confidentiality, and should be of high integrity and be appropriately skilled.

38. Mutual legal assistance: freezing and confiscation:

Countries should ensure that they have the authority to take expeditious action in response to requests by foreign countries to identify, freeze, seize and confiscate property laundered; proceeds from money laundering, predicate offences, and terrorist financing; instrumentalities used in, or intended for use in, the commission of these offences; or property of the corresponding value. This authority should include being able to respond to requests made based on non-conviction-based confiscation proceedings and related provisional measures unless this is inconsistent with fundamental principles of their domestic law. Countries should also have effective mechanisms for managing such property, instrumentalities, or a property of corresponding value, and arrangements for coordinating seizure and confiscation proceedings, which should include the sharing of confiscated assets.

39. Extradition:

Countries should constructively and effectively execute extradition requests in a relation to money laundering and terrorist financing, without undue delay. Countries should also take all possible measures to ensure that they do not provide safe havens for individuals charged with the financing of terrorism, terrorist acts, or terrorist organisations. In particular, countries should:

(a) Ensure money laundering and terrorist financing are extraditable offences;

(b) Ensure that they have clear and efficient processes for the timely execution of extradition requests including prioritization where appropriate. To monitor the progress of requests a case management system should be maintained;

(c) Not place unreasonable or unduly restrictive conditions on the execution of requests; and

(d) Ensure they have an adequate legal framework for extradition.

Each country should either extradite its nationals or, where a country does not do so solely on the grounds of nationality, that country should, at the request of the country seeking extradition, submit the case, without undue delay, to its competent authorities for prosecution of the offences outlined in the request. Those authorities should take their decision and conduct their proceedings in the same manner as in the case of any other offence of a serious nature under the domestic law of that country. The countries concerned should cooperate, in particular on procedural and evidentiary aspects, to ensure the efficiency of such prosecutions.

Where dual criminality is required for extradition, that requirement should be deemed to be satisfied regardless of whether both countries place the offence within the same category of offence, or denominate the offence by the same terminology, provided that both countries criminalize the conduct underlying the offence.

Consistent with fundamental principles of domestic law, countries should have simplified extradition mechanisms, such as allowing direct transmission of requests for provisional arrests between appropriate authorities, extraditing persons based only on warrants of arrest or judgments, or introducing simplified extradition of consenting persons who waive formal extradition proceedings. The authorities responsible for extradition should be provided with adequate financial, human, and technical resources. Countries should have in place processes to ensure that the staff of such authorities maintain high professional standards, including standards concerning confidentiality, and should be of high integrity and be appropriately skilled.

40. Other forms of international cooperation:

Countries should ensure that their competent authorities can rapidly, constructively, and effectively provide the widest range of international cooperation about money laundering, associated predicate offences, and terrorist financing. Countries should do so both spontaneously and upon request, and there should be a lawful basis for providing cooperation.

Countries should authorize their competent authorities to use the most efficient means to cooperate. Should a competent authority need bilateral or multilateral agreements or arrangements, such as a Memorandum of Understanding (MOU), these should be negotiated and signed in a timely way with the widest range of foreign counterparts.

Competent authorities should use clear channels or mechanisms for the effective transmission and execution of requests for information or other types of assistance. Competent authorities should have clear and efficient processes for the prioritization and timely execution of requests, and for safeguarding the information received.

Note: **Interpretive Notes** to the FATF Recommendations are mentioned in The FATF Recommendations on "International Standard on Combating Money Laundering and the Financing of Terrorism & Proliferation" updated March 2022 – Page No: 31 to 115).

Guidance for a Risk-based Approach for the Accounting Profession

18.2

(Note: Sl. No.60 to Sl. No.209 of Guidance for a Risk-Based Approach – Accounting Profession of FATF document (2019) deals with Guidance for a Risk-Based Approach for Accounting Profession – Refer FATF Document for detailed REGULATIONS).

Acronyms:

AML/CFT: Anti-money laundering/Countering the financing of terrorism

CDD: Client due diligence

DNFBP: Designated non-financial businesses and professions

FATF: Financial Action Task Force

FIU: Financial intelligence unit

INR: Interpretive Note to Recommendation

ML: Money laundering

NRA: National Risk Assessment

PEP: Politically Exposed Person

R: Recommendation

RBA: Risk-based approach

SRB: Self-regulatory body

STR: Suspicious transaction report

TCSP: Trust and company service providers

TF: Terrorist financing

Risk identification and assessment:

60. Accountants should take appropriate steps to identify and assess the risk firmwide, given their particular client base, that they could be used for ML/TF. This is usually performed as part of the overall client and engagement acceptance processes. They should document those assessments, keep these assessments up to date, and have appropriate mechanisms to provide risk assessment information to competent authorities and supervisors. The nature and extent of any assessment of ML/TF risks should be appropriate to the type of business, nature of clients, and size of operations.

61. ML/TF risks can be organized into three categories: (a) country/geographic risk, (b) client risk, and (c) transaction/service and associated delivery channel risk. The risks and red flags listed in each category are not exhaustive but provide a starting point for accountants to use when designing their RBA.

62. When assessing risk, accountants should consider all the relevant risk factors before determining the level of overall risk and the appropriate level of mitigation to be applied. Such risk assessment may well be informed by findings of the NRA, the supranational risk assessments, sectoral reports conducted by competent authorities on ML/TF risks that are inherent in the accounting services/sector, risk reports in other jurisdictions where the accountant is based in, and any other information which may be relevant to assess the risk level particular to their practice. For example, press articles and other widely available public information highlighting issues that may have arisen in particular jurisdictions. Accountants may well also draw references to FATF Guidance on indicators and risk factors. During a client relationship, procedures for ongoing monitoring and review of the client's risk profile are also important. Competent authorities should consider how they can best alert accountants to the findings of any national risk assessments, supranational risk assessments, and any other information which may be relevant to assessing the risk level particular to accounting practice in the relevant country.

63. Due to the nature of services that an accountant generally provides, automated transaction monitoring systems of the type used by financial institutions will not be appropriate for most accountants. There may be some scope to use artificial intelligence and analytical tools in an audit context to spot unusual transactions. The accountant's knowledge of the client and its business will develop throughout a longer-term and interactive professional relationship (in some cases, such relationships may exist for short-term clients as well, e.g., for property transactions). However, although individual accountants are not expected to investigate their client's affairs, they may be well-positioned to identify and detect changes in the type of work or the nature of the client's activities in the course of the business relationships. Accountants will also need to consider the nature of the risks presented by short-term client relationships that may inherently, but not necessarily be low risk (e.g., one-off client relationship). Accountants should also be mindful of the subject matter of the professional services (the engagement) being sought by an existing or potential client and the related risks.

64. Identification of the ML/TF risks associated with certain clients or categories of clients, and certain types of work will allow accountants to determine and implement reasonable and proportionate measures and controls to mitigate such risks. The risks and appropriate measures will depend on the nature of the accountant's role and involvement. Circumstances may vary considerably between professionals who represent clients on a single transaction and those involved in a long-term advisory relationship.

65. The amount and degree of ongoing monitoring and review will depend on the nature and frequency of the relationship, along with the comprehensive assessment of client/transactional risk. An accountant may also have to adjust the risk assessment of a particular client based upon information received from a designated competent authority, SRB, or other credible sources (including a referring accountant).

66. Accountants may assess ML/TF risks by applying various categories. This provides a strategy for managing potential risks by enabling accountants, where required, to subject each client to reasonable and proportionate risk assessment.

67. The weight given to these risk categories (individually or in combination) in assessing the overall risk of potential ML/TF may vary given the size, sophistication, nature, and scope of services provided by the accountant and/or firm. These criteria, however, should be considered holistically and not in isolation. Accountants, based on their practices and reasonable judgments, will need to independently assess the weight to be given to each risk factor.

68. Although there is no universally accepted set of risk categories, the examples provided in this Guidance are the most commonly identified risk categories. There is no single methodology to apply these risk categories, and the application of these risk categories is intended to provide a suggested framework for approaching the assessment

and management of potential ML/TF risks. For smaller firms and sole practitioners, it is advisable to look at the services they offer (e.g., providing company management services may entail greater risk than other services).

69. Criminals use a range of techniques and mechanisms to obscure the beneficial ownership of assets and transactions. Many of the common mechanisms/techniques have been compiled by FATF in previous studies, including the 2014 FATF Guidance on Transparency and Beneficial Ownership and the 2018 Joint FATF and Egmont Group Report on Concealment of Beneficial Ownership. Accountants may refer to the studies for more details on the use of obscuring techniques and relevant case studies.

70. A practical starting point for accounting firms (especially smaller firms) and accountants (especially sole practitioners) would be to take the following approach. Many of these elements are critical to satisfying other obligations owed to clients, such as fiduciary duties, and as part of their general regulatory obligations:

(a) Client acceptance and know your client policies: Identify the client (and its beneficial owners where appropriate) and the true “beneficiaries” of the transaction. Obtain an understanding of the source of funds and source of wealth (The source of funds and the source of wealth are relevant to determining a client’s risk profile). The source of funds is the activity that generates the funds for a client (e.g., salary, trading revenues, or payments out of a trust), while the source of wealth describes the activities that have generated the total net worth of a client (e.g., ownership of a business, inheritance, or investments). While these may be the same for some clients, they may be partially or entirely different for other clients. For example, a PEP who receives a modest official salary, but who has substantial funds, without any apparent business interests or inheritance, might raise suspicions of bribery, corruption, or misuse of position. Under the RBA, accountants should satisfy themselves that adequate information is available to assess a client’s source of funds and source of wealth as legitimate with a degree of certainty that is proportionate to the risk profile of the client, where required, its owners, and the purpose of the transaction.

(b) Engagement acceptance policies: Understand the nature of the work. Accountants should know the exact nature of the service that they are providing and have an understanding of how that work could facilitate the movement or obscure the proceeds of crime. Where an accountant does not have the requisite expertise, the accountant should not undertake the work.

(c) Understand the commercial or personal rationale for the work: Accountants need to be reasonably satisfied that there is a commercial or personal rationale for the work undertaken. Accountants however are not obliged to objectively assess the commercial or personal rationale if it appears reasonable and genuine.

(d) Be attentive to red-flag indicators: Exercise vigilance in identifying and then carefully reviewing aspects of the transaction if there are reasonable grounds to suspect that funds are the proceeds of criminal activity, or related to terrorist financing. These cases would trigger reporting obligations. Documenting the thought process by having an action plan may be a viable option to assist in interpreting/assessing red flags/indicators of suspicion.

(e) Then consider what action if any, needs to be taken.

(f) The outcomes of the above action (i.e., the comprehensive risk assessment of a particular client/transaction) will dictate the level and nature of the evidence/documentation collated under a firm’s CDD/EDD procedures (including evidence of source of wealth or funds).

(g) Accountants should adequately document and record steps taken under (a) to (e).

Country/Geographic risk:

71. A client may be at higher risk when features of their business are connected to a higher risk country as regards:

(a) the origin or current location of the source of wealth or funds;

(b) where the services are provided;

(c) the client's country of incorporation or domicile;

(d) the location of the client's major operations;

(e) the beneficial owner's country of domicile; or

(f) target company's country of incorporation and location of major operations (for potential acquisitions).

72. There is no universally agreed definition of a higher risk country or geographic area but accountants should pay attention to those countries that are:

(a) Countries/areas identified by credible sources ("Credible sources" refers to information that is produced by reputable and universally recognised international organisations and other bodies that make such information publicly and widely available. In addition to the FATF and FATF-style regional bodies, such sources may include, but are not limited to, supra-national or international bodies such as the International Monetary Fund, the World Bank, and the Egmont Group of Financial Intelligence Units.) as providing funding or support for terrorist activities or that have designated terrorist organisations operating within them.

(b) Countries identified by credible sources as having significant levels of organized crime, corruption, or other criminal activity, including source or transit countries for illegal drugs, human trafficking, smuggling, and illegal gambling.

(c) Countries subject to sanctions, embargoes, or similar measures issued by international organisations such as the United Nations.

(d) Countries identified by credible sources as having weak governance, law enforcement, and regulatory regimes, including countries identified by FATF statements as having weak AML/CFT regimes, about which financial institutions (as well as DNFBPs) should give special attention to business relationships and transactions.

(e) Countries identified by credible sources to be uncooperative in providing beneficial ownership information to competent authorities, a determination of which may be established from reviewing FATF mutual evaluation reports or reports by organisations that also consider various co-operation levels such as the OECD Global Forum reports on compliance with international tax transparency standards.

Client Risk:

73. The key risk factors that accountants should consider are:

(a) The firm's client base includes industries or sectors where opportunities for ML/TF are particularly prevalent.

(b) The firm's clients include PEPs or persons closely associated with or related to PEPs, who are considered higher risk clients (Please refer to the FATF Guidance (2013) on politically-exposed persons for further guidance on how to identify PEPs).

Box 2

Particular considerations for PEPs and source of funds and wealth: If an accountant is advising a PEP client, or where a PEP is the beneficial owner of assets in a transaction, appropriate enhanced CDD is required if a specified activity under R.22 is involved. Such measures include obtaining senior management (e.g., senior partner, managing partner, or CEO) approval before establishing a business relationship, taking reasonable measures to establish the source of wealth and source of funds of clients and beneficial owners identified as PEPs, and conducting enhanced ongoing monitoring on that relationship.

The source of funds and the source of wealth are relevant to determining a client's risk profile. The source of funds is the activity that generates the funds for a client (e.g., salary, trading revenues, or payments out of a trust). The Source of funds relates directly to the literal origin of funds to be used in a transaction. This is likely to be a bank account. Generally, this would be evidenced by bank statements or similar. Source of wealth describes the activities that have generated the total net worth of a client (e.g., ownership of a business, inheritance, or investments). The Source of wealth is the origin of the accrued body of wealth of an individual. Understanding the source of wealth is about taking reasonable steps to be satisfied that the funds to be used in a transaction are not the proceeds of crime.

While the source of funds and wealth may be the same for some clients, they may be partially or entirely different for other clients. For example, a PEP who receives a modest official salary, but who has substantial funds, without any apparent business interests or inheritance, might raise suspicions of bribery, corruption, or misuse of position. Under the RBA, accountants should satisfy themselves that adequate information is available to assess a client's source of funds and source of wealth as legitimate with a degree of certainty that is proportionate to the risk profile of the client.

Relevant factors that influence the extent and nature of CDD include the particular circumstances of a PEP, PEPs separate business interests and the time those interests prevailed about the public position, whether the PEP has access to official funds, makes decisions regarding the allocation of public funds or public procurement contracts, the PEP's home country, the type of activity that the PEP is instructing the accountant to perform, whether the PEP is domestic or international, particularly having regard to the services asked for, and the scrutiny to which the PEP is under in the PEP's home country.

(c) Clients conducting their business relationship or requesting services in unusual or unconventional circumstances (as evaluated taking into account all the circumstances of the client's representation).

(d) Clients where the structure or nature of the entity or relationship makes it difficult to identify promptly the true beneficial owner or controlling interests or clients attempting to obscure understanding of their business, ownership, or the nature of their transactions, such as:

(i) Unexplained use of shell and/or shelf companies, front company, legal entities with ownership through nominee shares or bearer shares, control through nominee and corporate directors, legal persons or legal arrangements, splitting company incorporation and asset administration over different countries, all without any apparent legal or legitimate tax, business, economic or other reason.

(ii) Unexplained use of informal arrangements such as family or close associates acting as nominee shareholders or directors.

(iii) Unusual complexity in control or ownership structures without a clear explanation, where certain circumstances, structures, geographical locations, international activities, or other factors are not consistent with the accountants' understanding of the client's business and economic purpose.

(e) Client companies that operate a considerable part of their business in or have major subsidiaries in countries that may pose a higher geographic risk.

(f) Clients that are cash (and/or cash equivalent) intensive businesses. Where such clients are themselves subject to and regulated for a full range of AML/CFT requirements consistent with the FATF Recommendations, this will aid to mitigate the risks. These may include, for example:

(i) Money or Value Transfer Services (MVTS) businesses (e.g., remittance houses, currency exchange houses, Casas de Cambio, Centro's cambia Rios, remisores de Fondos, bureaux de change, money transfer agents and banknote traders, or other businesses offering money transfer facilities);

(ii) Operators, brokers, and others providing services in virtual assets;

(iii) Casinos, betting houses, and other gambling-related institutions and activities;

(iv) Dealers in precious metals and stones.

(g) Businesses that while not normally cash-intensive appear to have substantial amounts of cash.

(h) Non-profit or charitable organisations engaging in transactions for which there appears to be no logical economic purpose or where there appears to be no link between the stated activity of the organisation and the other parties in the transaction.

(i) Clients using financial intermediaries, financial institutions, or DNFBPs that are not subject to adequate AML/CFT laws and measures and that are not adequately supervised by competent authorities or SRBs.

(j) Clients who appear to be acting on somebody else's instructions without disclosure.

(k) Clients who appear to actively and inexplicably avoid face-to-face meetings or who provide instructions intermittently without legitimate reasons and are otherwise evasive or very difficult to reach when this would not normally be expected.

(l) Clients who request that transactions be completed in unusually tight or accelerated timeframes without a reasonable explanation for accelerating the transaction, which would make it difficult or impossible for the accountants to perform a proper risk assessment.

(m) Clients with previous convictions for crimes that generated proceeds, who instruct accountants (who in turn know such convictions) to undertake specified activities on their behalf.

(n) Clients who have no address, or multiple addresses without legitimate reasons.

(o) Clients who have funds that are obviously and inexplicably disproportionate to their circumstances (e.g., their age, income, occupation, or wealth).

(p) Clients who change their settlement or execution instructions without appropriate explanation.

(q) Clients who change their means of payment for a transaction at the last minute and without justification (or with suspect justification), or where there is an unexplained lack of information or transparency in the transaction. This risk extends to situations where last-minute changes are made to enable funds to be paid in from/out to a third party.

(r) Clients who insist, without adequate justification or explanation, that transactions be effected exclusively or mainly through the use of virtual assets to preserve their anonymity.

(s) Clients who offer to pay unusually high levels of fees for services that would not ordinarily warrant such a premium. However, bona fide and appropriate contingency fee arrangements, where accountants may receive a significant premium for a successful provision of their services, should not be considered a risk factor.

(t) Unusually high levels of assets or unusually large transactions compared to what might reasonably be expected of clients with a similar profile may indicate that a client not otherwise seen as higher risk should be treated as such.

(u) Where there are certain transactions, structures, geographical location, international activities, or other factors that are not consistent with the accountants' understanding of the client's business or economic situation.

(v) The accountants' client base includes industries or sectors where opportunities for ML/TF are particularly prevalent.

(w) Clients who are suspected to be engaged in falsifying activities through the use of false loans, false invoices, and misleading naming conventions.

(x) The transfer of the seat of a company to another jurisdiction without any genuine economic activity in the country of destination poses a risk of the creation of shell companies that might be used to obscure beneficial ownership.

(y) The relationship between employee numbers/structure and the nature of the business is divergent from the industry norm (e.g., the turnover of a company is unreasonably high considering the number of employees and assets used compared to similar businesses).

(z) Sudden activity from a previously dormant client without any clear explanation.

(aa) Clients that start or develop an enterprise with an unexpected profile of abnormal business cycles or clients that enter into new/emerging markets. Organized criminality generally does not have to raise capital/debt, often making them first into a new market, especially where this market may be retail/cash-intensive.

(ab) Indicators that the client does not wish to obtain necessary governmental approvals/filings, etc.

(ac) Reason for the client choosing the accountant is unclear, given the firm's size, location, or specialization.

(ad) Frequent or unexplained change of client's professional adviser(s) or members of management.

(ae) Client is reluctant to provide all the relevant information or accountants have reasonable grounds to suspect that the information provided is incorrect or insufficient.

(af) Clients seeking to obtain residents' rights or citizenship in the country of establishment of the accountants in exchange for capital transfers, purchase of property or government bonds, or investment in corporate entities.

74. The clients referred to above may be individuals that are, for example, trying to obscure their business interests and assets or the clients may be representatives of a company's senior management who are, for example, trying to obscure the ownership structure.

Transaction/Service and associated delivery channel risk

75. Services that may be provided by accountants and which (in some circumstances) risk being used to assist money launderers may include:

(a) Use of pooled client accounts or safe custody of client money or assets without justification.

(b) Situations where advice on the setting up of legal arrangements may be misused to obscure ownership or real economic purpose (including setting up of trusts, companies or change of name/corporate seat, or establishing complex group structures). This might include advising about a discretionary trust that gives the trustee discretionary power to name a class of beneficiaries that does not include the real beneficiary (e.g. naming a charity as the sole discretionary beneficiary initially to add the real beneficiaries at a later stage). It might also include situations where a trust is set up to manage shares in a company to make it more difficult to determine the beneficiaries of assets managed by the trust.

(c) In the case of an express trust, and unexplained (where an explanation is warranted) nature of classes of beneficiaries and acting as trustees of such a trust.

(d) Services where accountants may in practice represent or assure the client's standing, reputation, and credibility to third parties, without a commensurate knowledge of the client's affairs.

(e) Services that are capable of concealing beneficial ownership from competent authorities.

(f) Services requested by the client for which the accountant does not have expertise except where the accountant is referring the request to an appropriately trained professional for advice.

(g) Non-cash wire transfers through the use of many inter-company transfers within the group to disguise the audit trail.

(h) Services that rely heavily on new technologies (e.g., initial coin offerings or virtual assets) that may have inherent vulnerabilities to exploitation by criminals, especially those not regulated for AML/CFT.

(i) Transfer of real estate or other high-value goods or assets between parties in a period that is unusually short for similar transactions with no apparent legal, tax, business, economic, or other legitimate reason.

(j) Transactions where it is readily apparent to the accountant that there is inadequate consideration, where the client does not provide legitimate reasons for the transaction.

(k) Administrative arrangements concerning estates where the deceased was known to the accountant as being a person who had been convicted of proceeds generating crimes.

(l) Services that have deliberately provided or depend upon, more anonymity about the client's identity or regarding other participants than is normal under the circumstances and in the experience of the accountant.

(m) Use of virtual assets and other anonymous means of payment and wealth transfer within the transaction without apparent legal, tax, business, economic, or other legitimate reason.

(n) Transactions using unusual means of payment (e.g., precious metals or stones).

(o) The postponement of a payment for an asset or service delivered immediately to date far from the moment at which payment would normally be expected to occur, without appropriate assurances that payment will be made.

(p) Unexplained establishment of unusual conditions/clauses in credit arrangements that do not reflect the commercial position between the parties and may require accountants to be aware of risks. Arrangements that may be abused in this way might include unusually short/long amortization periods, interest rates materially above/below market rates, or unexplained repeated cancellations of promissory notes/mortgages or other security instruments substantially ahead of the maturity date initially agreed.

(q) Transfers of goods that are inherently difficult to value (e.g., jewels, precious stones, objects of art or antiques, virtual assets), where this is not common for the type of clients, transaction, or with accountant's normal course of business such as a transfer to a corporate entity, or generally without any appropriate explanation.

(r) Successive capital or other contributions in a short period to the same company with no apparent legal, tax, business, economic, or other legitimate reason.

(s) Acquisitions of businesses in liquidation with no apparent legal, tax, business, economic, or other legitimate reason.

(t) Power of representation given in unusual conditions (e.g., when it is granted irrevocably or about specific assets) and the stated reasons for these conditions are unclear or illogical.

(u) Transactions involving closely connected persons and for which the client and/or its financial advisors provide inconsistent or irrational explanations and are subsequently unwilling or unable to explain by reference to legal, tax, business, economic, or other legitimate reasons.

(v) Situations where a nominee is being used (e.g., friend or family member is named as the owner of property/assets where it is clear that the friend or family member is receiving instructions from the beneficial owner) with no apparent legal, tax, business, economic or other legitimate reason.

(w) Payments received from un-associated or unknown third parties and payments for fees in cash where this would not be a typical method of payment.

(x) Commercial, private, or real property transactions or services to be carried out by the client with no apparent legitimate business, economic, tax, family governance, or legal reasons.

(y) Existence of suspicions regarding fraudulent transactions, or transactions that are improperly accounted for.

These might include:

(i) Over or under-invoicing of goods/services.

(ii) Multiple invoicing of the same goods/services.

(iii) Falsely described goods/services – over or under shipments (e.g. false entries on bills of lading).

(iv) Multiple trading of goods/services.

76. About the areas of risk identified above, accountants may also consider the examples of fraud risk factors listed in International Standard of Auditing 240: The auditor's responsibilities relating to fraud in an audit of financial statements (ISA 240) and the examples of conditions and events that may indicate risks of material misstatement in International Standard of Auditing 315: Identifying and assessing risks of material misstatement through understanding the entity and its environment (ISA315). Even where the accountant is not performing an audit, ISA 240 and ISA 315 provide helpful lists of additional red flags.

Variables that may impact an RBA and risk

77. While all accountants should follow robust standards of due diligence to avoid regulator arbitrage, due regard should be accorded to differences in practices, size, scale, and expertise amongst accountants, as well as the nature of the clients they serve. As a result, consideration should be given to these factors when creating an RBA that complies with the existing obligations of accountants.

78. Consideration should also be given to the resources that can be reasonably allocated to implement and manage an appropriately developed RBA. For example, a sole practitioner would not be expected to devote an equivalent level of resources as a large firm; rather, the sole practitioner would be expected to develop appropriate systems and controls and an RBA proportionate to the scope and nature of the practitioner's practice and its clients. Small firms serving predominantly locally based and low-risk clients cannot generally be expected to devote a significant amount of senior personnel's time to conducting risk assessments. In such cases, it may be more reasonable for sole practitioners to rely on publicly available records and information supplied by a client for a risk assessment than it would be for a large firm having a diverse client base with different risk profiles. However, where the source is a public registry or the client, there is always a potential risk in the correctness of the information. Sole practitioners and small firms may be regarded by criminals as more of a target for money launderers than large law firms. Accountants in many jurisdictions and practices are required to conduct both a risk assessment of the general risks of their practice and all new clients and current clients engaged in one-off specific transactions. The emphasis must be on following an RBA.

79. A significant factor to consider is whether the client and proposed work would be unusual, risky, or suspicious for the particular accountant. This factor must always be considered in the context of the accountant's practice, as well as the legal, professional, and ethical obligations in the jurisdiction(s) of practice. An accountant's RBA methodology may thus take account of risk variables specific to a particular client or type of work. Consistent with the RBA and proportionality, the presence of one or more of these variables may cause an accountant to conclude that either enhanced CDD and monitoring are warranted, or conversely that standard CDD and monitoring can be reduced, modified, or simplified. When reducing, modifying, or simplifying CDD, accountants should always adhere to the minimum requirements as set out in national legislation. These variables may increase or decrease the perceived risk posed by a particular client or type of work. While the presence of the specific factors referred to in paragraphs 71-76 may tend to increase risk, more general client/ engagement-related variables may add to or mitigate that risk.

80. Examples of factors that may increase risk are:

(a) Unexplained urgency of assistance required.

(b) Unusual sophistication of client, including the complexity of control environment.

(c) Unusual sophistication of transaction/scheme.

(d) The irregularity or duration of the client relationship. One-off engagements involving limited client contact throughout the relationship may present a higher risk.

81. Examples of factors that may decrease risk are:

(a) Involvement of adequately regulated financial institutions or other DNFBP professionals.

(b) Similar country location of accountants and clients.

(c) Role or oversight of a regulator or multiple regulators.

(d) The regularity or duration of the client relationship. Long-standing relationships involving frequent client contact and easy flow of information throughout the relationship may present less risk.

(e) Private companies that are transparent and well-known in the public domain.

(f) Accountant's familiarity with a particular country, including knowledge of and compliance with local laws and regulations as well as the structure and extent of regulatory oversight.

Documentation of risk assessments:

82. Accountants must always understand their ML/TF risks (for clients, countries, geographic areas, services, transactions, or delivery channels). They should document those assessments to be able to demonstrate their basis and exercise due professional care and use compelling good judgment. However, competent authorities or SRBs may determine that individual documented risk assessments are not required if the specific risks inherent to the sector are identified and understood.

83. Accountants may fail to satisfy their AML/CFT obligations, for example by relying completely on a checklist risk assessment where there are other clear indicators of potential illicit activity. Completing risk assessments in a time-efficient yet comprehensive manner has become more important.

84. Each of these risks could be assessed using indicators such as low risk, medium risk, and/or high risk. A short explanation of the reasons for each attribution should be included and an overall assessment of risk determined. An action plan (if required) should then be outlined to accompany the assessment and dated. In assessing the risk profile of the client at this stage, reference must be made to the relevant targeted financial sanctions lists to confirm that neither the client nor the beneficial owner is designated and included in any of them.

85. A risk assessment of this kind should not only be carried out for each specific client and service on an individual basis, but also to assess and document the risks on a firm-wide basis, and to keep risk assessment up-to-date through monitoring of the client relationship. The written risk assessment should be made accessible to all professionals having to perform AML/CFT duties.

Risk mitigation:

86. Accountants should have policies, controls, and procedures that enable them to effectively manage and mitigate the risks that they have identified (or that have been identified by the country). They should monitor the implementation of those controls and enhance or improve them if they find the controls to be weak or ineffective. The policies, controls, and procedures should be approved by senior management, and the measures taken to manage and mitigate the risks (whether higher or lower) should be consistent with national requirements and with

guidance from competent authorities and supervisors. Measures and controls may include:

(a) General training on ML/TF methods and risks relevant to accountants.

(b) Targeted training for increased awareness by the accountants providing specified activities to higher risk clients or accountants undertaking higher risk work.

(c) Increased or more appropriately targeted CDD or enhanced CDD for higher risk clients/situations that concentrate on providing a better understanding of the potential source of risk and obtaining the necessary information to make informed decisions about how to proceed (if the transaction/ business relationship can be proceeded with). This could include training on when and how to ascertain, evidence, and record source of wealth and beneficial ownership information if required.

(d) Periodic review of the services offered by the accountant, and the periodic evaluation of the AML/CFT framework applicable to the accountant and the accountant's own AML/CFT procedures, to determine whether the ML/TF risk has increased.

(e) Review client relationships from time to time to determine whether the ML/TF risk has increased.

Initial and ongoing CDD (R.10 and 22):

87. Accountants should design CDD procedures to enable them to establish with reasonable certainty the true identity of each client and, with an appropriate degree of confidence, know the types of business and transactions the client is likely to undertake. Accountants should have procedures to:

(a) Identify the client and verify that client's identity using reliable, independent source documents, data, or information.

(b) Identify the beneficial owner, and take reasonable measures to verify the identity of the beneficial owner, such that accountants are satisfied that they know who the beneficial owner is. This should include accountants' understanding of the ownership and control structure of the client. This is articulated in the following box.

Box 3. Beneficial ownership information obligations (see R.10, R.22, and INR.10)

R.10 sets out the instances where accountants will be required to take steps to identify and verify beneficial owners, including when there is a suspicion of ML/TF when establishing business relations, or where there are doubts about the veracity of previously provided information. INR.10 indicates that the purpose of this requirement is two-fold: first, to prevent the unlawful use of legal persons and arrangements, by gaining a sufficient understanding of the client to be able to properly assess the potential ML/TF risks associated with the business relationship; and, second, to take appropriate steps to mitigate the risks. Accountants should have regard to these purposes when assessing what steps are reasonable to take to verify beneficial ownership, commensurate with the level of risk. Accountants should also have regard to the AML/CFT 2013 Methodology Criteria 10.5 and 10.8-10.12.

At the outset of determining beneficial ownership, steps should be taken to identify how the immediate client can be identified. Accountants can verify the identity of a client by, for example meeting the client in person and then verifying their identity through the production of a passport/identity card and documentation confirming his/her address. Accountants can further verify the identity of a client based on documentation or information obtained from reliable, publicly available sources (which are independent of the client).

A more difficult situation arises where there is a beneficial owner who is not the immediate client (e.g., in the case of companies and other entities). In such a scenario reasonable steps must be taken so that the accountant is satisfied with the identity of the beneficial owner and takes reasonable measures to verify the beneficial owner's identity. This likely requires taking steps to understand the ownership and control of a separate legal entity that is the client and may include conducting public searches as well as seeking information directly from the client.

Accountants will likely need to obtain the following information for a client that is a legal entity:

(a) the name of the company;

(b) the company registration number;

(c) the registered address and/ or principal place of business (if different);

(d) the identity of shareholders and their percentage ownership;

(e) names of the board of directors or senior individuals responsible for the company's operations;

(f) the law to which the company is subject and its constitution; and

(g) the types of activities and transactions in which the company engages.

To verify the information listed above, accountants may use sources such as the following:

(a) constitutional documents (such as a certificate of incorporation, memorandum, and articles of incorporation/ association);

(b) details from company registers;

(c) shareholder agreements or other agreements between shareholders concerning control of the legal person; and

(d) filed audited accounts.

Accountants should adopt an RBA to verify the beneficial owners of an entity. It is often necessary to use a combination of public sources and to seek further confirmation from the immediate client that information from public sources is correct and up-to-date or to ask for additional documentation that confirms the beneficial ownership and company structure. The obligation to identify beneficial ownership does not end with identifying the first level of ownership but requires reasonable steps to be taken to identify the beneficial ownership at each level of the corporate structure until an ultimate beneficial owner is identified.

(c) Understand and, as appropriate, obtain information on the purpose and intended nature of the business relationship.

(d) Conduct ongoing due diligence on the business relationship. Ongoing due diligence ensures that the documents, data, or information collected under the CDD process are kept up-to-date and relevant by undertaking reviews of existing records, particularly for higher-risk categories of clients. Undertaking appropriate CDD may also facilitate the accurate filing of suspicious transaction reports (STRs) to the financial intelligence unit (FIU), or to respond to requests for information from an FIU and law enforcement agencies.

88. Accountants should design their policies and procedures so that the level of client due diligence addresses the risk of being used for ML/TF by the client. By the national AML/CFT framework, accountants should design a 'standard' level of CDD for normal risk clients and a reduced or simplified CDD process for low-risk clients. Simplified CDD measures are not acceptable whenever there is a suspicion of ML/TF or where specific higher-risk scenarios apply. Enhanced due diligence should be applied to those clients that are assessed as high risk. These activities may be carried out in conjunction with firms' normal client acceptance procedures and should take account of any specific jurisdictional requirements for CDD.

89. In the normal course of their work, accountants are likely to learn more about some aspects of their client, such as their client's business or occupation and/or their level and source of income, than other advisors. This

information is likely to help them reassess the ML/TF risk.

90. An RBA means that accountants should perform varying levels of work according to the risk level. For example, where the client or the owner of the controlling interest is a public company that is subject to regulatory disclosure requirements, and that information is publicly available, fewer checks may be appropriate. In the case of trusts, foundations, or similar legal entities where the beneficiaries are distinct from the legal owners of the entity, it will be necessary to form a reasonable level of knowledge and understanding of the classes and nature of the beneficiaries; the identities of the settlor, trustees or natural persons exercising effective control; and an indication of the purpose of the trust. Accountants will need to obtain a reasonable level of comfort that the declared purpose of the trust is its true purpose.

91. Changes in ownership or control of clients should lead to review or repeat of client identification and verification procedures. This may be carried out in conjunction with any professional requirements for client continuation processes.

92. Public information sources may assist with this ongoing review (scrutinizing transactions undertaken throughout that relationship). The procedures that need to be carried out can vary, by the nature and purpose for which the entity exists, and the extent to which the underlying ownership differs from apparent ownership by the use of nominees and complex structures.

93. The following box provides a non-exhaustive list of examples of standard, enhanced, and simplified CDD:

Box 4. Examples of Standard/Simplified/Enhanced CDD measures (see also INR.10)

Standard CDD

- Identifying the client and verifying that client's identity using reliable, independent source documents, data, or information
- Identifying the beneficial owner, and taking reasonable measures on a risk-sensitive basis to verify the identity of the beneficial owner, such that the accountant is satisfied with the identity of the beneficial owner. For legal persons and arrangements, this should include understanding the ownership and control structure of the client and gaining an understanding of the client's source of wealth and source of funds, where required
- Understanding and obtaining information on the purpose and intended nature of the business relationship
- Conducting ongoing due diligence on the business relationship and scrutiny of transactions undertaken throughout that relationship to ensure that the transactions being conducted are consistent with the business and risk profile of the client, including, where necessary, the source of wealth and funds

Simplified CDD

- Limiting the extent, type, or timing of CDD measures
- Obtaining fewer elements of client identification data
- Altering the type of verification carried out on the client's identity
- Simplifying the verification carried out on the client's identity
- Inferring the purpose and nature of the transactions or business relationship established based on the type of transaction carried out or the relationship established
- Verifying the identity of the client and the beneficial owner after the establishment of the business relationship

- Reducing the frequency of client identification updates in the case of a business relationship
- Reducing the degree and extent of ongoing monitoring and scrutiny of transactions

Enhanced CDD

- Obtaining additional information on the client (e.g., occupation, the volume of assets, information available through public databases, the internet, etc.), and updating more regularly the identification data of the client and beneficial owner
- Carrying out additional searches (e.g., internet searches using independent and open sources) to better inform the client risk profile (provided that the internal policies of accountants should enable them to disregard source documents, data, or information, which is perceived to be unreliable)
- Obtaining additional information and, as appropriate, substantiating documentation, on the intended nature of the business relationship
- Obtaining information on the source of funds and/or source of wealth of the client and evidencing this through appropriate documentation obtained
- Obtaining information on the reasons for intended or performed transactions
- Obtaining the approval of senior management to commence or continue the business relationship
- Conducting enhanced monitoring of the business relationship, by increasing the number and timing of controls applied, and selecting patterns of transactions that need further examination
- Requiring the first payment to be carried out through an account in the client's name with a bank subject to similar CDD standards
- Increasing awareness of higher risk clients and transactions, across all departments with a business relationship with the client, including the possibility of the enhanced briefing of engagement teams responsible for the client.
- Enhanced CDD may also include lowering the threshold of ownership (e.g., below 25%), to ensure a complete understanding of the control structure of the entity involved. It may also include looking further than simply holdings of equity shares, to understand the voting rights of each party who holds an interest in the entity.

Politically exposed persons (PEP) (R.12 and R.22):

94. Accountants should take reasonable measures to identify whether a client is a PEP or a family member or close associate of a PEP. Accountants should also refer to the 2013 FATF Guidance on politically-exposed persons for further guidance on how to identify PEPs.

95. If the client or the beneficial owner is a PEP or a family member or close associate of a PEP, accountants should perform the following additional procedures:

(a) obtain senior management approval for establishing (or continuing, for existing clients) such business relationships;

(b) take reasonable measures to establish the source of wealth and source of funds; and

(c) conduct enhanced ongoing monitoring of the business relationship.

96. Relevant factors that will influence the extent and nature of CDD include the particular circumstances of a PEP, the PEP's role in a particular government/ government agency, whether the PEP has access to official funds, the PEP's home country, the type of work the PEP is instructing the accountant to perform or carry out (i.e. the services that are being asked for), whether the PEP is domestically based or international, particularly having regard to the services asked for, and the scrutiny to which the PEP is under in the PEP's home country.

97. The nature of the risk should be considered in light of all relevant circumstances, such as:

(a) The nature of the relationship between the client and the PEP. If the client is a trust, company, or legal entity, even if the PEP is not a natural person exercising effective control or the PEP is merely a discretionary beneficiary who has not received any distributions, the PEP may nonetheless affect the risk assessment.

(b) The nature of the client (e.g., where it is a public listed company or regulated entity which is subject to and regulated for a full range of AML/CFT requirements consistent with FATF recommendations, the fact that it is subject to reporting obligations will be a relevant factor, albeit this should not automatically qualify the client for simplified CDD).

(c) The nature of the services sought. For example, lower risks may exist where a PEP is not the client but a director of a client that is a public listed company or regulated entity and the client is purchasing property for adequate consideration.

Ongoing monitoring of clients and specified activities (R.10 and 22):

98. Accountants are not expected to scrutinize every transaction that goes through their clients' books and some accounting services are provided only on a one-off basis, without a continuing relationship with the client and without the accountant having access to the client's books and/or bank records. However, many of the professional services provided by accountants put them in a relatively good position to encounter and recognize suspicious activities (or transactions) carried out by their clients through their inside knowledge of, and access, to the client's records and management processes, and operations, as well as through close working relationships with senior managers and owners. The continued administration and management of the legal persons and arrangements (e.g. account reporting, asset disbursements, and corporate filings) would also enable the relevant accountants to develop a better understanding of the activities of their clients.

99. Accountants need to be alert for events or situations which are indicative of a reason to be suspicious of ML/TF, employing their professional experience and judgment in the forming of suspicions where appropriate. An advantage in carrying out this function is professional scepticism which is a defining characteristic of many professional accountancy functions and relationships.

100. Ongoing monitoring of the business relationship should be carried out on a risk-related basis, to ensure that accountants are aware of any changes in the client's identity and risk profile established at client acceptance. This requires an appropriate level of scrutiny of activity during the relationship, including an inquiry into the source of funds where necessary, to judge consistency with expected behaviour based on accumulated CDD information. As discussed below, ongoing monitoring may also give rise to filing an STR.

101. Accountants should also consider reassessing CDD on an engagement/assignment basis for each client. Well-known, reputable, long-standing clients may suddenly request a new type of service that is not in line with the previous relationship between the client and accountant. Such an assignment may suggest a greater level of risk.

102. Accountants should not conduct investigations into suspected ML/TF on their own but instead file an STR or if the behaviour is egregious, they should contact the FIU or law enforcement or supervisors, as appropriate, for guidance. Within the scope of engagement, an accountant should be mindful of the prohibition of "tipping off" the client where suspicion has been formed. Carrying out additional investigations, which are not within the scope of the engagement should also be considered against the risk of alerting a money launderer.

103. When deciding whether or not an activity or transaction is suspicious, accountants may need to make additional inquiries (within the normal scope of the assignment or business relationship) of the client or their records this could typically be done as part of the accountant's CDD process. Normal commercial inquiries, being made to fulfil duties to clients, may assist in understanding an activity or transaction to determine whether or not it is suspicious.

Suspicious activity/transaction reporting, tipping-off, internal controls, and higher-risk countries (R.23)

104. R.23 sets out obligations for accountants on reporting and tipping-off, internal controls, and higher-risk countries as set out in R.20, R.21, R.18, and R.19.

Suspicious transaction reporting and tipping-off (R.20, 21, and 23) 105.

105. R.23 requires accountants to report suspicious transactions set out in R.20. Where a legal or regulatory requirement mandates the reporting of suspicious activity once suspicion has been formed, a report must always be made promptly. The requirement to file an STR is not subject to an RBA but must be made whenever required in the country concerned.

106. Accountants may be required to report suspicious activities, as well as specific suspicious transactions, and so may make reports on several scenarios including suspicious business structures or management profiles that have no legitimate economic rationale and suspicious transactions, such as the misappropriation of funds, false invoicing or company purchase of goods unrelated to the company's business. As specified under INR.23, where accountants seek to dissuade a client from engaging in illegal activity, this does not amount to tipping-off.

107. However, it should be noted that an RBA is appropriate for identifying a suspicious activity or transaction, by directing additional resources at those areas that have been identified as higher risk. The designated competent authorities or SRBs may provide information to accountants, which can inform their approach to identifying suspicious activity or transactions, as part of an RBA. The accountant should also periodically assess the adequacy of their system for identifying and reporting suspicious activity or transactions.

108. Accountants should review CDD if they have a suspicion of ML/TF.

Internal controls and compliance (R.18 and 23)

109. For accountants to have effective RBA, the risk-based process must be embedded within the internal controls of the firm and they must be appropriate for the size and complexity of the firm.

Internal controls and governance

110. Strong leadership and engagement by senior management and the Board of Directors (or equivalent body) in AML/CFT is an important aspect of the application of the RBA. Senior management must create a culture of compliance, ensuring that staff adheres to the firm's policies, procedures, and processes designed to limit and control risks.

111. The nature and extent of the AML/CFT controls, as well as meeting national legal requirements, need to be proportionate to the risk involved in the services being offered. In addition to other compliance internal controls, the nature and extent of AML/CFT controls will encompass several aspects, such as:

1. designating an individual or individuals, at the management level responsible for managing AML/CFT compliance;
2. designing policies and procedures that focus resources on the firm's higher risk, services, products, clients, and geographic locations in which their clients/they operate, and include risk-based CDD policies, procedures, and processes;
3. ensuring that adequate controls are in place before new services are offered; and
4. ensuring adequate controls for accepting higher-risk clients or providing higher-risk services, such as management approval.

112. These policies and procedures should be implemented across the firm and include:

(a) performing a regular review of the firm's policies and procedures to ensure that they remain fit for purpose;

(b) performing a regular compliance review to check that staff are properly implementing the firm's policies and procedures;

(c) providing senior management with a regular report of compliance initiatives, identifying compliance deficiencies, corrective action is taken, and STRs filed;

(d) planning for changes in management, staff, or firm structure so that there is compliance continuity;

(e) focusing on meeting all regulatory record-keeping and reporting requirements, recommendations for AML/CFT compliance, and providing timely updates in response to changes in regulations;

(f) enabling the timely identification of reportable transactions and ensuring accurate filing of required reports;

(g) incorporating AML/CFT compliance into job descriptions and performance evaluations of appropriate personnel;

(h) providing for appropriate training to be given to all relevant staff;

(i) having appropriate risk management systems to determine whether a client, potential client or beneficial owner is a PEP or a person subject to applicable financial sanctions;

(j) providing for adequate controls for higher risk clients and services, as necessary (e.g. additional due diligence, evidencing the source of wealth and funds of a client and escalation to senior management, or additional review and/or consultation);

(k) providing increased focus on the accountant/accounting firm's operations (e.g. services, clients, and geographic locations) that are more vulnerable to abuse for ML/TF;

(l) providing for periodic review of the risk assessment and management processes, taking into account the environment within which the accountant/accounting firm operates and the services it provides; and

(m) providing for an AML/CFT compliance function and review program, as appropriate, given the scale of the organisation and the nature of the accountant's practice.

113. The firm should perform a firm-wide risk assessment that takes into account the size and nature of the practice; the existence of high-risk clients (if any); and the provision of high-risk services (if any). Once completed, the firm-wide risk assessment will assist the firm in designing its policies and procedures.

114. Accountants should consider using proven technology-driven solutions to minimize the risk of error and find efficiencies in their AML/CFT processes. As these solutions are likely to become more affordable, and more tailored to the needs of accountants as they continue to develop, this may be particularly important for smaller firms that may be less able to commit significant resources of time to these activities.

115. Depending on the size of the firm, the types of services provided, the risk profile of clients, and the overall assessed ML/TF risk, it may be possible to simplify internal procedures. For example, for sole practitioners, providing limited services to low-risk clients, client acceptance may be reserved for the sole owners/proprietors taking into account their business and client knowledge and experience. The involvement of the sole owner/proprietor may also be required in detecting and assessing possible suspicious activities. For larger firms, serving a diverse client base and providing multiple services across geographical locations, more sophisticated procedures are likely to be necessary.

Internal mechanisms to ensure compliance

116. Accountants (at the senior management level) should monitor the effectiveness of internal controls. If accountants identify any weaknesses in those internal controls, improved procedures should be designed.

117. The most effective tool to monitor the internal controls is a regular (typically at least annually) independent (internal or external) compliance review. If carried out internally, a staff member that has a good working knowledge

of the firm's AML/CFT internal control framework, policies, and procedures and is sufficiently senior to challenge them should perform the review. The person conducting an independent review should not be the same person who designed or implemented the controls being reviewed. The compliance review should include a review of CDD documentation to confirm that staff is properly applying the firm's procedures.

118. If the compliance review identifies areas of weakness and makes recommendations on how to improve the policies and procedures, then senior management should monitor how the firm is acting on those recommendations.

119. Accountants should review/update firm-wide risk assessments regularly and ensure that policies and procedures continue to target those areas where the ML/TF risks are highest.

Vetting and recruitment

120. Accountants should consider the skills, knowledge, and experience of staff both before they are appointed to their role and on an ongoing basis. The level of assessment should be proportionate to their role in the firm and the ML/TF risks they may encounter. Assessment may include criminal records checking and other forms of pre-employment screening such as credit reference checks and background verification (as permitted under national legislation) for key staff positions.

Education, training, and awareness

121. R.18 requires that accounting firms/ accountants provide their staff with AML/CFT training. For accountants, and those in smaller firms, in particular, such training may also assist with raising awareness of monitoring obligations. The accounting firm's commitment to having appropriate controls in place relies fundamentally on both training and awareness. This requires a firm-wide effort to provide all relevant staff with at least general information on AML/CFT laws, regulations, and internal policies.

122. Firms should provide targeted training for increased awareness by the accountant by providing specified activities to higher-risk clients and accountants undertaking higher-risk work. Case studies (both fact-based and hypotheticals) are a good way of bringing the regulations to life and making them more comprehensible. Training should also be targeted toward the role that the individual performs in the AML/CFT process. This could include false documentation training for those undertaking identification and verification duties or training regarding red flags for those undertaking client/transactional risk assessment.

123. In line with an RBA, particular attention should be given to risk factors or circumstances occurring in an accountant's practice. In addition, competent authorities, SRBs, and representative bodies should work with educational institutions to ensure that the relevant curricula address ML/TF risks. The same training should also be made available for students taking courses to train to become accountants.

124. Firms must provide their employees with appropriate AML/CFT training. In ensuring compliance with this requirement, accountants may take account of any AML/CFT training included in entry requirements and continuing professional development requirements for their professional staff. They must also ensure appropriate training for any relevant staff without professional qualification, at a level appropriate to the functions being undertaken by those staff, and the likelihood of their encountering suspicious activities.

125. The overall risk-based approach and the various methods available for training and education give accountants flexibility regarding the frequency, delivery mechanisms, and focus of such training. Accountants should review their staff and available resources and implement training programs that provide appropriate AML/CFT information that is:

(i) tailored to the relevant staff responsibility (e.g. client contact or administration);

(ii) at the appropriate level of detail (e.g. considering the nature of services provided by the accountants);

(iii) at a frequency suitable to the risk level of the type of work undertaken by the accountants; and

(iv) used to test to assess staff knowledge of the information provided.

Higher-risk countries (R.19 and 23)

126. Consistent with R.19, accountants should apply enhanced due diligence measures (also see paragraph 72 above), proportionate to the risks, to business relationships and transactions with clients from countries for which this is called for by the FATF.

Section IV – Guidance for supervisors

127. R.28 requires that accountants are subject to adequate AML/CFT regulation and supervision. Supervisors and SRBs must ensure that accountants are implementing their obligations under R.1.

A risk-based approach to supervision

128. A risk-based approach to AML/CFT means that measures taken to reduce ML/TF are proportionate to the risks. Supervisors and SRBs should supervise more effectively by allocating resources to areas of higher ML/TF risk. R.28 requires that accountants are subject to adequate AML/CFT regulation and supervision. While it is each country's responsibility to ensure there is an adequate national framework in place for the regulation and supervision of accountants, any relevant supervisors, and SRBs should have a clear understanding of the ML/TF risks present in the relevant jurisdiction.

Supervisors and SRBs' role in supervision and monitoring

129. According to R.28, countries can designate a competent authority or SRB to ensure that accountants are subject to effective oversight, provided that such an SRB can ensure that its members comply with their obligations to combat ML/TF.

130. An SRB is a body representing a profession (e.g. accountants, legal professionals, notaries, other independent legal professionals, or TCSPs) made up of member professionals, which has a role (either exclusive or in conjunction with other entities) in regulating the persons that are qualified to enter and who practice in the profession. An SRB also performs supervisory or monitoring functions (e.g. enforcing rules to ensure that high ethical and moral standards are maintained by those practicing the profession).

131. Supervisors and SRBs should have appropriate powers to perform their supervisory functions (including powers to monitor and impose effective, proportionate, and dissuasive sanctions), and adequate financial, human, and technical resources. Supervisors and SRBs should determine the frequency and intensity of their supervisory or monitoring actions on accountants based on their understanding of the ML/TF risks, and taking into consideration the characteristics of the accountants, in particular their diversity and number.

132. Countries should ensure that supervisors and SRBs are as equipped as competent authorities in identifying and sanctioning non-compliance by its members. Countries should also ensure that SRBs are well-informed about the importance of AML/CFT supervision, including enforcement actions as needed.

133. Countries should also address the risk that AML/CFT supervision by SRBs could be hampered by conflicting objectives about the SRB's role in representing their members, while also being obligated to supervise them. If an SRB contains members of the supervised population or represents those people, the relevant persons should not continue to take part in the monitoring/ supervision of their practice/firm to avoid conflicts of interest.

134. Supervisors and SRBs should allocate responsibility for managing AML/CFT related activity, where they are also responsible for other regulatory areas.

Understanding ML/TF risk

135. The extent to which a national framework allows accountants to apply an RBA should also reflect the nature, diversity, and maturity of the sector and its risk profile as well the ML/TF risks associated with individual accountants.

136. Access to information about ML/TF risks is essential for an effective risk-based approach. Countries are required to take appropriate steps to identify and assess ML/TF risks on an ongoing basis to (a) inform potential changes to the country's AML/CFT regime, including changes to laws, regulations, and other measures; (b) assist in the allocation and prioritization of AML/CFT resources by competent authorities; and (c) make information available for AML/CFT risk assessments conducted by accountants and the jurisdictions' national risk assessment. Countries should keep the risk assessments up-to-date and should have mechanisms to provide appropriate information on the results to competent authorities, SRBs, and accountants. In situations where some accountants have limited capacity to identify ML/TF risks, countries should work with the sector to understand their risks.

137. Supervisors and SRBs should, as applicable, draw on a variety of sources to identify and assess ML/TF risks. These may include, but will not be limited to, the jurisdiction's national risk assessments, supranational risk assessments, domestic or international typologies, supervisory expertise, and FIU feedback. The necessary information can also be obtained through appropriate information-sharing and collaboration among AML/CFT supervisors when there are more than one for different sectors (legal professionals, accountants, and TCSPs).

138. These sources can also help determine the extent to which an accountant can effectively manage ML/TF risk. Information-sharing and collaboration should take place among AML/CFT supervisors across all sectors (legal professionals, accountants, and TCSPs).

139. Competent authorities may also consider undertaking a targeted sectoral risk assessment to get a better understanding of the specific environment in which accountants operate in the country and the nature of services provided by them.

140. Supervisors and SRBs should understand the level of inherent risk including the nature and complexity of services provided by the accountant. Supervisors and SRBs should also consider the type of services the accountant is providing as well as its size and business model (e.g., whether it is a sole practitioner), corporate governance arrangements, financial and accounting information, delivery channels, and client profiles, geographic location, and countries of operation. Supervisors and SRBs should also consider the controls accountants have in place (e.g., the quality of the risk management policy, the functioning of the internal oversight functions, and the quality of oversight of any outsourcing and subcontracting arrangements).

141. Supervisors and SRBs should seek to ensure their supervised populations are fully aware of and compliant with, measures to identify and verify a client, the client's source of wealth, and funds were required, along with measures designed to ensure transparency of beneficial ownership, as these are cross-cutting issues that affect several aspects of AML/CFT.

142. To further understand the vulnerabilities associated with beneficial ownership, with a particular focus on the involvement of professional intermediaries, supervisors should stay abreast of research papers and typologies published by international bodies. Useful references include the Joint FATF and Egmont Group Report on Concealment of Beneficial Ownership published in July 2018.

143. Supervisors and SRBs should review their assessment of accountants' ML/TF risk profiles periodically, including when circumstances change materially or relevant new threats emerge, and appropriately communicate this assessment to the profession.

Mitigating and managing ML/TF risk

144. Supervisors and SRBs should take proportionate measures to mitigate and manage ML/TF risk. Supervisors and SRBs should determine the frequency and intensity of these measures based on their understanding of the inherent ML/TF risks. Supervisors and SRBs should consider the characteristics of accountants, particularly where they act as professional intermediaries, in particular their diversity and number. It is essential to have a clear understanding of the ML/TF risks: (a) present in the country; and (b) associated with the type of accountant and their clients, products, and services.

145. Supervisors and SRBs should take account of the risk profile of accountants when assessing the adequacy of internal controls, policies, and procedures.

146. Supervisors and SRBs should develop a means of identifying which accountants are at the greatest risk of being used by criminals. This involves considering the probability and impact of ML/TF risk.

147. Probability means the likelihood of ML/TF taking place as a consequence of the activity undertaken by accountants and the environment in which they operate. The risk can also increase or decrease depending on other factors:

(i) service and product risk (the likelihood that services or products can be used for ML/TF);

(ii) client risk (the likelihood that clients' funds may have criminal origins);

(iii) the nature of transactions (e.g., frequency, volume, counterparties);

(iv) geographical risk (whether the accountant, its clients, or other offices trade in riskier locations); and

(v) other indicators of risk are based on a combination of objective factors and experience, such as the supervisor's wider work with the accountant as well as information on its compliance history, complaints about the accountant or the quality of its internal controls, and intelligence from law enforcement agencies on suspected involvement in financial crimes (including unwitting facilitation). Other such factors may include information from government/law enforcement sources, whistle-blowers, or negative news reports from credible media particularly those related to predicate offences for ML/TF or financial crimes.

148. In adopting an RBA to supervision, supervisors may consider allocating supervised entities sharing similar characteristics and risk profiles into groupings for supervision purposes. Examples of characteristics and risk profiles could include the size of the business, type of clients serviced, and geographic areas of activities. The setting up of such groupings could allow supervisors to take a comprehensive view of the sector, as opposed to an approach where the supervisors concentrate on the individual risks posed by the individual firms. If the risk profile of an accountant within a grouping changes, supervisors may reassess the supervisory approach, which may include removing the accountant from the grouping.

149. Supervisors and SRBs should also consider the impact, i.e. the potential harm caused if ML/TF is facilitated by the accountant or group of accountants. A small number of accountants may cause a high level of harm. This can depend on:

(a) size (i.e. turnover), number and type of clients, number of premises, the value of transactions, etc.); and

(b) links or involvement with other businesses (which could affect the susceptibility to being involved in 'layering' activity, e.g., concealing the origin of the transaction with the purpose to legalize the asset).

150. The risk assessment should be updated by supervisors and SRBs on an ongoing basis. The result from the assessment will help determine the resources the supervisor will allocate to the supervision of accountants.

151. Supervisors or SRBs should consider whether accountants meet the ongoing requirements for continued participation in the profession as well as assessments of competence and fitness and propriety. This will include whether the accountant meets expectations related to AML/CFT compliance. This will take place both when a supervised entity joins the profession, and on an ongoing basis thereafter.

152. If a jurisdiction chooses to classify an entire sector as higher risk, it should be possible to differentiate between categories of accountants based on factors such as their client base, countries they deal with, applicable AML/CFT controls, etc.

153. Supervisors and SRBs should acknowledge that in a risk-based regime, not all accountants will adopt identical AML/CFT controls and that an isolated incident where the accountant is part of an illegal transaction unwittingly

does not necessarily invalidate the integrity of the accountant's AML/CFT controls. At the same time, accountants should understand that a flexible RBA does not exempt them from applying effective AML/CFT controls.

154. Supervisors and SRBs should use their findings to review and update their ML/TF risk assessments and, where necessary, consider whether their approach to AML/CFT supervision and the existing AML/CFT rules and guidance remain adequate. Whenever appropriate, and in compliance with relevant confidentiality requirements, these findings should be communicated to accountants to enable them to enhance their RBA.

Supervision of the RBA Licensing or registration

155. R.28 requires a country to ensure that accountants are subject to regulatory and supervisory measures to ensure compliance by the profession with AML/CFT requirements.

156. R.28 requires the supervisor or SRB to take the necessary measures to prevent criminals or their associates from being professionally accredited or holding or being the beneficial owner of a significant or controlling interest or holding a management function in an accountancy practice. This can be achieved through the evaluation of these persons through a "fit and proper" test.

157. A licensing or registration mechanism is one of the means to identify accountants to whom the regulatory and supervisory measures, including the "fit and proper" test should be applied. It also enables the identification of the number of accountants to assess and understand the ML/TF risks for the country, and the action that should be taken to mitigate them by R.1.

158. Licensing or registration provides a supervisor or SRB with the means to fulfil a "gatekeeper" role over who can undertake the activities specified in R.22. Licensing or registration should ensure that upon qualification, accountants are subject to AML/CFT compliance monitoring.

159. The supervisor or SRB should actively identify individuals and businesses who should be supervised by using intelligence from other competent authorities (e.g., FIUs, company registry, or tax authority), information from financial institutions and DNFBPs, complaints by the public, open-source information from advertisements and business and commercial registries, or any other sources which indicate that unsupervised individuals or businesses are providing the activities specified in R.22.

160. Licensing or registration frameworks should define the activities that are subject to licensing or registration, prohibit unlicensed or unregistered individuals or businesses providing these activities and s, et out measures for both refusing licenses or registrations and for removing "bad actors".

161. The terms "licensing" or "registration" are not interchangeable. Licensing regimes generally tend to operate over financial institutions and impose mandatory minimum requirements based upon Core Principles on issues such as capital, governance, and resources to manage and mitigate prudential, conduct as well as ML/TF risks on an ongoing basis. Some jurisdictions have adopted similar licensing regimes for accountants, generally where accountants carry out trust and corporate services, to encompass aspects of prudential and conduct requirements in managing the higher level of ML/TF risks that have been identified in that sector.

162. A jurisdiction may have a registration framework over the entire DNFBP sector, including accountants, or have a specific registration framework for each constituent of a DNFBP. Generally, a supervisor or SRB carries out the registration function.

163. The supervisor or SRB should ensure that requirements for licensing or registration and the process for applying are clear, objective, publicly available, and consistently applied. Determination of the license or registration should be objective and timely. An SRB could be responsible for both supervision and for representing the interests of its members. If so, the SRB should ensure that registration decisions are taken separately and independently from its activities regarding member representation.

Fit and proper tests:

164. A fit and proper test provide a possible mechanism for a supervisor or SRB to take the necessary measures to prevent criminals or their associates from owning, controlling, or holding a management function in an accountancy practice.

165. By R.28, the supervisor or SRB should establish the integrity of every beneficial owner, controller, and individual holding a management function in an accountancy practice. However, the decisions on an individual's fitness and propriety may also be based upon a range of factors concerning the individual's competency, probity, and judgment as well as integrity.

166. In some jurisdictions, a "fit and proper test" forms a fundamental part of determining whether to license or register the applicant and whether on an ongoing basis the licensee or registrant (including its owners and controllers, where applicable) remains fit and proper to continue in that role. The initial assessment of an individual's fitness and propriety is a combination of obtaining information from the individual and corroborating elements of that information against independent credible sources to determine whether the individual is fit and proper to hold that position.

167. The process for determining fitness and propriety generally requires the applicant to complete a questionnaire. The questionnaire could gather personal identification information, and residential and employment history, and require disclosure by the applicant of any convictions or adverse judgments, including pending prosecutions and convictions relating to the applicant. Elements of this information should be corroborated to establish the bona fides of an individual. Such checks could include inquiries about the individual with law enforcement agencies and other supervisors or screening the individual against independent electronic search databases. The personal data collected should be kept confidential.

168. The supervisor or SRB should also ensure on an ongoing basis that those holding or being the beneficial owner of a significant or controlling interest and individuals holding management functions are fit and proper. A fit and proper test should apply to new owners, controllers, and individuals holding a management function. The supervisor or SRB should consider re-assessing the fitness and propriety of these individuals arising from any supervisory findings, receipt of information from other competent authorities; or open-source information indicating significant adverse developments.

Guarding against "brass-plate" operations

169. The supervisor or SRB should ensure that its licensing or registration requirements require the applicant to have a meaningful physical presence in the jurisdiction. This usually means that the applicant should have their place of business in the jurisdiction. Where an applicant is a legal person, those individuals who form its mind and management, should also be residents in the jurisdiction and be actively involved in the business. A business with only staff who do not possess the professional requirements of an accountant should not be licensed or registered.

170. A supervisor or SRB should consider the ownership and control structure of the applicant to determine that sufficient control over its operation will reside within the business, which it is considering licensing or registering.

Factors to take into account could include consideration where the beneficial owners and controllers reside, the number and type of management functions the applicant is proposing to have in the country, such as directors and managers, including compliance managers, and the caliber of the individuals who will be occupying those roles.

171. The supervisor or SRB should also consider whether the ownership and control structure of accountants unduly hinders its identification of the beneficial owners and controllers or presents obstacles to applying effective supervision.

Monitoring and supervision

172. Supervisors and SRBs should take measures to effectively monitor accountants through on-site and off-site supervision. The nature of this monitoring will depend on the risk profiles prepared by the supervisor or SRB and the connected risk-based approach. Supervisors and SRBs may choose to adjust:

(a) the level of checks required to perform their licensing/registration function: where the ML/TF risk associated with the sector is low, the opportunities for ML/TF associated with a particular business activity may be limited, and approvals may be made on a review of basic documentation. Where the ML/TF risk associated with the sector is high, supervisors and SRBs may ask for additional information.

(b) the type of on-site or off-site AML/CFT supervision: supervisors and SRBs may determine the correct mix of on-site and off-site supervision of accountants. Off-site supervision may involve analysis of annual independent audits and other mandatory reports, identifying risky intermediaries (i.e. based on the size of the firms, involvement in cross-border activities, or specific business sectors), automated scrutiny of registers to detect missing beneficial ownership information, and identification of persons responsible for the filing. It may also include undertaking thematic reviews of the sector, making compulsory the periodic information returns from firms. Off-site supervision alone may not be appropriate in higher-risk situations. On-site inspections may involve reviewing AML/CFT internal policies, controls, and procedures, interviewing members of senior management, compliance officers' other relevant staff, considering gatekeeper's risk assessments, spot-checking CDD documents and supporting evidence, looking at reporting ML/TF suspicions about clients and other matters, which may be observed in the course of an onsite visit and, where appropriate, sample testing of reporting obligations.

(c) the frequency and nature of ongoing AML/CFT supervision: supervisors and SRBs should proactively adjust the frequency of AML/CFT supervision in line with the risks identified and combine periodic reviews and ad hoc AML/CFT supervision as issues emerge (e.g. as a result of whistleblowing, information from law enforcement, or other supervisory findings resulting from accountants' inclusion in thematic review samples).

(d) the intensity of AML/CFT supervision: supervisors and SRBs should decide on the appropriate scope or level of assessment in line with the risks identified, to assess the adequacy of accountants' policies and procedures that are designed to prevent them from being abused. Examples of more intensive supervision could include; detailed testing of systems and files to verify the implementation and adequacy of the accountant's risk assessment, CDD, reporting, and record-keeping policies and processes, internal auditing, interviews with operational staff, senior management, and the Board of directors and AML/CFT assessment in particular lines of business.

173. Supervisors and SRBs should use their findings to review and update their ML/TF risk assessments and, where necessary, consider whether their approach to AML/CFT supervision and the existing AML/CFT rules and guidance remain adequate. Whenever appropriate, and in compliance with relevant confidentiality requirements, these findings should be communicated to accountants to enable them to enhance their RBA.

174. Record keeping and quality assurance are important so that supervisors can document and test the reasons for significant decisions relating to AML/CFT supervision. Supervisors should have an appropriate information retention policy and be able to easily retrieve information while complying with the relevant data protection legislation. Record keeping is crucial and fundamental to the supervisors' work. Undertaking adequate quality assurance is also fundamental to the supervisory process to ensure decision-making/sanctioning is consistent across the supervised population.

Enforcement

175. R.28 requires supervisors or SRBs to have adequate powers to perform their functions, including powers to monitor compliance by accountants. R.35 requires countries to have the power to impose sanctions, whether criminal, civil or administrative, on DNFPBs, to include accountants when providing the services outlined in R.22(d). Sanctions should be available for the directors and senior management of the firm when an accountant fails to comply with requirements.

176. Supervisors and SRBs should use proportionate actions, including a range of supervisory interventions and corrective actions to ensure that any identified deficiencies are addressed promptly. Sanctions may range from an informal or written warning, reprimand, and censure to punitive measures (including disbarment and criminal prosecutions where appropriate) for more egregious non-compliance, as identified weaknesses can have wider consequences. Generally, systemic breakdowns or significantly inadequate controls will result in a more severe supervisory response.

177. Enforcement by supervisors and SRBs should be proportionate while having a deterrent effect. Supervisors and SRBs should have (or should delegate to those who have) sufficient resources to investigate and monitor non-compliance. Enforcement should aim to remove the benefits of non-compliance.

Guidance:

178. Supervisors and SRBs should communicate their regulatory expectations. This could be done through a consultative process after meaningful engagement with relevant stakeholders, including accountants. This guidance may be in the form of high-level requirements based on desired outcomes, risk-based rules, and information about how supervisors interpret relevant legislation or regulation, or more detailed guidance about how particular AML/CFT controls are best applied. Guidance issued to accountants should also discuss ML/TF risk within their sector and outline ML/TF indicators to help them identify suspicious transactions and activity. All such guidance should preferably be consulted on, where appropriate, and drafted in ways that are appropriate to the context of the role of supervisors and SRBs in the relevant jurisdiction.

179. Where supervisors' guidance remains high-level and principles-based, this may be supplemented by further guidance written by the accountancy profession, which may cover operational and practical issues, and be more detailed and explanatory. Where supervisors cooperate to produce combined guidance across sectors, supervisors should ensure this guidance adequately addresses the diversity of roles that come within the guidance's remit, and that such guidance provides practical direction to all its intended recipients. The private sector guidance should be consistent with national legislation and with any guidelines issued by competent authorities about the accountancy profession and be consistent with all other legal requirements and obligations.

180. Supervisors should consider communicating with other relevant domestic supervisory authorities to secure a coherent interpretation of the legal obligations and to minimize disparities across sectors (such as legal professionals, accountants, and TCSPs). Multiple guidance should not create opportunities for regulatory arbitrage. Relevant supervisory authorities should consider preparing joint guidance in consultation with the relevant sectors while recognizing that in many jurisdictions accountants will consider that separate guidance targeted at their profession will be the most appropriate and effective form.

181. Information and guidance should be provided by supervisors in an up-to-date and accessible format. It could include sectoral guidance material, newsletters, internet-based material, oral updates on supervisory visits, meetings, and annual reports.

Training

182. Training is important for supervisory staff, and other relevant employees, to understand the accountancy profession and the various business models that exist. In particular, supervisors should ensure that staff is trained

to assess the quality of ML/TF risk assessments and to consider the adequacy, proportionality, effectiveness, and efficiency of AML/CFT policies, procedures, and internal controls. It is recommended that the training has a practical basis/dimension.

183. Training should allow supervisory staff to form sound judgments about the quality of the risk assessments made by accountants and the adequacy and proportionality of AML/CFT controls of accountants. It should also aim at achieving consistency in the supervisory approach at a national level, in cases where there are multiple competent supervisory authorities, or when the national supervisory model is devolved or fragmented.

Endorsements

184. Supervisors should avoid mandating the use of AML systems, tools, or software of any third-party commercial providers to avoid conflicts of interest in the effective supervision of firms.

Information exchange

185. Information exchange between the public and private sectors and within the private sector (e.g., between financial institutions and accountants) is important to combat ML/TF. Information sharing and intelligence sharing arrangements between supervisors and public authorities (such as Financial Intelligence Units and law enforcement) should be robust, secure, and subject to compliance with national legal requirements.

186. The type of information that could be shared between the public and private sectors include:

(a) ML/TF risk assessments;

(b) Typologies (i.e., case studies) of how money launderers or terrorist financiers have misused accountants;

(c) feedback on STRs and other relevant reports;

(d) targeted unclassified intelligence. In specific circumstances, and subject to appropriate safeguards such as confidentiality agreements, it may also be appropriate for authorities to share targeted confidential information with accountants as a class or individually; and

(e) countries, persons, or organisations whose assets or transactions should be frozen under targeted financial sanctions as required by R.6.

187. Domestic co-operation and information exchange between FIU and supervisors of the accountancy profession and among competent authorities including law enforcement, intelligence, FIU, tax authorities, supervisors, and SRBs is also vital for effective monitoring/supervision of the sector. Such cooperation and coordination may help avoid gaps and overlaps in supervision and ensure sharing of good practices and findings. Intelligence about active misconduct investigations and completed cases between supervisors and law enforcement agencies should also be encouraged. When sharing information, protocols and safeguards should be implemented to protect personal data.

188. Cross-border information sharing of authorities and the private sector with their international counterparts is of importance in the accountancy profession, taking account of the multi-jurisdictional reach of many accounting firms.

Supervision of Beneficial Ownership requirements and source of funds/wealth requirements:

189. The FATF Recommendations require competent authorities to have access to adequate, accurate, and timely information on the beneficial ownership and control of legal persons (R.24). In addition, countries must take measures to prevent the misuse of legal arrangements for ML/TF, in particular ensuring that it is adequate, accurate, and timely information on express trusts (R.25). Implementation of the FATF Recommendations on beneficial ownership has proven challenging. As a result, the FATF developed a Guidance on Transparency and

Beneficial Ownership (2014) to assist countries in their implementation of R.24 and R.25, as well as R.1 as it relates to understanding the ML/TF risks of legal persons and legal arrangements. The FATF and Egmont Group also published the Report on Concealment of Beneficial Ownership in July 2018 which identified issues to help address the vulnerabilities associated with the concealment of beneficial ownership.

190. R.24 and R.25 require countries to have mechanisms to ensure that information provided to registries is accurate and updated on a timely basis and that beneficial ownership information is accurate and current. To determine the adequacy of a system for monitoring and ensuring compliance, countries should have regarded the risk of AML/CFT in given businesses (i.e. if there is a proven higher risk then higher monitoring measures should be taken). Accountants must, however, be cautious in blindly relying on the information contained in registries. It is important for there to be some form of ongoing monitoring during a relationship to detect unusual and potentially suspicious transactions as a result of a change in beneficial ownership as registries are unlikely to provide such information on a dynamic basis.

191. Those responsible for company formation and the creation of legal arrangements fulfill a key gatekeeper role to the wider financial community through the activities they undertake in the formation of legal persons and legal arrangements or their management and administration.

192. As DNFBPs, accountants are required to apply CDD measures to beneficial owners of legal persons and legal arrangements to whom they are providing advice or formation services. In several countries, an accountant may be required as part of the process of registering the legal person and will be responsible for providing basic and/or beneficial ownership information to the registry.

193. In their capacity as company directors, trustees, foundation officials, etc. of these legal persons and legal arrangements, accountants often represent these legal persons and legal arrangements in their dealings with other financial institutions and DNFBPs that are providing banking or audit services to these types of clients.

194. These financial institutions and other DNFBPs may request the CDD information collected and maintained by accountants, who because of their role as director or trustee, will be their principal point of contact with the legal person or legal arrangement. These financial institutions and other DNFBPs may never meet the beneficial owners of the legal person or legal arrangement.

195. Under R.28, countries are to ensure that accountants are subject to effective systems for monitoring and ensuring compliance with AML/CFT requirements, which includes identifying the beneficial owner/s and taking reasonable measures to verify them. R.24 and R.25, which deal with transparency of beneficial ownership of legal persons and legal arrangements, require countries to have mechanisms for ensuring that adequate, accurate, and up-to-date information on these legal entities is available on a timely basis.

196. By R.28, accountants should be subject to risk-based supervision by a supervisor or SRB covering the beneficial ownership and recordkeeping requirements of R.10 and R.11. The supervisor or SRB should have a supervisory framework, which can help in ascertaining that accurate and current basic and beneficial ownership information on legal persons and legal arrangements is maintained and will be available on a timely basis to competent authorities.

197. The supervisor or SRB should analyse the adequacy of the procedures and the controls, which accountants have established to identify and record the beneficial owner. In addition, they should undertake sample testing of client records on a representative basis to gauge the effectiveness of the application of those measures and the accessibility of accurate beneficial ownership information.

198. During onsite and offsite inspections, the supervisor or SRB should examine the policies, procedures, and controls that are in place for taking on new clients to establish what information and documentation are required where a client is a natural person or legal person or arrangement. The supervisor or SRB should verify the adequacy of these procedures and controls to identify beneficial owners understand the ownership and control structure of

these legal persons and arrangements and ascertain the business activity. For example, self-declaration on beneficial ownership provided by the client without any other mechanism to verify the information will not be adequate in all cases.

199. Sample testing of records will assist the supervisor or SRB in determining whether controls are effective for the accurate identification of beneficial ownership, accurate disclosure of that information to relevant parties, and for establishing if that information is readily available. The extent of testing will be dependent on risk but the records selected should reflect the profile of the client base and include both new and existing clients.

200. The supervisor or SRB should consider the measures the accountants have put in place for monitoring changes in the beneficial ownership of a legal person and legal arrangements to whom they provide services to ensure that beneficial ownership information is accurate and current and to determine how timely updated filings are made, where relevant to a registry.

201. During examinations, the supervisor or SRB should consider whether to verify the beneficial ownership information available on the records of accountants with that held by the relevant registry, if any. The supervisor or SRB may also consider information from other competent authorities such as FIUs, public reports, and information from other financial institutions or DNFBPs, to verify the efficacy of accountants' controls.

202. Accountants should be subject to risk-based supervision by a supervisor or SRB covering the requirements to identify and evidence the source of funds and source of wealth for higher-risk clients to whom they provide services. The supervisor or SRB should have a supervisory framework, which can help in ascertaining that accurate and current information on sources of funds and wealth is properly evidenced and available on a timely basis to competent authorities. The supervisor or SRB should analyse the adequacy of the procedures and controls that accountants have established to identify and record sources of wealth in arrangements.

Nominee arrangements:

203. A nominee director is a person who has been appointed to the Board of Directors of the legal person who represents the interests and acts by instructions issued by another person, usually the beneficial owner.

204. A nominee shareholder is a natural or legal person who is officially recorded in the register of members and shareholders of a company as the holder of a certain number of specified shares, which are held on behalf of another person who is the beneficial owner. The shares may be held in trust or through a custodial agreement.

205. In several countries, accountants act or arrange for other persons (either individuals or corporate) to act as directors. Accountants also act or arrange for other persons (either individuals or corporate) to act as nominee shareholders for another person as part of their professional services. By R.24, one of the mechanisms to ensure that nominee shareholders and directors are not misused is by subjecting these accountants to licensing and recording their status in company registries. Countries may rely on a combination of measures in this respect.

206. There are legitimate reasons for accountants to act as or provide directors to a legal person or act or provide nominee shareholders. These may include the settlement and safekeeping of shares in listed companies were post-traded specialists act as nominee shareholders. However, nominee director and nominee shareholder arrangements can be misused to hide the identity of the true beneficial owner of the legal person. There may be individuals prepared to lend their name as a director or shareholder of a legal person on behalf of another without disclosing the identity of the person from whom they will take instructions or whom they represent. They are sometimes referred to as "strawmen".

207. Nominee directors and nominee shareholders can create obstacles to identifying the true beneficial owner of a legal person, particularly where the status is not disclosed. This is because it will be the identity of the nominee that is disclosed in the corporate records of the legal person held by a registry and in the company records at its registered office. Company law in various countries does not recognize the status of a nominee director because in

law it is the directors of the company who are liable for its activities and the directors must act in the best interest of the company.

208. The supervisor or SRB should be aware that undisclosed nominee arrangements may exist. They should consider whether undisclosed nominee arrangements would be identified and addressed during their onsite and offsite inspections and examination of the policies, procedures, controls, and client records of the accountant, including the CDD process and ongoing monitoring by the accountant.

209. An undisclosed nominee arrangement may exist where there are the following (non-exhaustive) indicators:

(a) the profile of a director or shareholder is inconsistent with the activities of the company;

(b) the individual holds numerous appointments to unconnected companies;

(c) a director's or shareholder's source of wealth is inconsistent with the value and nature of the assets within the company;

(d) funds into and out of the company are sent to, or received from unidentified third party/ies;

(e) the directors or shareholders are accustomed to acting on the instruction of another person; and

(f) requests or instructions are subject to minimal or no scrutiny and/or responded to extremely quickly without challenge by the individual/s purporting to act as the director/s.

Sum up:

Money laundering is a common issue around the globe. In recent times, money laundering and terror financing have forced several governments and regulators globally to focus on stopping the illegitimate flow of funds. However, combating this problem remains a primary challenge for nations and financial institutions all over the world. The legalization of crime revenues has numerous damaging outcomes. Financial crimes result in the deterioration of the administrative order and economic stability. Governments have taken several measures from the past prevent money laundering. The objective of these measures is to prevent financial crimes and ensure that the administrative and economic stability of the nation is maintained.

Anti-Money Laundering (AML) in India is described as a set of regulations, laws, or procedures particularly designed to prevent the activity of generating money via illegal ways and methods. The Prevention of Money Laundering Act, 2002 (PMLA) along with the Prevention of Money Laundering (Maintenance of Records) Rules,

2005 (Rules) are the principal laws that are enforced to prohibit money laundering activities in India. There are specialised authorities that deal with the money laundering problems such as the Reserve Bank of India/ Securities and Exchange Board of India (SEBI)/ Insurance Regulatory and Development Authority of India, which lay down guidelines on anti-money laundering standards following PMLA and Rules.

Anti-Money Laundering Laws & Regulations: The Financial Action Task Force on Money Laundering (FATF), an intergovernmental body introduced by the G-7 Summit in Paris in 1989 and responsible for setting global standards on anti-money laundering and combating the financing of terrorism explains money laundering as the processing of criminal proceeds to disguise their illegitimate origin to legitimize the illegal gains of crime. In 2010, India became the 34th nation member of the Financial Action Task Force. India is one of the signatories to several United Nations Conventions which tackle anti-money laundering and countering the financing of terrorism.

India has prohibited money laundering under the Prevention of Money Laundering Act, 2002 (PMLA) and also in the Narcotic Drugs and Psychotropic Substances Act, 1985 (NDPS Act) (amended in 2001). The Prevention of Money Laundering Act, 2002 coupled with the rules issued under it and the rules and regulations formed by regulators such as the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) displays a broad framework for the anti-money laundering laws in India.

The Prevention of Money Laundering Act, 2002: In 1998, The Prevention of Money Laundering Bill was introduced in the Lok Sabha, passed in 2003, and came into force in 2005. It has gone through several amendments, with the last one being in 2019. Administration and enforcement authorities are chosen under PMLA to execute its provisions and rules. Certain powers are vested, which are very similar to those granted to the civil courts of the nation, to exercise the provisional attachment of properties that are involved in the offence under PMLA.

The PMLA attempts to combat acts related to money laundering in India and because of this, it has three main objectives i.e.

(i) to prevent and control money laundering

(ii) to confiscate and seize the property acquired from the laundered money

(iii) to deal with any other issue about money laundering in India.

Under the provisions of the PMLA, the Financial Intelligence Unit of India (FIU-IND) was formed in 2004 as the primary body for coordinating India's AML efforts. The primary function of FIU-IND is to receive, analyse, process and disseminate information relating to suspect financial transactions. FIU-IND also coordinates and strengthens efforts of national investigation, international intelligence, and enforcement agencies in pursuing the global efforts against money laundering and financing of terrorism. In 2005, the Enforcement Directorate (ED) was introduced by the Government of India to utilize exclusive powers related to the investigation and prosecution under PMLA.

The primary legislation other than the Prevention of Money Laundering Act, 2002, which directly or indirectly focuses to curb and fight money laundering activities are as follows:

1. **The Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974:** The act was passed in 1974 in furtherance of the government's attempt to retain foreign exchange within the nation. The Act is established on the concept of Preventive Detention which, apart from being a colonial legacy, is also given explicitly in our constitution as 'the necessary evil' and laws exist under Article 22 of the Indian Constitution for the same reasons related to the security of the state and maintenance of public order. According to the provisions of section 10, the stipulated period of detention is 1 to 2 years.

All decisions in furtherance of the Act may be taken by the state or central government. The relevant provisions in this regard which must be taken into consideration are Section 3 (power to make orders detaining certain persons), Section 4 (execution of detention orders), Section 5 (power to regulate place and conditions of detention), and Section 11 (revocation of detention orders).

2. The Benami Transactions (Prohibition) Act, 1988: A Benami transaction is a transaction in which property is transferred to one person for a value paid or provided by another person and often, the identity of the persons involved is concealed. This Act was passed in 1988. It is to constrain Benami transactions and the right to recover property held by Benami. Section 3 of the Act specifically debars anyone from getting into a Benami transaction. The Act further specifies those properties obtained under the Benami transaction which are liable to be acquired by the competent authorities without any need for compensation to be payable by such authority.

3. The Indian Penal Code, 1860 and Code of Criminal Procedure, 1973: The Indian Penal Code, 1860 is the primary substantive law that regulates several criminal activities and also prescribes penalties for them. The Code of Criminal Procedure, 1973 on the other hand is a part of procedural law that specify procedures to be followed in criminal cases. Several offences under the Indian Penal Code have been recognised as being scheduled offences within the meaning explained in the PMLA. Further, Section 65 of the PMLA also specifies that the provisions of the Code of Criminal Procedure are to be followed in respect of the several proceedings prescribed under the PMLA.

4. The Narcotic Drugs and Psychotropic Substances Act, 1985: This Act was passed in 1985 to consolidate and amendment of laws relating to narcotic drugs. Keeping in line with its objectives identifies, lists, and explains several forms and types of narcotic drugs and psychotropic substances.

The Act, in its essence, attempts to stop and restrict the transport and vending of narcotic and psychotropic substances and does not mention money laundering activities. It may, however, be taken into consideration that the trade of narcotic substances does generate a lot of cash for people involved in it. So much so that a noticeable portion of the money involved in drug trafficking is then mobilised to give it legitimacy or in simple words, the same money gets laundered. The NDPS Act, by working against practices involving drug trading and trafficking puts a direct restriction on the flow of money into illegitimate activities.

To Conclude, Money Laundering is a universal menace and cannot be resolved by a single nation alone. The activities related to money laundering have been spreading in Indian society, despite the best efforts of the Indian government to stop such practices. Through legislation and administrative bodies and efficient regulators who work tirelessly in this matter, the fight against money laundering activities continues to go on. Although such activities may be controlled at a domestic level, such practices are never restricted to the confines of a single jurisdiction. Restrictions at a specific jurisdiction motivate launderers to shift base to another jurisdiction which may give a hospitable environment for their activities to grow.

It may be noted that funds brought in by illegitimate ways for legitimisation, once legalised, be again utilised for the vested interests of the beneficiaries who may not always have good intentions in mind. Crime can only result in more crime and the vicious circle would only continue. Whereas checks are required to be maintained regularly on money laundering activities- one of the better methods to stop money laundering practices may be for governments to introduce such legitimate interests into confidence and provide them protection and certain benefits which may altogether restrict people from engaging in money laundering activities.

Solved Case

M/s XYZ Limited is a company engaged in the real estate and construction business. To build a land bank in various parts of India that were likely to see commercial development and anticipate a future upward trend in land prices in various parts of India. M/s XYZ Limited hired the services of Mr Mahesh to assist in the process of acquisition of lands.

M/s XYZ Limited issued a detailed offer letter to Mr Mahesh for the purchase of around 100 acres of land at the maximum price of ₹10, 00,000 per acre in different parts of India within a period not exceeding five years. The said offer was accepted by Mr Mahesh by a letter of acceptance. Upon exchange of offer and acceptance, a legally binding and valid contract came to be forced between M/s XYZ Limited and Mr Mahesh.

Mr Mahesh received from M/s XYZ Limited a sum of ₹1,000 Crore as a loan/advance for the purchase of lands as specified in the contract between the parties. Mr Mahesh purchased various movable and immovable properties with the funds received from M/s XYZ Limited. Since all the funds could not be directly invested in the land as required by the contract, investments were made by Mr Mahesh by himself or through his company in the purchase of immovable property, including land, built-up residential and commercial buildings, etc. and Investment in fixed deposits in name of Mr Mahesh and M/s PQR Limited (95% shareholding by Mr Mahesh) also investment in the movable property including bank balance and few vehicles.

In the meantime, the Directorate of Enforcement initiated Suo moto proceedings under the Prevention of Money Laundering Act, 2002 (PMLA) and registered a complaint under Sections 3 and 4 of the PMLA and attached the property of Mr Mahesh under the Prevention of Money Laundering Act, 2002.

Given the above, answer the following question:

(a) Discuss the attachment of property involved in money laundering under PMLA.

(b) Explain the extent of punishment prescribed under PMLA.

(c) Discuss Appellate Authority establish under PMLA and what is the time limit to file an appeal.

Suggested Solution:

(a) Section 5 of the Prevention of Money Laundering Act, 2002 (PMLA) deals with the provision of attachment of property involved in money laundering.

As per Section 5(1) of the PMLA, Where the Director or any other officer not below the rank of Deputy Director authorised by the Director, has reason to believe (the reason for such belief to be recorded in writing), based on material in his possession, that Section 5(2) states that the Director, or any other officer not below the rank of Deputy Director, shall, immediately after attachment under sub-section (1), forward a copy of the order, along with the material in his possession, to the Adjudicating Authority, in a sealed envelope, in the manner as may be prescribed and such Adjudicating Authority shall keep such order and material for such period as may be prescribed.

Section 5(3) provides that every order of attachment made under sub-section (1) shall cease to have effect after the expiry of the period specified in sub-section (1) or on the date of an order made under sub-section (3) of section 8, whichever is earlier.

As per Section 5(4) of PMLA, nothing in this section shall prevent the person interested in the enjoyment of the immovable property attached under sub-section (1) from such enjoyment.

It may be noted that the person interested, in any immovable property, includes all persons claiming or entitled to claim any interest in the property.

Section 5(5) states that the Director or any other officer who provisionally attaches any property under sub-section (1) shall, within thirty days from such attachment, file a complaint stating the facts of such attachment before the Adjudicating Authority.

(b) The offence of money Laundering and Punishment for money Laundering are specified under Sections

3 and 4 of the Prevention of Money Laundering Act, 2002 respectively.

Section 3 of the Prevention of Money Laundering Act, 2002 provides that whosoever directly or indirectly attempts to indulge or knowingly assists or is a party or is involved in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property shall be guilty of the offence of money-laundering.

It may be further noted that proceeds of crime mean any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offence or the value of any such property.

According to Section 4 of the Prevention of Money Laundering Act, 2002, whoever commits the offence of money-laundering shall be punishable with rigorous imprisonment for a term which shall not be less than three years but which may extend to seven years and shall also be liable to fine.

It may be noted that where the proceeds of crime involved in money-laundering relate to any offence specified under paragraph 2 of Part A of the Schedule to the PMLA, shall be punishable with rigorous imprisonment for a term which shall not be

(a) any person has any proceeds of crime; and

(b) such proceeds of crime are likely to be concealed, transferred or dealt with in any manner which may result in frustrating any proceedings relating to the confiscation of such proceeds of crime, he may, by order in writing, provisionally attach such property for a period not exceeding one hundred and eighty days from the date of the order, in such manner as may be prescribed.

It may be noted that no such order of attachment shall be made unless, about the scheduled offence, a report has been forwarded to a Magistrate under section 173 of the Code of Criminal Procedure, 1973, or a complaint has been filed by a person authorised to investigate the offence mentioned in that Schedule, before a Magistrate or court for taking cognizance of the scheduled offence, as the case may be, or a similar report or complaint has been made or filed under the corresponding law of any other country.

Further, notwithstanding anything contained above, any property of any person may be attached, if the Director or any other officer not below the rank of Deputy Director authorised by him for Section of the PMLA has reason to believe (the reasons for such belief to be recorded in writing), based on material in his possession, that if such property involved in money-laundering is not attached immediately, the non-attachment of the property is likely to frustrate any proceeding under the Act.

To compute the period of one hundred and eighty days, the period during which the proceedings under Section 5 of PMLA are stayed by the High Court, shall be excluded and a further period not exceeding thirty days from the date of order of vacation of such stay order shall be counted.

Section 5(2) states that the Director, or any other officer not below the rank of Deputy Director, shall, immediately after attachment under sub-section (1), forward a copy of the order, along with the material in his possession, to the Adjudicating Authority, in a sealed envelope, in the manner as may be prescribed and such Adjudicating Authority shall keep such order and material for such period as may be prescribed.

Section 5(3) provides that every order of attachment made under sub-section (1) shall cease to have effect after the expiry of the period specified in sub-section (1) or on the date of an order made under sub-section (3) of section 8, whichever is earlier.

As per Section 5(4) of PMLA, nothing in this section shall prevent the person interested in the enjoyment of the immovable property attached under sub-section (1) from such enjoyment.

It may be noted that the person interested, in any immovable property, includes all persons claiming or entitled to claim any interest in the property.

Section 5(5) states that the Director or any other officer who provisionally attaches any property under sub-section (1) shall, within thirty days from such attachment, file a complaint stating the facts of such attachment before the Adjudicating Authority.

The offence of money Laundering and Punishment for money Laundering are specified under Sections 3 and 4 of the Prevention of Money Laundering Act, 2002 respectively.

Section 3 of the Prevention of Money Laundering Act, 2002 provides that whosoever directly or indirectly attempts to indulge or knowingly assists or is a party or is involved in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property shall be guilty of the offence of money-laundering.

It may be further noted that proceeds of crime mean any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offence or the value of any such property.

According to Section 4 of the Prevention of Money Laundering Act, 2002, whoever commits the offence of money-laundering shall be punishable with rigorous imprisonment for a term which shall not be less than three years but which may extend to seven years and shall also be liable to fine.

It may be noted that where the proceeds of crime involved in money-laundering relate to any offence specified under paragraph 2 of Part A of the Schedule to the PMLA, shall be punishable with rigorous imprisonment for a term which shall not be less than three years but which may extend to ten years and shall also be liable to fine.

(c) The Director or any person aggrieved by an order made by the Adjudicating Authority under this Act may prefer an appeal to the Appellate Tribunal. An appeal has to be filed within forty-five days from the date of receipt of a copy of the order made by the Adjudicating Authority. Appellate Tribunal may entertain an appeal after the expiry of the period of forty-five days if it is satisfied that there was sufficient cause for not filing it within that period.

Any person aggrieved by any decision or order of the Appellate Tribunal may file an appeal to the High Court within sixty days from the date of communication of the decision or order of the Appellate Tribunal to him on any question of law or fact arising out of such order. Thus, an appeal can be filed before High Court on any question of law or fact. High Court may if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.

Solved Questions:

1. What are the key laws governing anti-money laundering activities in India?

Solution:

The Prevention of Money Laundering Act, 2002 ("PMLA") along with the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 ("Rules") are the principal laws enacted to prevent money laundering activities in India. Specialised authorities are dealing with money laundering issues such as the Reserve Bank of India / Securities and Exchange Board of India("SEBI")/Insurance Regulatory and Development Authority of India which also prescribe guidelines on anti-money laundering standards based on PMLA and Rules.

2. What do the SEBI / IRDAI guidelines cover?

Solution:

SEBI has introduced 'Guidelines on Anti-Money Laundering (AML) Standards and Combating the Financing of Terrorism (CFT) /Obligations of Securities Market Intermediaries' and IRDAI has introduced 'Guidelines on Anti Money Laundering programme for Insurers'. They are sector-specific based on the principles of PMLA and Rules.

3. What is the extent of applicability of PMLA and the Rules?

Solution:

The PMLA and rules apply to all persons which include individuals, a company, a firm, an association of persons, or a body of individuals (incorporated or otherwise), and any agency, office, or branch owned or controlled by any of the above persons.

4. What is money laundering?

Solution:

Money laundering is the processing of criminal proceeds i.e., profits generated from criminal acts, to disguise their illegal origin. For example, embezzlement, insider trading, bribery, computer fraud schemes, illegal arms sales, smuggling, and the activities of organized crime can produce large profits and create the incentive to legitimize the ill-gotten gains through money laundering.

5. What constitutes an offence of money laundering under the PMLA?

Solution:

Any person who directly or indirectly attempts to indulge or knowingly assists or is involved in any activity connected with the proceeds of crime is guilty of the offence of money laundering. Further, concealment, possession, acquisition or use, and projecting or claiming it as untainted property, of such proceeds of crime, in any manner is also an offence under the provisions of PMLA.

6. What are the proceeds of crime?

Solution:

Any property obtained directly or indirectly through a criminal activity relating to a scheduled offence constitutes proceeds of crime. The value of such property or its equivalent value held within the country or abroad are also considered to be proceeds of crime.

7. What does 'property' mean? Are intangible assets also included?

Solution:

Under PMLA, 'property' means any property/assets of every description, corporeal or incorporeal, movable or immovable, tangible or intangible, and includes deeds and instruments evidencing title/interest in the property/ assets wherever located and includes any kind of property used in the commission of an offence under PMLA.

8. What is a 'scheduled offence'?

Solution:

There is a list of offences provided under a schedule in the PMLA. These offences are called scheduled offences. The schedule consists of three parts specifying offences from thirty legislations. Some of the major legislations covered in the schedule include Indian Penal Code, 1860, Narcotic Drugs and Psychotropic Substances Act, 1985, Explosive Substances Act, 1908, Unlawful Activities (Prevention) Act, 1967, Arms Act, 1959, Wild Life (Protection) Act, 1972, Prevention of Corruption Act, 1988, the Companies Act, 2013 and the Customs Act, 1962.

9. What is the punishment for the offence of money laundering?

Solution:

The PMLA prescribes rigorous imprisonment for at least 3 (three) years which may extend up to 7 (seven) years and also a fine. In the event that the offence of money laundering is related to the Narcotic Drugs and Psychotropic Substances Act, 1985, the rigorous imprisonment may extend up to 10 (ten) years.

If an offence of money laundering is committed by a company, then every person in charge of and responsible for the conduct of the business of the company at the time of such contravention as well as the company will be deemed to be guilty and will be liable to be proceeded against and punished accordingly.

10. Which Authorities Regulate the PMLA?

Solution:

The Directorate of Enforcement in the Department of Revenue, Ministry of Finance is responsible for investigating offences of money laundering. The Financial Intelligence Unit - India ("FIU-IND") under the Department of Revenue, Ministry of Finance is the central national agency responsible for receiving, processing, analysing, and disseminating information relating to suspected financial transactions to enforcement agencies and foreign FIUs.

11. What are the compliances/obligations prescribed under PMLA and the Rules?

Solution:

Every banking company, financial institution, intermediary, or a person carrying on a designated business or profession ("Reporting Entity") is required to verify the identity of their clients and the beneficial owner, maintain records of all transactions and documents evidencing identity of its clients as well as beneficial owners and periodical furnishing of information related to certain transactions.

12. Who is covered under "persons carrying on a designated business or profession"?

Solution:

This expression includes : (a) a person carrying on activities for playing games of chance for cash or kind, and includes such activities associated with the casino; (b) inspector-general of registration appointed under the Registration Act, 1908; (c) real estate agent engaged in providing services about sale or purchase of real estate and having annual turnover of INR 2,000,000 or above; (d) dealer in precious metals, precious stones, and other high-value goods if they engage in any cash transactions with a customer equal to or above INR 1,000,000 carried out in a single operation or in several operations that appear to be linked; (e) a person engaged in safekeeping and administration of cash and liquid securities on behalf of other persons, as notified by the central government; or (f) a person carrying on such other activities as notified by the central government from time to time.

13. Is there a standard or a procedure required to be followed for verification of the client by the Reporting Entity?

Solution:

Every Reporting Entity is required to conduct an enhanced client due diligence to take steps to examine the client's ownership and financial positions including the source of funds and the intended nature of the relationship between the transaction parties. The Reporting Entity is required to:

(i) Identify and verify its clients and the beneficial owner (if applicable), obtain information on the purpose and intended nature of the business relationship in case of an account-based relationship. After the commencement of an account-based relationship, the Reporting Entity must file the electronic copy of the client's Know Your Client ("KYC") records with the central KYC records registry. The verification process may be done by relying on a third party as well.

(ii) Verify identity while carrying out the transaction of an amount of INR 50,000 or more or any international money transfer operations.

14. Who is considered a 'beneficial owner'?

Solution:

The beneficial owner for the verification process is as mentioned below:

S. No.	Nature of Client	Description (Beficial Owner)
(i)	Company	Natural person, who acting alone or together has a controlling ownership interest or who exercises control through other means. 'Controlling ownership interest' – ownership of or entitlement ot more than 25% of shares or capital or profits of the company. 'Control' – includes the right to appoint majority of the directors or to control the management or policy decisions such as by virtue of their shareholding or management rights or shareholders agreements or voting agreements.
(ii)	Partnership Firm	Natural person, who acting alone or together has ownership of or entitlement to more than 15% of the property or capital or profits of such association or body of individuals.
(iii)	Unincorporated association or body of individuals	Natural person, who acting alone or together has ownership of or entitlement to more than 15% of the property or capital or profits of such association or body of individuals.
(iv)	Trust	Includes identification of the author of the trust, the trustee, the beneficiaries with 15% or more interest in the trust and any other natural person exercising ultimate effective control over the trust through a chain of control or ownership.

15. What are the records that are required to be maintained by the Reporting Entity? How long do these records have to be maintained?

Solution:

Every banking company, financial institution, intermediary, or a person carrying on a designated business or profession ("Reporting Entity") is required to verify the identity of their clients and the beneficial owner, maintain records of all transactions and documents evidencing identity of its clients as well as beneficial owners and periodical furnishing of information related to certain transactions. The records maintained must contain information including: (a) the nature of the transactions; (b) the amount of the transaction and the currency in which it was denominated; (c) the date on which the transaction was conducted and (d) the parties to the transaction to enable the Reporting Entity to reconstruct individual transactions.

The information relating to the transaction must be maintained for five years from the date of the transaction between a client and the Reporting Entity. The records relating to the identity of clients and beneficial owners as well as account files and business correspondence must be maintained for five years after the business relationship between a client and the Reporting Entity has ended or the account has been closed, whichever is later.

16. What type of information is required to be furnished by the Reporting Entities and to whom?

Solution:

The information required to be furnished by the Reporting Entities is provided in the table below. This information is required to furnish information to the Director of FIU-IND.

Sr. No.	Description	Due Date
(i)	All cash transactions of the value or more than INR 1,00,000 or its equivalent in foreign currency.	15th day of the succeeding month
	All series. of cash transactions integrally connected to each other which have been valued below INR 1,00,000 or its equivalent in foreign currency where such series of transactions have taken place within a month and the monthly aggregate exceeds an amount of INR 1,00,000 or its equivalent in foreign currency	15th day of the succeeding month
(ii)	All cash transactions where forged or counterfeit currency notes of bank notes have been used as genuine or where any forgery of a valuable security or a document has taken place facilitating the transactions	15th day of the succeeding month
(iii)	All transactions involving receipts by non- profit organisations of value more than INR 1,00,000 or, its equivalent in foreign currency	15th day of the succeeding month
(iv)	All cross-border "wire transfers of the value of more than INR 5,00,000 or its equivalent in foreign currency where erther the origin or destination of fund is in India.	15th day of the succeeding month
(v)	All purchase and sale by any person of immovable property valued at INR 5,00,000 or more that ts registered Py the reporting entity, as the case may be.	15th day of the month succeeding the quarter
(vi)	All suspicious transactions whether or not made in cash	Not later than 7 (seven) working days on being satisfied that the transaction is suspicious

17. What is the format in which the information is required to be furnished by the Reporting Entity?

Solution:

The reporting entity must register itself with FIU-IND using the portal https://finnet.gov.in/. Once the registration is complete, the Reporting Entity can furnish information to Director, FIU-IND online in a standard format prescribed for the purpose.

18. Who is responsible to furnish the information from the Reporting Entity?

Solution:

Every Reporting Entity is required to appoint two officers i.e., Designated Director and the Principal Officer. The Designated Director is required to ensure overall compliance with the obligations under PMLA and Rules. The Principal Officer is responsible for the overall compliance of the Reporting Entity. Accordingly, the Principal Officer is responsible to furnish the information promptly to the Director of FIU-IND.

19. What are the penalties for non-compliance with the client due diligence process, maintenance of records, and reporting obligations of the Reporting Entities?

Solution:

On failure to comply with the diligence, maintenance, or reporting obligations by the Reporting Entities, the Director of FIU-IND may:

1. Issue a warning in writing; or
2. Direct such Reporting Entity or it's Designated Director on the board or any of its employees, to comply with specific instructions; or
3. Direct such Reporting Entity or its Designated Director on the board or any of its employees, to send reports at such interval as may be prescribed on the measures it is taking; or
4. Impose a monetary penalty of not less than INR 10,000 but may extend up to INR 100,000 on such Reporting Entity or its Designated Director on the board or any of its employees for each failure.

20. What is the forum for appeal against the order of the Director of FIU-IND for noncompliance with diligence, maintenance, or reporting obligations?

Solution:

Any reporting entity aggrieved by any order of the Director of FIU-IND may appeal before the appellate tribunal constituted under the Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976. This appeal must be made within 45 days from the date on which a copy of the order made by the Director of FIU-IND is received.

21. What is a forum for appeal against the order of the appellate tribunal?

Solution:

A person aggrieved by the decision of the appellate tribunal may file an appeal to the High Court within 60 days from the date of communication of the decision of the appellate tribunal to it on any question of law or fact arising out of such decision. The High Court may accept an appeal within a further period of 60 days if sufficient cause for the delay is shown.

22. What is the court of the first instance to try and levy punishment for the offence of money laundering?

Solution:

The central government has designated special courts, in consultation with the Chief Justice of the High Court, for trial and punishment of the offence of money laundering. The list of special courts designated by the central government can be accessed.

23. What is the court of appeal against the order of the special court?

Solution:

An appeal or revision may be made to the High Court within the local limit of the jurisdiction of the special courts.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Prevention of Money-Laundering Act, 2002 is?
   (a) Act No.15 of 2003
   (b) Act No.22 of 2003
   (c) Act No.11 of 2003
   (d) Act No.3 of 2003

2. Prevention of Money Laundering Act, 2002 came into force on?
   (a) 1st January 2002
   (b) 1st July 2005
   (c) 1st June 2004
   (d) 1st November 2002

3. "Financial institution" as defined under Section 2(l) of Prevention of Money Laundering Act, 2002 does NOT include? (i) a chit fund company, (ii) a housing finance institution, (iii) a payment system operator, (iv) a non- banking financial company, (v) Department of Posts in the Government of India.
   (a) (v) only
   (b) (iv) only
   (c) (ii), (iv) and (v) only
   (d) None of the above

4. "Payment system" as defined under PMLA Act, 2002 does include? (i) systems enabling credit card operations, debit card operations (ii) smart card operations (iii) money transfer operations
   (a) Only (i)
   (b) Only (iii)
   (c) Only (i) and (iii)
   (d) All the above

5. "Person" as defined under the Prevention of Money Laundering Act, 2002 includes?
   (a) A Hindu undivided family
   (b) Every artificial juridical person

(c) An association of persons or a body of individuals, whether incorporated or not

(d) All the above

6. "Precious metal" as defined by PMLA Act, 2002 does not include?

(a) Gold

(b) Palladium or rhodium

(c) Diamond

(d) Platinum

7. "Precious stone" as defined under PMLA Act, 2002 does not include?

(a) Diamond

(b) Graphite

(c) Emerald

(d) Sapphire

8. Offence of money laundering is defined in which section of PMLA Act, 2002?

(a) Section 3

(b) Section 2

(c) Section 1

(d) Section 11

9. "Punishment for money-laundering" is defined under which Section of PMLA Act 2002?

(a) Section 3

(b) Section 7

(c) Section 4

(d) Section 10

10. Which of the following is not prescribed in the provision of the Prevention of Money Laundering Act, 2002?

(a) Seizure of property

(b) Attachment of Property

(c) Confiscation of Property

(d) Life Imprisonment

11. Whoever commits the offence of money-laundering shall be punishable with rigorous imprisonment for a term which shall not be less than three years but which may extend to?
    (a) Three Years
    (b) Five Years
    (c) Seven years
    (d) Ten years

12. Whoever commits the offence of money-laundering, which relates to any offence specified under paragraph 2 of Part A of the Schedule, shall be punishable with rigorous imprisonment for a term which shall not be less than three years but which may extend to?
    (a) Three Years
    (b) Five Years
    (c) Seven years
    (d) Ten years

13. As per section 5 of PMLA Act, 2002, the property can be provisionally attached for a period not exceeding ______ from the date of the order?
    (a) 60 days
    (b) 90 days
    (c) 120 days
    (d) 180 days

14. Director or any other officer who provisionally attaches any property under PMLA Act, 2002, shall, within a period of days from such attachment, file a complaint stating the facts of such attachment before the Adjudicating Authority?
    (a) Thirty days
    (b) Sixty days
    (c) Forty-five days
    (d) Ninety days

15. Which among the following authority appointed by the Central Government shall exercise jurisdiction, powers, and authority conferred by or under the Prevention of Money Laundering Act, 2002?
    (a) Administrative Authority
    (b) Adjudicating Authority
    (c) Appellate Authority
    (d) Adjudicating Commission

Essay Type Questions

1. What do you mean by "money laundering"? What is the role of RBI in the Prevention of Money Laundering?
2. "Non-adherence of KYC norms can create opportunity for money laundering". Explain.
3. What is meant by pooled accounts?
4. What is meant by KYC Policy?
5. Describe the Customer Acceptance Policy in AML/KYC.
6. Explain the customer identification procedure in AML/KYC.
7. What can be a ground for a transaction to be a suspicious transaction?
8. What do you mean by Money Laundering?
9. What are the objectives of KYC?
10. What are the stages of money laundering?
11. Why is there a need to perform Anti-Money Laundering Checks?
12. What do you understand about money laundering and financial terrorism?

Answer:

Multiple Choice Questions (MCQ)

1.	(a)	Act No.15 of 2003
2.	(b)	1st July 2005
3.	(d)	None of the above
4.	(d)	All the above
5.	(d)	All the above
6.	(c)	Diamond
7.	(b)	Graphite
8.	(a)	Section 3
9.	(c)	Section 4
10.	(d)	Life Imprisonment
11.	(c)	Seven years
12.	(d)	Ten years
13.	(d)	180 days
14.	(a)	Thirty days
15.	(b)	Adjudicating Authority