Ministry of Corporate Affairs

Explanatory Statement to the review of Cost Accounting Record Rules, Cost Audit Report Rules & Cost Accounting Standards

Section 209(1)(d) of the Companies Act, 1956 provides for maintenance of cost accounting records for certain classes of companies and section 233B provides for audit of cost accounts of such companies as ordered by the Central Government. In this regard, Cost Accounting Records Rules and Cost Audit Report Rules were prescribed by the Central Government from time to time.

2. It is imperative that in context of an economic environment, determined by increasing competition both domestically and internationally, efficiency and economy be brought about in the operations of the manufacturing sector to catalyze and facilitate the cost competitiveness of the manufacturing sector in India. It is equally necessary to enable the industry to address issues arising from unfair trade practices such as dumping, subsidies & cartels, etc. in the International Trade.

3. Cost accounting, through the determination and allocation of costs to various products, provides a valuable service to the managements of companies in cost analysis and management control. In this way, it can help to improve efficiency in the use of materials, labour and plant, maximize production and realize greater profits. At the same time, cost analysis furnishes useful information in respect of such important matters as gross margin, differential costs, replacement costs, etc. Cost analysis can be useful to the Regulators of public utilities and provide a basis for comparing claims and assessing the validity of issues arising out of international trade.

4. To enable development of relevant cost accounting methodologies and standards to increase the competitiveness of the Indian manufacturing sector,

and to advise the Government on suitable measures for the same, a Group of Experts was constituted under the chairmanship of Shri B.B. Goyal, Cost Advisor.

5. The Expert Group has reviewed the Cost Accounting Record Rules and their continued relevance in the contemporary competitive business environment and has recommended the modifications and / or alternative structures. Existing Cost Audit Report Rules and formats prescribed therein have been reviewed and modifications to make them more relevant to the needs of different stakeholders have been recommended. Further, the existing system has also been reviewed and suggestions for addressing the concerns of the industry with regard to confidentiality of company cost data and cost of compliance have been made. The Expert Group has also recommended to restructure all the existing Cost Accounting Standards.

6. The report of the Expert Group is annexed to this Memorandum for viewing by all stakeholders. Suggestions/comments on the recommendations of the Expert Group may be addressed/sent with in 90 days from the publication of this report to Shri Diwan Chand, Director (Inspection & Investigation), Ministry of Corporate Affairs, Room No. 525, ‘A’ Wing, 5th Floor, Shastri Bhawan, Dr. Rajendra Prasad Road, New Delhi.

7. The suggestions/comments may also be sent through e-mail at diwan.chand@mca.gov.in and mahinder.pachouri@mca.gov.in. It will be appreciated if the name, address and contact number of the sender is also indicated clearly at the time of sending the suggestions/comments.

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PART - I

SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS OF THE EXPERT GROUP

CHAPTER-1:

CURRENT ECONOMIC SCENARIO

1. The above paragraphs have highlighted the current economic scenario and in that context the relevance and significance of cost information systems in companies and the cost audit mechanism to ensure that cost information systems are existing in the form desired so that cost related competitiveness of industries and the Indian economy is ensured.

CHAPTER-6:

CORPORATE STRUCTURE & COMPETITIVENESS OF INDIA INC.

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

   <u>Base Level</u> : Plethora of legacy practices of cost accounting/ management

   <u>Level II</u> : A National standard level of cost accounting discipline

   <u>Level III</u> : A self driven level of world class cost/management accounting

3. The Expert Group is of the view that migrating through above levels should be at great speed and especially Level II will require statutory drive through standard cost accounting practices for the entire corporate sector. Once an enterprise crosses Level II into Level III it will be in a mode of voluntary adoption of all cost and

management accounting guidelines to be issued by professional bodies either for internal financial management or for external reporting. A typical case is in Japan where corporates disclose voluntarily the environment costs to shareholders under the guidelines issued by Ministry.

RECOMMENDATION NO. 1: As the Expert Group has subsequently recommended, phased introduction of cost accounting and cost audit framework in all companies to achieve the highest levels of competitiveness, the Expert Group also recommends that only such companies maturing into higher levels of adoption of best cost and management accounting practices/guidelines may be permitted voluntary compliance.

CHAPTER-8:

GLOBAL COST ACCOUNTING PRACTICES

4. In India, various apex level industry associations have been playing key role in infusing a sense of cost consciousness among the member companies so as to enhance their competitiveness in the global market. For example, the Confederation of the Indian Industry (CII), which is a pioneer in several aspects as an association of business, initiated a movement of Total Cost Management (TCM). This movement has been in vogue for almost 6 to 7 years and has been attempting consistently drive home the message of a structured approach to the needs of cost management in a competitive environment. Since we as a nation are building our manufacturing and service competitiveness in the global arena, it is important that the CMA skills are honed to perfection and we do not mistakenly focus on measuring the end financial short term results through accounting standards as the only way of performing cost and management accounting.
5. While the business started recognizing the need for a structured movement on quality management, customer relations, etc., on the cost front, it has confined the efforts to waste elimination and lean manufacturing strategies without considering cost management as a holistic process. Industry federations such as Confederation of Indian Industry commenced movements such as Total Cost Management which is yet to gain critical mass such as TQM or TPM. Just like in Japan adherence to a minimum cost accounting plan is considered as a part of the social discipline and corporates adhere to the same without demur a base line plan for good cost accounting practices is yet to be accepted in India. When it comes to cost accounting the business is yet to come to terms with a base

line adherence legally which one finds in countries like France, Japan, and Korea. For that matter in countries which are self disciplined in this aspect like Canada or UK consider the pronouncements of the CMA bodies in those countries (which do not have a legal status like ICWAI) as best practice. Besides this context, till a matured behaviour of the stakeholder emerges as India continues with the reforms process cost accounting discipline needs to be considered as an enabler of healthy competition and insurance against predatory behaviour. To top all the developments, there needs to be a check on the presence of a good cost accounting mechanism as a part of the risk management environment for ensuring good governance. The underlying spirit being, a business enterprise without a sound decision making including proper cost information is prone to more business risk.

6. From the aforesaid cross-country cost & management accounting practices, the Expert Group observed that these largely depend upon the maturity level of each economy in terms of its competitiveness, liberalisation & globalization, business pattern/models, average size/scale of an enterprise, risk-management models, market & information network, level of corporate/enterprise governance, strategic strengths & weaknesses, cost-leadership movement, sustainable cost reduction practices, extent of applied research, benchmarking, etc. Three maturity levels are recognized regarding the Regulation System in an economy:

7. **LEVEL-I**: This is lowest level in the maturity scale of regulation. It is characterized by lack of self motivation to discipline themselves; lack of appreciation for regulation and no perceived benefits of regulation by the players in the economy. This is a level where the Government has to perform role of regulation completely by itself. It makes detailed rules, procedures etc.; it monitors them whether they are properly followed; and punish those who are not abiding by these rules. This provides practically no flexibility to the players for necessary growth with the change in time and conditions; enforcement of the rules is usually through by force; and it leads to sometime unnecessary interference from the side of the Government.

8. **LEVEL-II**: This is a higher level of maturity where the players in the economy have become more matured; they start appreciating role of discipline in the economy; started coming out voluntarily with models of self discipline; Government role reduced to provide necessary direction and guidance so as to achieve the desired objectives of the economy. At this level, usually Government directly do not monitor the functioning of the companies to ensure whether the players are following necessary guidelines or not;

rather some independent institution or regulator or some agency has been given the responsibility of monitoring and ensuring the necessary discipline among the players of the economy.

9. **LEVEL-III**: This is the highest level of maturity among the players of the economy. At this level, every player is well conscious about his/her responsibilities; develops systems to ensure that necessary self-disciple mechanism exists so as to achieve the objectives of the whole economy and as well as those of stakeholders. At this stage, the Government role is practically non-existent in the regulation mechanism; market forces more dominant in disciplining the market.

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

11. The transitory phase through which economies like India are passing, having moved from being under-developed to developing and now to a fast developing and finally gradually heading towards the developed stage still require suitable regulatory mechanism. Thus, besides routine financial information and other disclosures, companies should be subjected to a cost-effective cost & management information system, enabling the Government and regulatory authorities to play their intended role in enhancing the competitiveness of Indian industry and ensuring a fair-play for all stakeholders.

CHAPTER-9:

INTERNATIONAL FEDERATION OF ACCOUNTANTS (IFAC)

12. Important features of the aforesaid exposure draft that are found relevant to the present exercise of the Expert Group are:

    - Cost accounting that includes the accumulating and assigning of costs to the organization’s various activities enables the organization’s cost structure to be understood, explained and improved.
    - Costing is an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It

informs how profits and value are created, and how efficiently and effectively operational processes transform input into output.

- Costing includes product, process, and resource-related information covering the organization and its value chain. Costing information can be used to provide feedback on past performance, and to motivate future performance.
- Cost accounting serves as a most useful tool in communicating not only what the costs are, but also how and why they are incurred.
- 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 improvement; and
  - guide product mix and investment decisions.
- Costing is not an exact science, but the selected costing approach should be rigorously applied.
- Costing methodologies applied in organizations, measures the consumption of economic resources and support the accountability of business performance. This is best achieved within a financial management system that
  - delivers both cost information and operational feedback for planning, budgeting, cost and financial accounting purposes, and for operational improvement;
  - helps to ensure the fulfilment of external reporting and other compliance requirements; and
  - helps to manage an organization.
- Larger and more complex organizations (in terms of employee numbers, product and service lines, geographical spread, and complexity of processes) usually aim for a single costing system to develop reliable costing information to support both performance and conformance (against legal and regulatory requirements) decisions at both operational and strategic levels.
- Organizations with a single costing system typically derive cost data from a common data source to support the needs of both external users (investors, regulators, and tax authorities) and internal managers and employees.

- 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.
- An integrated information system is not necessarily a single, closed information system for cost measurement, and performance improvement.
- Integrating databases and information systems can help to provide useful costing information more efficiently as well as reducing source data manipulation.
- A comprehensive enterprise information system typically (a) tracks daily expenses by account code, activity, and business process, and (b) measures performance information that supports feedback to operations, such as the cost of resource consumption, defects, throughput, and quality, in addition to cost information associated with products, customers, and activities.
- Small and/or less complex organizations necessarily need cost information to manage their business operations. Therefore, these organizations must maintain proper cost accounting records. However, since their requirements may involve costing systems with less formal procedures and methods, these are likely to develop as a natural consequence of needing costing information.
- An accounting system refers to the ledgers and the collection of financial information for financial reporting, supplemented by information needed for budgetary control. Costing systems draw on the same data, but require the additional ability to break particular ledger code outputs into smaller sums.
- While cost accounting is the process of accumulating, measuring, analyzing, interpreting, and reporting cost information to both internal and external users; costing methods are methods of assigning costs; and a costing model is the description of sources, drivers, classification, and organization of costs and the relationships between them and the relationship between costs and income.

13. Further, as per the IFAC document, the key principles underlying widely accepted good practice in costing that drive the organizational performance are:

    - The ability to account for, analyze, interpret, and present costs is necessary for an informed understanding of the drivers of profit and value, and is therefore an essential part of good financial management and decision-making.

- Cost information should be collected and analyzed systematically and consistently, whether in a routine information system, or for a specific application and/or purpose.
- Costing systems and methods should be designed and maintained to reflect an organization's chosen strategy and business model, taking account of its structure, culture and competitive environment.
- Cost information used to support strategic and operational decisions, performance management, or reporting should be appropriate for the specific purpose, context, and legal requirements.
- The professional judgment used to (a) determine costing methods, and (b) specifically select cost information to support decision-making, including any limitations on its applicability, should be transparent, rational, and understandable by the user.
- Definitions and sources of cost data, and the methods of calculation of costs, should be recorded and capable of review, risk analysis, and assurance.
- Cost information and costing assumptions should be periodically reviewed for their relevance, robustness, and susceptibility to change.
- The design, implementation, and continuous improvement of costing methods, data collection, and systems should reflect a balance between the required level of accuracy and cost.

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

15. This Exposure Draft further said that cost audits help to ascertain whether an organization's cost accounting records are so maintained as to give a true and fair view of the cost of production, processing, manufacturing, and mining of a product. Therefore, cost audits can be used to the benefit of management, consumers and shareholders by (a) helping to identify weaknesses in cost accounting systems, and (b) to help drive down costs by detecting

wastage and inefficiencies. Cost audits are also of assistance to governments in helping to formulate tariff and taxation policies.

16. Further, in a public sector context, using full cost information along with non-financial information on program outputs and outcomes can aid governments, managers, and other stakeholders to make decisions on service delivery. The full costing of public service programs (or the output of a responsibility centre) generally involves compiling the sum of direct and indirect costs that contribute to the program or output. This compilation also includes the full costs of intermediate activities, processes, projects, or programs that need to be measured to calculate the full costs of their outputs. This can enable better evaluation of the merits of a public service policy or program (although program outcomes may require separate measurement).

17. As per IFAC, activities that are referred to as Management Accounting can be:

    - Generation or creation of value through the effective use of resources (financial and otherwise) through the understanding of the drivers of stakeholder value (which may include shareholders, customers, employees, suppliers, communities and government) and organizational innovation.
    - The provision, analysis and interpretation to management for formulation of strategy, planning, decision making and control.
    - Performance measurement and communication to stakeholders, including the financial recording of transactions and subsequent reporting to stakeholders typically under national or internationally Generally Accepted Accounting Principles (GAAP).
    - Cost determination and financial control, through the use of cost accounting techniques, budgeting and forecasting.
    - The reduction of waste in resources used in business processes through the use of process analysis and cost management.
    - Risk management and business assurance.

18. The extent to which cost accounting is used within governments varies from country to country. In September 2000, the Public Sector Committee (PSC) of IFAC published a Study Paper on "*Perspectives on Cost Accounting for Governments, an International Public Sector Study*". This provided useful governmental perspectives on cost accounting and is aimed at improving public sector financial management and accountability. On the uses of Cost Accounting in Government, it said that in addition to its historical function of determining values in the

financial accounting process for inventories or other types of property, cost accounting has a number of primarily management functions, including budgeting; cost control and reduction; setting prices and fees; performance measurement; program evaluations; and a variety of economic choice decisions. When cost accounting is used in the commercial activities of governments, its applications in financial accounting and management functions need not be materially different than those in the private sector. A copy of the aforesaid study paper is enclosed as Annexure –XVI.

19. Based on the above observations, the Expert Group concluded that in the approach of IFAC there is a major focus shift from the corporate governance to the enterprise governance. Hence, to achieve the objectives of enterprise governance, the content and relevance of purely financial accounting data and information, as a means to evaluate performance, is poised for a sea change. This is clearly reflected in many documents published by IFAC. In this context, IFAC has started recognizing the need for adequate cost information and reporting framework to the governing body of enterprises for risk-management and decision making needed to enhance the stakeholders' value. IFAC has also very clearly highlighted the usage of such framework in the functioning of government and other public agencies.

CHAPTER-10:

ROLE OF REGULATORY BODIES

20. At present, the regulatory bodies have prescribed their own formats in which the companies are required to submit the necessary cost information. In the absence of accurate and reliable cost data at the end of the companies/utilities, the regulatory bodies cannot discharge their statutory responsibilities in, say, fixing the correct tariff and other charges. They take the certified cost data in the prescribed formats from the companies/service providers. Such data is generated from the companies costing systems and if they are not well designed and implemented, even the certified copies may not provide relevant and reliable data to the regulatory bodies on which they base their decisions. Hence, it is highly mandated and imperative to ensure that the companies are maintaining proper records of costing through well designed costing accounting system and get these records duly audited/certified from an independent cost expert.

CHAPTER-12:

MAINTENANCE OF COST ACCOUNTING RECORDS

21. The Expert Group noted that section 209(1) of the Companies Act, 1956 primarily relate to maintenance of books of account by the companies that includes cost records as well. This section does not insist on having separate books for maintaining particulars relating to costs referred to in clause (d) of sub-section (1) thereof. ICAI in their Guidance Note has also said that the cost records form part of the books of account of the company within the meaning of section 209. Therefore, the Group noted that the law does not distinguish between the books of account maintained by a company either for the purposes of financial statements or for the preparation and presentation of cost statements. While financial accounting/reporting is supported by the principle based accounting standards approved by NACAS and adopted as Companies (Accounting Standards) Rules, 2006, a differential treatment has been accorded to cost accounting by prescribing separate rules/formats causing an extra burden of additional records.

RECOMMENDATION NO. 2: Therefore, the Expert Group recommends that individual Cost Accounting Records Rules (CARR) prescribing product wise formats for maintenance of cost records are not required. As such, necessary cost data should logically emanate from the same set of primary books of account and other accounting data/records.

22. The Expert Group noted that in the Object & Reasons of the Bill seeking insertion of clause (d) under sub-section (1) of section 209 of the Companies Act, 1956, in the Report of the Joint Select Committee, and in the statements of the then Hon'ble Finance Minister made in reply to the debate in Rajya Sabha, it was stated that (a) maintenance of proper cost accounting records by the companies is essential which would make the efficiency audit possible; (b) all companies belonging to class of companies engaged in the production, processing, manufacturing or mining activities to include in their books of account particulars relating to the utilisation of materials, labour or other items of cost; and (c) every producing/manufacturing company to employ a cost accountant and to have a cost accountant's report in regard to the product(s) that it produces. The Group also noted that the term "class of companies" belongs to all such companies that are engaged in the production, or processing, or manufacturing or mining activities. However, "class of companies" has been interpreted to mean companies engaged in the manufacture of a particular product or those belonging to a specified industry. Accordingly Central Government has been prescribing separate

CARR for each industry or product by assigning it the meaning as "class of companies". In fact, the Companies Act, 1956 has nowhere defined the concept "class of companies" as those producing cement or textiles or cycles or steel or petroleum products, etc. Therefore, class of companies should have been taken in totality as those engaged in the production, processing, manufacturing or mining activities and not merely those engaged in the production of a single product or belonging to a single industry. Further, for the purpose of preparation & presentation of financial records, under section 211(2), there is a reference to the term "class of companies" that is primarily construed to mean companies for which a form of profit and loss account has been specified in or under the Act governing such class of company. For example, insurance companies are governed by the Insurance Act of 1938, banking companies by the Banking Regulation Act of 1949, electricity generation/distribution companies by the Electricity Act of 2003, etc. Therefore, the existing term "class of companies" under section 209(1)(d) also need to be understood in a similar manner as that given under section 211(2) but restricted to those engaged in the production, processing, manufacturing or mining activities.

RECOMMENDATION NO. 3: Therefore, the Group recommends that in order to enhance the competitiveness of the company, the term "class of companies" under the existing section 209(1)(d) of the Companies Act, 1956, should be considered at the company level rather than at the product level. This will facilitate focus shift to the enterprise governance. This would also remove the present anomaly of maintaining a separate set of cost records only for a particular "product" (as prescribed under the extant rules) of a multi-product company and not doing so for the rest of the products/activities.

23. The Group noted that with globalisation the entire world economy is integrating into one single, huge system where geographic boundaries are fading out and protecting umbrellas held by governments over the industry and national economy are gradually closing down. In this 'borderless' world one has to venture out not only for survival but also for life-supporting growth and prosperity. In this context, strategic cost management plays the most vital role. In the WTO regime, we need to build up appropriate cost database to detect or fight all anti-dumping cases. Similarly, cases relating to transfer pricing or arm's length price cannot be decided judiciously in the absence of reliable cost data. Further, proper allocation/apportionment of common costs to the enterprises

operating in SEZ areas would also require adoption of well laid down costing principles. Such a reliable, standardized and industry-wide database is possible only by way of statutory cost accounting and cost reporting. Further, in the present economic scenario, maintenance of cost records in a systematic manner is essential for all the companies. It is also considered necessary to provide requisite cost inputs to various regulators and government departments/bodies to protect the interest of consumers and investors and to protect the industry from unfair trade practices under WTO agreements. The Group also noted that in a survey conducted by the Expert Group, there has been a general consensus among all the respondents that all companies should maintain cost records as an integral part of books of account, but to be left free to follow and apply relevant method of cost management.

RECOMMENDATION NO. 4: In view of this, the Group recommends that all companies (excluding the exempted categories), should maintain cost accounting records in respect of utilisation of materials, labour or other items of cost, as an integral part of books of account. However, in order to promote uniformity and consistency in the preparation and presentation of cost statements under different statutes and under WTO, it is also recommended that such cost accounting records should adhere to the cost accounting standards issued by ICWAI that have integrated, harmonized and standardized the generally accepted cost accounting principles and practices. The above should be introduced in a phased manner as recommended in a later paragraph.

24. The Group noted that cost management is distinct from the cost accounting. In a customer-driven, market oriented, and competitive world, one cannot survive unless its costs and quality are competitive and there is comprehensive cost management for maximising value, keeping an eye to the market strategy. In the context of a sustainable competitive environment which a nation builds through individual firm's competitiveness, the result is enduring competitiveness of the nation in the entire globe. This competitive environment determines the form and intensity of each firm's cost and management practices being followed.

RECOMMENDATION NO. 5: Therefore, the Expert Group recommends that it should be the management's prerogative to choose appropriate cost management framework. The Group also

recommends that the Government, professional bodies and industry associations should play a pro-active role in promoting such competitiveness of India Inc. by undertaking sector-based competitiveness and benchmarking studies. The Group further recommends that ICWAI should undertake an exercise to suggest sector specific standard costs on priority basis.

25. The Group noted that all the existing 44 Cost Accounting Records Rules (CARRs) carry almost identical prescription and formats (except for some industry specific minor variations) for maintaining cost accounting records by the companies. The Group also noted that these rules are incomplete documents that lack clarity leading to presentation of non-uniform and inconsistent results; create conflict with the parent Statute; forces companies manufacturing multiple products to follow multiple rules; leaves no room for flexibility with the company management to follow one standard cost accounting system suited to its' size, scale & type of operations; results in companies incurring huge cost in preparing cost records as per the notified rules/formats; and the strait-jacketed formats are perceived to be an additional burden that are required to be "made and filled up" as an additional exercise on the part of the corporates. Moreover, all this is done more from the compliance point of view rather than maintaining the same as part of management information tool and as an aid to management for improving efficiency into the system. Further, there is a dichotomy in understanding of the existing provisions by the Government as well as of the entire professional fraternity. While on the one hand, separate industry/product specific Cost Accounting Record Rules including the formats/proformae have been prescribed, on the other, there are only one combined Cost Audit Report Rules incorporating one single set of common formats/proformae for presentation of same cost data/information and these common formats/proformae are applicable to all companies (covered by cost audit) across industries. The existing mechanism can be considered as the prescriptive methodology rather than a principle based approach. Therefore, the Working Group noted that separate rules and/or formats are not needed for each industry/product and viewed that there is need to shift from present practice of rule-based to principle-based accounting. Hence, the Working Group opined that all the existing Cost Accounting Record Rules (CARRs) may be repealed and in place, Government may prescribe maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards. However, since the requisite cost accounting standards covering all the elements of cost, as presently included in the CARRs, are not in-

place and it is likely to take considerable time, a state of vacuum should not be created for the interregnum period. Therefore, the Working Group is of the view that all the existing CARRs should be immediately replaced with a single combined CARR, covering all companies engaged in the production, processing, manufacturing or mining activities, incorporating simplified format/proformae for preparation and presentation of requisite cost data/information. The Expert Group has deliberated upon this issue in greater detail and concluded that in the present competitive scenario having rapid changes in all dimensions, different needs of the industry can be met only from principle based costing system that would result in its value addition, flexibility and innovations.

RECOMMENDATION NO. 6: **Based on the wide-spread opinion expressed by all categories of stakeholders to provide due flexibility to the companies to have a sound cost accounting framework, as also to reduce their compliance cost, the Expert Group recommends as under:**

a. **Maintenance of cost accounting records by the corporate sector should be shifted from the existing rule/format-based mechanism to a principle-based mechanism having universal application.**

b. **Maintenance of cost accounting records by the corporate sector should be based on generally accepted cost accounting principles that have to be integrated, harmonized and standardized in the Cost Accounting Standards (CAS) to be issued by ICWAI in consultation with all stakeholders and in harmony with the Indian GAAP and Accounting Standards. The Group has already made detailed recommendations in the relevant chapter on CAS.**

c. **As recommended by the Working Group, this may be done in a phased manner as under:**

Phase-I:

- **No change in the existing provisions under section 209(1)(d) of the Companies Act, 1956 required.**
- **In place of all the existing CARRs, single combined CARR should be notified.**
- **Scope of CARR should cover all companies (except the micro & small companies) engaged in the production, processing, manufacturing or mining activities.**

Phase-II:

- **No change in the existing provisions under section 209(1)(d) of the Companies Act, 1956 required.**
- **All the Cost Accounting Standards issued by ICWAI should be adopted under the Companies Act, 1956 based on the recommendations of either the existing NACAS or a similar body to be set-up.**
- **Single combined CARR as notified in Phase-I should be replaced with modified CARR containing adherence to the Cost Accounting Standards issued by ICWAI.**

Phase-III:

- **The existing provisions under section 209(1)(d) of the Companies Act, 1956 should be amended as under:**

  Section 209(1)(d): Every company shall keep at its registered office proper books of account with respect to utilization of material or labour or to other items of cost as may be prescribed by the Central Government.

  The Central Government may, by notification in the Official Gazette, exempt any company or class of companies from compliance with any of the requirements of section 209(1)(d), if in its opinion, it is necessary to grant the exemption in the public interest.

- **Scope of CARR as notified in Phase-II above should cover all companies.**

d. ICWAI should issue simplified format/proformae for preparation and presentation of requisite cost data/information for the benefit of industry & professional fraternity.

e. For certain regulated industries such as electricity, telecommunications, petroleum & natural gas, etc., ICWAI should issue industry-specific guidelines in consultation with the concerned regulatory body and industry association.

f. A sample of combined simplified CARR is enclosed.

26. The Group noted that even though the law clearly envisaged the fact that all companies belonging to class of companies engaged in the production, processing, manufacturing or mining activities should include in their books of account particulars relating to the utilisation of materials, labour or other items of cost and every producing/manufacturing company to employ a cost accountant and to have a cost accountant's report in regard to the product(s) that it produces, still as per the present rules notified under section 209(1)(d) of the Act, small scale industrial undertakings, as defined

in the Industries (Development and Regulation) Act, 1951 were granted exemption from the requirement of maintaining cost accounting records even if they belong to a class of companies for which CARRs are prescribed subject to the certain conditions i.e. *the aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year,* does *not exceed limit as specified for a small scale industrial undertaking* under *the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and the aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crore of rupees.* The Group also noted that as per IFAC statement, even though small and/or less complex organizations will need cost information to manage their business operations, their requirements, however, may involve costing systems with less formal procedures and methods and these are likely to develop as a natural consequence of needing costing information.

RECOMMENDATION NO. 7: In view of above, the Group recommends that the existing provision of exemption to small scale industrial undertakings, as defined in the Industries (Development and Regulation) Act, 1951 from the requirement of maintaining cost accounting records should be continued.

27. As regards the threshold limit for identifying such small scale industrial undertakings, the Group already noted that the limit for the value of machinery & plant that was earlier fixed as Rs.3 crore has been revised to Rs.5 crore as per the Micro, Small and Medium Enterprises Development Act, 2006. Therefore, this has to be revised accordingly. In respect of the second condition of annual turnover, the Group noted that the ICWAI Council has recommended retaining the existing limit of Rs.10 crore; CII said that all small and medium sized companies whose turnover is less than Rs.50 crore should be exempted from maintaining the cost accounting records; internal Policy Guidelines of Ministry of Corporate Affairs desired to enhance the limit to Rs.20 crore; and the Working Group-II has also recommended to enhance the limit for annual turnover from the existing level of Rs.10 crore to Rs.20 crore in the immediately preceding accounting year. The Expert Group deliberated on this issue in greater detail and decided to go along the limits suggested by the MCA and Working Group-II.

RECOMMENDATION NO. 8: Accordingly, the Expert Group recommends that all micro & small scale industrial undertakings, as defined in

the Micro, Small and Medium Enterprises Development Act, 2006 should continue to remain exempted from the requirement of maintaining cost accounting records even if they belong to class of companies engaged in the production, processing, manufacturing or mining activities, subject to the following conditions. Such companies should also remain outside the ambit of cost audit.

a. ***The aggregate value of the machinery and plant installed wherein, as on the last date of the immediate preceding accounting year,*** **does** ***not exceed limit as specified for a small scale industrial undertaking*** **under** ***the provisions of Micro, Small and Medium Enterprises Development Act, 2006;***

b. ***The aggregate value of the turnover made by the company from sale or supply of all its products during the immediate preceding accounting year does not exceed twenty crore of rupees;***

c. ***The company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;***

d. ***It is not a bank, financial institution or an insurance company;***

e. **It does not have borrowings (including public deposits) in excess of rupees five crore at any time during the immediately preceding accounting year; and**

f. **It is not a holding or subsidiary company of a company which is not a small sized company.**

28. The Group noted that medium size companies are not presently exempted from the application of CARRs. Such companies would necessarily require requisite cost data/information for internal purposes as well as for legal or statutory purposes. Hence, the Working Group is of the view that there appears no justification in granting them exemption from merely maintenance of cost records as they would draw much greater benefits from such mechanism and it would also help them to comply with any type of legal/statutory requirements. Therefore, medium size companies should maintain cost records based on generally accepted cost accounting principles and cost accounting standards, as may be notified under section 209(1)(d) of the Companies Act, 1956. However, with a view to avoid incidence of any additional cost of compliance, such class of companies should also be exempted from the provisions of cost audit. But such companies should only file a compliance report with the Central Government, on a proforma to be notified, from a cost accountant certifying requisite maintenance of cost records. The Working Group further recommended that the

threshold limits for exemption to medium size companies from the provisions of section 233B of the Companies Act, 1956 should be investment in plant & machinery exceeding Rs.5 crore but not exceeding Rs.10 crore (as defined in the statute) and annual turnover exceeding Rs.20 crore but not exceeding Rs.50 crore in the immediately preceding accounting year. While calculating annual turnover, any turnover from trading operations, consultancy services, other incomes, etc. in a manufacturing organisation will not be considered. But turnover from job work or loan license operations would stand included. Other conditions that would apply to a medium size company to avail exemption from cost audit shall be (a) the company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; (b) it is not a bank, financial institution or an insurance company; (c) it does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and (d) it is not a holding or subsidiary company of a company which is not a small and medium sized company.

RECOMMENDATION NO. 9: Taking into account the aforesaid, the Expert Group recommends as under:

I. All medium size companies should maintain cost accounting records based on generally accepted cost accounting principles and cost accounting standards, as may be notified under section 209 (1)(d) of the Companies Act, 1956.

II. With a view to avoid incidence of any additional cost of compliance, such class of companies should also be exempted from the provisions of cost audit under section 233B of the Act.

III. Such companies should only file a compliance report with the Central Government, on a proforma to be notified, from a cost accountant certifying requisite maintenance of cost accounting records, as notified under section 209 (1)(d) of the Act.

IV. Medium size companies should be classified based on investment in plant & machinery exceeding Rs.5 crore but not exceeding Rs.10 crore (as defined in the statute) and annual turnover exceeding Rs.20 crore but not exceeding Rs.50 crore in the immediately preceding accounting year. While calculating annual turnover, any turnover from trading operations, consultancy services, other incomes, etc. in a manufacturing organisation will not be considered. But

turnover from job work or loan license operations would stand included.

V. **Other conditions that would apply to a medium size company shall be as under:**

   a. ***The aggregate value of the machinery and plant installed wherein, as on the last date of the immediate preceding accounting year,* does *not exceed limit as specified for a medium size industrial undertaking* under *the provisions of Micro, Small and Medium Enterprises Development Act, 2006;***

   b. ***The aggregate value of the turnover made by the company from sale or supply of all its products during the immediate preceding accounting year does not exceed fifty crore of rupees;***

   c. ***The company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;***

   d. ***It is not a bank, financial institution or an insurance company;***

   e. ***It does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and***

   f. ***It is not a holding or subsidiary company of a company which is not a small and/or medium sized company.***

CHAPTER-13:

AUDIT OF COST ACCOUNTING RECORDS

29. The Expert Group deliberated, in greater detail, on the observations/suggestions/recommendations made by the Working Group-III, the global practice and the opinions expressed by various stakeholders/interest groups in the replies sent to the questionnaire and those expressed in various open-house consultative meetings and make the following observations/recommendations.

30. The Expert Group noted that owing to notification of industry/product wise separate Cost Accounting Records Rules under section 209(1)(d) of the Companies Act 1956 and thus issue of multiple cost audit orders under section 233B ibid for a single company producing multiple products has led to large number of anomalies/difficulties viz., (a) much greater complexities and difficulties in maintaining and reporting the requisite cost

data/information; (b) causes avoidable burden in complying with multiple rules; (c) companies cannot maintain & follow any single prudent cost accounting system as different formats/methods have been prescribed under different rules; (d) how to maintain or not maintain cost records for products not covered under section 209(1)(d) and/or section 233B of the Companies Act, 1956; (e) appointment of multiple cost auditors within the same company/unit; (f) companies required to submit multiple cost audit reports; (g) high cost of compliance for the companies; (h) it does not result in drawing full advantage either by the company or by the Government; and (i) monitoring at the Government (MCA) level becomes too cumbersome and time consuming. Therefore, the existing practice of notifying industry/product wise CARR and ordering product-wise cost audit orders only on selective companies, seeking unit-wise cost details and other data/information, does not support to any justification either from the user (i.e. the Government) point of view or from the provider's (i.e. the company) viewpoint. Such a situation should be avoided and rectified.

RECOMMENDATION NO. 10: In view of this, the Expert Group recommends that the existing practice of notifying industry/product wise CARR and ordering product-wise cost audit orders only on selective companies, seeking unit-wise cost details and other data/information, should be dispensed with.

31. With regard to the utility of cost audit reports, cost data/information, and the need to review the existing mechanism/framework, the Group noted the following observations made by the Working Group-III.

    - In terms of utility of cost audit report, besides the company management, these reports and the cost data is of immense use to the Regulators and various agencies of Government in areas like, subsidy determination; administered pricing; detection of cases of evasion of direct & indirect taxes; determination of goods for inclusion under free trade agreements; transfer pricing for related party transactions under the Income Tax Act; predatory pricing under Competition Commission; to check cases of unfair trade practices such as price-rigging, cartelization, over-charging, discriminatory pricing, profiteering, siphoning of funds, etc; valuation of goods under antidumping & other agreements under WTO; valuation of goods for captive consumption under the Excise Act; valuation of imports under the Customs Act; valuation of assets and also for IPR; etc. As in case of various advanced countries, cost data is very useful for defence contacts where large potential exists. Similarly, Government has been emphasizing for determination of cost-based user charges.

- Cost audit data could also be used by various other stakeholders like banks & financial institutions (to make performance analysis, inter-firm comparison and monitoring), lenders & creditors, shareholders, employees, consumers, etc. Similarly, such data can also be of immense use for undertaking economic analysis, competitiveness studies and bench-marking studies by various academic institutions, research bodies, management schools, etc. Cost related issues are also relevant in determination of fair price and in various Accounting Standards such as AS2, AS10, AS17, and AS18.
- With regard to cost audit, various industry associations are of the view that the cost audit methodology as structured originally under Section 233B and the existing Cost Audit Report Rules needs re-look. What needs to be done is to redefine the audit objectives without losing the legal backup and the mandatory force it gives for compliance. Instead of the attestation perspective, which was emphasized earlier for price control, the efficiency review aspect should be blown in full force to enable better corporate governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness. There is need to revisit the current methodologies of cost auditing and reporting frameworks. Present formats of Cost Audit Report need to be restructured.
- A view has also been expressed that in a liberalized but regulatory framework operating under global competition, there is need to align the revised structure of Cost Audit Report with the IFRS issued by the International Accounting Standards Board so as to achieve complete harmony in the reporting framework.
- As far as Ministry of Corporate Affairs is concerned, the existing mechanism of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism built under MCA-21 has ensured complete confidentiality of cost details of the company. However, as the information is shared by MCA with other government agencies like Competition Commission, Anti Dumping Authority, Sectoral Regulators, etc., there is no mechanism to ensure complete confidentiality of sensitive cost data/information by these Government agencies. Therefore,

companies should not be asked to provide in the cost audit report any information which may adversely affect their cost competitiveness.

- In large number of companies, especially the medium size ones, the present cost accounting and cost audit mechanism is providing vital inputs to the company management for decision making. Various Government departments/agencies and the regulators make use of cost audit data/information to draw important policies/programmes which in-turn give benefits to the companies themselves and also to the economy at large. In addition, cost auditors generally make very valuable observations and suggestions for improvement of the company's operations. Therefore, there is need to continue the cost audit mechanism. However, to save costs, to ensure complete confidentiality of company's sensitive cost data and to avoid any possible misuse, present structure of cost audit report need to be simplified.

32. The Expert Group also noted that in a country-wide survey conducted, it was found that different stakeholders/interest groups are in total support of continuation of the existing mechanism of cost audit, but with simplification of the structure/formats as contained in the existing Cost Audit Report Rules, 2001. Majority companies, both public and private, and industry associations supported this view.

33. Further, such practices of cost accounting, audit & assurance do prevail in many developed/developing countries, across the globe, in varying degrees, content and structure. Large numbers of external interest groups for cost data/information exist in these economies. The fundamental driving principle would be the maturity and corporate discipline; in matured context they are voluntary but in an evolutionary phase they had always been mandatory.

34. On the issue of audit, assurance & good governance, the International Federation of Accountants (IFAC), in its various documents, has observed that (a) creation and optimization of stakeholder value should be the objective of governance; (b) the conformance and performance dimensions of governance are both important to optimize shareholder value; (c) cost accounting that includes the accumulating and assigning of costs to the organization's various activities enables the organization's cost structure to be understood, explained and improved; and (d) costing is an important tool in assessing organizational performance in terms of shareholder and stakeholder value. IFAC further said that costing methodologies applied in organizations,

measures the consumption of economic resources and support the accountability of business performance. This is best achieved within a financial management system that helps to ensure the fulfilment of external reporting and other compliance requirements. As per IFAC, larger and more complex organizations usually develop reliable costing information to support both performance and conformance (against legal and regulatory requirements) decisions at both operational and strategic levels. Cost audits help to ascertain whether an organization's cost accounting records are so maintained as to give a true and fair view of the cost of production, processing, manufacturing, and mining of a product. Therefore, cost audits can be used to the benefit of management, consumers and shareholders by (a) helping to identify weaknesses in cost accounting systems, and (b) to help drive down costs by detecting wastage and inefficiencies. Cost audits are also of assistance to governments in helping to formulate tariff and taxation policies.

35. From the aforesaid cross-country cost & management accounting practices and the statements of IFAC, the Expert Group observed that these largely depend upon the maturity level of each economy in terms of its competitiveness, liberalisation & globalization, business pattern/models, average size/scale of an enterprise, risk-management models, market & information network, level of corporate/enterprise governance, strategic strengths & weaknesses, cost-leadership movement, sustainable cost reduction practices, extent of applied research, benchmarking, etc. Three maturity levels are recognized regarding the Regulation System in an economy. The Group strongly believes that the Indian economy is at a maturity level II. Therefore, instead of strict rules and laws, Indian industry needs directions, principles and guidance from the Government. At this maturity level, the Group feels that the industry should be given more freedom and flexibility and ultimately, over a period of time, the industry will achieve sufficient maturity level where driving force will be self discipline rather than any law of the Government. Till Indian industry reaches at the highest level of maturity, there is a need for compliance & monitoring mechanism. The transitory phase through which economies like India are passing, having moved from being under-developed to developing and now to a fast developing and finally gradually heading towards the developed stage still require suitable regulatory mechanism. Thus, besides routine financial information and other disclosures, companies should be subjected to a cost-effective cost & management information system, enabling the Government and regulatory authorities to play their intended role in enhancing the competitiveness of Indian industry and ensuring a fair-play for all stakeholders.

<u>RECOMMENDATION NO. 11</u>: In view of above, the Expert Group strongly endorses the Working Group's recommendation that there is need to continue the cost audit mechanism. However, to save costs, to ensure complete confidentiality of company's sensitive cost data and to avoid any possible misuse, present structure of cost audit report need to be modified and the formats prescribed therein needs to be simplified.

36. The Group noted that in the existing framework, there is no mechanism to capture data/information with respect to all such companies that are covered by the provisions of section 209(1)(d) of the Companies Act, 1956 and the Rules notified there under. The Group further noted that in the absence of such data/information, Government finds it difficult to decide as to which companies should be covered under the cost audit under section 233B of the Act. Hence, the Group noted that selective coverage of companies for cost audit not only leads to adopting total ad hoc & arbitrary approach but also results in a sense of discrimination and heart burn among companies belonging to the same industry. This gets aggravated after knowing that many large companies and multinationals have been left out while other relatively smaller ones have been covered. The Group further noted that selective coverage within a particular industry does not give any major advantage even to the Government for carrying out anti-dumping studies, tariff related studies, pricing studies, anti-competitive studies, subsidy related studies, sectoral studies or economic analysis, etc. for the simple reason that fully representative data of the industry is not available. It was noted that to give authenticity to the data/information/records, it is an accepted fact that the books of account of any organisation cannot & should not remain unaudited.

37. In this regard, the Expert Group also noted the following statements of the then Hon'ble Finance Minister of India, Shri T.T. Krishnamachari, made in 1965 in reply to the Debate in Rajya Sabha on introduction of sections 209(1)(d) and 233B in the Companies Act, 1956 that very clearly supported the view that when we would have sufficient number of cost accountants in the country (presently there are nearly 45,000 cost accountants in India), every producing/manufacturing company shall be covered by the mechanism of cost accounting records and cost audit.

> *"while we have made it obligatory or rather semi-obligatory to employ Cost Accountant, it is our intention to ask certain industries to have a cost accountant's report."*

> "*when we can have sufficient number of Cost Accountants so as to make it obligatory for every company, every producing concern and every manufacturing concern, to have a cost accountant's* report."
>
> "*we are really making it possible for the institution of Cost Accountants to grow so as to enable the Government some time later to make every manufacturing company employ a Cost Accountant, and have a cost accountant's report in regard to the cost of product that it produces.*"

RECOMMENDATION NO. 12: Keeping the aforesaid in view, the Group recommends that,

(a) The existing practice of a company covered under section 209(1)(d) of the Companies Act, 1956 and not covered under section 233B ibid (except medium size companies that would be required to maintain cost accounting records but have been recommended for exemption from cost audit) should be discontinued;

(b) All companies should be asked to furnish information, either in Form 23AC (relating to e-filing of Balance Sheet) or in Form 23ACA (relating to e-filing of Profit & Loss Account), whether the company is covered under section 209(1)(d) of the Companies Act, 1956 relating to maintenance of cost accounting records;

(c) Cost audit orders under section 233B of the Companies Act, 1956 should be issued on all such companies that are not specifically exempted; and

(d) MCA-21 data should be used to identify such companies.

RECOMMENDATION NO. 13: The Group has already recommended that all micro, small and medium size companies, engaged in the production, processing, manufacturing or mining activities, having investment in plant & machinery up to Rs.10 crore and annual turnover up to Rs.50 crore in the immediately preceding accounting year, subject to certain conditions, should be exempted from the provisions of cost audit under section 233B of the Companies Act, 1956. In addition, the Group recommends that other special categories such as section-25 companies, companies limited by guarantee and companies/associations not for profit, except those where any part of surplus income is allowed for distribution among the shareholders, companies having their total operations outside India, etc. should also be exempted from the ambit of cost audit.

38. As regards existing structure/contents/formats of the cost audit report, as prescribed in the Cost Audit Report Rules, 2001 (amended in 2006), the Group noted that (a) as per existing rules, cost audit report is required to be furnished for each unit separately. Since published Annual Report is available only for the company as a whole, not for each unit/product separately, there is no mechanism to verify the correctness of data/information provided in the unit related cost audit report; (b) data given in Form-I does not reflect true and fair view so as to make any correct & meaningful assessment of the unit's performance and it takes enormous time & efforts to verify same either from the attached cost audit report or from the annual report of the company; (c) information relating to certain issues may not be relevant or is redundant or it results in duplication as it is already contained in the company's annual report; (d) it is extremely difficult for the unit/company to prepare so much of information as sought for in the annexure attached to the cost audit report; (e) sometimes it is not even possible to extract such minute details even in a sophisticated ERP system environment; (f) few para contain so much of complexities that despite ICWAI having already issued detailed guidelines on the subject, majority do not submit it correctly; (g) under few para the information sought is totally irrelevant that does not serve any useful purpose of the Government or any Government authority or the regulators; (h) it results in the reports becoming too long, running into even more than 2,000 pages (in few cases) that takes enormous time and effort of the company to prepare such voluminous data/information; (i) so much of detailed data/information run a very high risk of losing competitive advantage, if leaked; (j) it also encompasses huge cost to the company; (k) under the present e-filing mechanism, it becomes difficult to file such voluminous reports, as there is limit imposed on the size of files that can be attached to the e-form; and (l) on the user side (i.e. in Government), linking and downloading such huge files becomes extremely difficult; lest the problems that are being faced in analyzing vast amount of data/information.

39. Therefore, the Group agrees with the conclusion of Working Group that the structure of existing cost audit report requires complete modification. In this context, the Group also endorses the Working Group's observation that it is only the proforma cost sheet that contains highly useful information which needs to be continued; but it has to be standardized based on the generally accepted cost accounting principles and practices. Further, since Indian accounting framework would be soon converging with IFRS, the

entire framework of cost accounting and reporting will also have to be aligned with the relevant issues in IFRS.

40. The Expert Group also noted that (as reported on the MCA's website) the existing Schedule-VI of the Companies Act, 1956 is under revision, in consultation with the ICAI and NACAS. The Expert Group is of the view that many of these concepts as used for reporting the financial statements, equally apply to the reporting of cost statements. These are, readable, useful, transparent and user friendly form; minimum disclosure requirements which are considered essential; not to be burdened with too many disclosure requirements; remove requirements of disclosures no longer considered relevant in view of the changed socio-economic structure and level of development of the economy; remove disclosure requirements which are meant for statistical purposes only; have inherent flexibility for amendments and industry/sector specific improvements from time to time and to cater to industry/sector specific disclosure requirements; harmonize and synchronize the general disclosure requirements with those prescribed in the Accounting Standards by removing the existing inherent anomalies; and attain compatibility and convergence with the International Accounting Standards and practices.

41. The Expert Group further noted that all respondents, who participated in the country-wide survey, have unanimously supported the view that while there is strong need to continue with the cost audit mechanism, especially for large size companies, the existing formats need to be simplified. The respondents suggested a three tier system viz. (i) a short report giving assurance to the stakeholders that organization has satisfactory Cost Management practices, (ii) a more detailed report may be sent to Government, and (iii) a very exhaustive report could be given to the company.

RECOMMENDATION NO. 14: Keeping these issues in mind, the Group recommends as under:

(a) Existing concept of filing unit-wise and product-wise cost audit report, introduced in 2001, should be dispensed forthwith. Filing of minute cost details for each factory/unit, within a factory/unit for each product, and within a product for each type/variety/description separately and all complexities in reporting have to be avoided. The revised structure should do away with providing detailed cost statements of individual products since the same compromises with the confidentiality and competitive edge of individual companies;

(b) Existing Cost Audit Report Rules, 2001, as amended in 2006, containing very detailed and complex reporting formats should be replaced with the new Cost Audit Report Rules, 2008;

(c) Only abridged statement containing product group-wise cost statements along with cost auditor's report should be filed with the Government. All other cost details, statements, schedules, etc. should remain with the company; and

(d) Cost auditor should submit detailed unit-wise and product-wise cost statements, duly certified by him, to the company, which may be called for by any Government agency and/or regulator depending upon the need.

(e) A sample copy of modified Cost Audit Report Rules, containing modified Form-I & other formats is enclosed as Annexure-XVIII.

42. Having recommended submission of product group-wise cost statements (instead of unit-wise, within a unit for each product, and within a product for each type/variety/description separately), the Expert Group felt necessity to define the term “product group” that can be universally understood and used by all industries/companies and cost auditors, without any ambiguity. A product group can be defined as *“a group of homogenous and alike products, produced from same raw materials & by using similar or same production process, having similar physical/chemical characteristics & common unit of measurement, and having same or similar usage/application”*. It can be considered as an alternate to “product family”. However, it cannot be considered as an alternate to the term “business segment” or “geographical segment” or “reportable segment” as defined in the Accounting Standard 17 for the purposes of reporting segment-wise financial results. Further, to avoid any ambiguity, the Group feels that ICWAI should issue a Guidance Note on the subject within a period of three months, in consultation with national level industry associations. The Group also feels that, for the time being, the companies may be left free to correctly interpret the term “product group”, in consultation with the cost auditor, as best suited to their product range.

RECOMMENDATION NO. 15: Accordingly, the Groups recommends as under:

(a) Product Group means a group of homogenous and alike products, produced from same raw materials & by using similar or same production process, having similar physical/chemical characteristics & common unit of measurement, and having same or similar usage/application;

(b) Product Group can be considered as an alternate to "product family". However, it cannot be considered as an alternate to the term "business segment" or "geographical segment" or "reportable segment" as defined in the Accounting Standard 17 for the purposes of reporting segment-wise financial results;

(c) ICWAI should issue a Guidance Note on the subject within a period of three months, in consultation with national level industry associations; and

(d) For the time being, the companies may be left free to correctly interpret the term "product group", in consultation with the cost auditor, as best suited to their product range.

43. The Expert Group noted that the requirements of cost data/information by various regulators, user ministries/ departments, financial institutions & Banks and other government authorities differ depending upon their purpose. Presently, they seek such details from the cost audit reports filed with MCA. In addition, few regulators have also prescribed their own formats seeking requisite cost details from the concerned companies. The Group feels that meeting with the need & requirements of all such organisations from the same cost audit report would make it too complex and unwieldy and also all companies would be unnecessarily forced to give such data/information.

RECOMMENDATION NO. 16: Therefore, as opined by all stakeholders/ interest groups and recommended by Working Group-III, the Expert Group recommends that apart from using the data/information available in the (modified) cost audit reports e-filed with MCA, all Regulators, user Ministries/Departments, Financial Institutions/Banks and other Government Authorities may be left free to directly seek such additional cost details from the concerned companies, as may be required by them based on legal/quasi legal requirement as mandated under their respective statutes.

44. The Expert Group noted that, as per existing provision of CARO, the [statutory] auditor(s) of the company appointed under section 224 of the Act, are required to include a statement in their Audit Report whether requisite cost accounts and records, as prescribed by the Central Government, have been made and maintained. In this regard, the Working Group observed that (a) it is not correct to seek such a statement from the financial auditor(s) of the company who, as per the Chartered Accountants Act, 1949, are not practicing in the field of cost accountancy; (b) the auditor(s) in their statement further add *"We have not made any detailed examination of these records with respect to their accuracy and completeness"*, thus, such a certificate does not serve any meaningful purpose; (c) in many cases, the certificate provided by the auditor(s) is not correct and there is no mechanism in the Government to verify its correctness; (d) in the changed principle based mechanism, adherence to CAS can be ensured by members of ICWAI. Ministry of Corporate Affairs, in their internal Policy Guidelines framed in 2006, also said that the existing system of compliance by Statutory Auditors under CARO should be reviewed periodically.

45. Further, the Expert Group has recommended a modified framework of cost accounting and cost audit in the corporate sector. As per this, all micro and small sized companies are fully exempted from the provisions of cost accounting and cost audit. All medium sized companies would also be exempted from the purview of cost audit; however, they would maintain the necessary cost accounting records and submit a compliance report to the Government duly certified by a Cost Accountant. For large sized companies, detailed mechanism of cost audit has been recommended. Therefore, no such certificate under CARO would be required. In fact, it would be a duplicate exercise causing extra burden on the companies.

RECOMMENDATION NO. 17: In view of above, the Working Group recommended that the existing provision of a Statutory (Financial) Auditor's certificate under CARO certifying maintenance of cost records by the company should be discontinued. The Expert Group endorses this and recommends for immediate implementation.

46. On the issue of appointment of cost auditors, the Expert Group noted the Irani Committee's recommendation that *"Government approval for appointment of Cost Auditor for carrying out such Cost Audit was also not considered necessary"*. Further, in the survey done, there was no consensus among the respondents. Cutting

across the type of respondent, there is almost equal voting in favour of all the three modes of appointment. Among the companies and regulators, about 50% voted for appointment by the Board of Directors without any Central Government approval; and among the practicing cost accountants, 50% have demanded appointment by the shareholders. Among the important ones, SEBI, CCI, CERC, ICSI, Chief Adviser Cost, and ICWAI Council, all are in favour of appointment of cost auditors by the shareholders in AGM for the reasons that the shareholders are the real owners of a company and they should be given right to appoint cost auditors as cost audit would be useful to them in making performance analysis, inter-firm comparison, etc. Contrary to this, the CII has said that the Board of Directors of a company without seeking any prior approval from the Central Government (i.e. MCA) and the same be reported in the Directors' Report to the shareholders.

RECOMMENDATION NO. 18: The Expert Group has deliberated upon this issue and opines that transparency, accountability as well as independence of the cost auditor are very important determinants of good enterprise governance, and therefore, shareholders should be given the right to appoint cost auditors and have the cost auditor's report for better evaluation of the company's performance & risk management. However, until such time, it is decided to share any part of the cost audit report with the shareholders, the appointment of cost auditors by the shareholders is not practicable and hence the Expert Group suggests that this issue may be examined separately. However, to begin with, the shareholders must know that their company is covered by the cost audit mechanism. Therefore, the Expert Group endorses the recommendation of the Working Group that the cost auditors should be appointed by the Board of Directors of a company without seeking any prior approval from the Central Government (i.e. MCA) and reports the same to the shareholders in the Board of Directors' Report.

47. The Working Group-III, in its report, recommended that in order to ensure transparency, efficiency, and credibility of the systems followed by the company and also to ensure better compliance, companies should be encouraged to rotate cost auditors after every 3-5 years. In this regard, the Expert Group noted that such a provision for rotation of auditors neither exist in the Indian laws nor found in any other country. However, a voluntary & healthy practice of rotating the lead auditors does prevail in many large size multinational companies.

RECOMMENDATION NO. 19: Therefore, the Expert Group recommends that Indian companies should also follow this healthy practice of voluntarily rotating the cost auditors after every 3-5 years.

48. The Expert Group noted that as per provisions of section 233B of the Companies Act, 1956, only Cost Accountants within the meaning of the Cost & Works Accountants Act, 1959 can be appointed as cost auditors. However, in the proviso to sub-section (1) of section 233B, even Chartered Accountants possessing the prescribed qualifications may also be appointed to conduct the audit of the cost accounts of companies. The Group noted that this proviso was provided in 1965 when sufficient number of qualified cost accountants was not available in the country. By virtue of amendment of the Act in February 1975, the Rules framed under the Cost Audit (Qualification) Amendment Rules 1972 which had provided that a practicing Chartered Accountant also might be appointed as a cost auditor, if he possessed the qualifications prescribed by those Rules have ceased to have effect. The Group noted that the number of qualified cost accountants has touched nearly 45,000. Hence, continuation of this proviso in the present circumstances is not relevant.

RECOMMENDATION NO. 20: Therefore, the Group recommends that the existing proviso under sub-section (1) of section 233B of the Companies Act, 1956 may be deleted.

49. Regarding periodicity of cost audit, the Expert Group noted that the majority opinion (including by CII) is in favour of annual audit only. Few companies and regulators have suggested half-yearly or quarterly audit or limited review may be in case of listed companies. Few have suggested that initially this may be left to the discretion of company management. There is another suggestion to recommend quarterly internal audit of cost records. The Group further noted that on this issue, SEBI has said that in case of listed companies, it may be quarterly linked with the corporate governance and segmental reporting in line with requirement of quarterly reporting of financial results and in case of unlisted companies, it may be yearly. The ICWAI Council in their reply has said that the real assessment of the improvement in performance or otherwise can be judged only when there is a trend analysis over the quarterly reporting system is done. This will also be a fair disclosure of performance of different segments of the company

over the period and enable comparison of one segment against the other. While the annual review will only have a compliance focus, the quarterly limited review will have a performance management focus. The inefficiencies disclosed by such limited review may be more useful to the company for cost control and cost reduction. However, Cost Audit should be conducted annually irrespective of whether it is a listed company or not. A limited review of key parameters that appear in the cost audit report should be considered by the Audit Committee on a quarterly basis for listed companies.

RECOMMENDATION NO. 21: In view of this, the Expert Group recommends that as at present, periodicity of cost audit should remain on annual basis. In addition, the Group recommends quarterly internal audit of cost records. The Group further recommends that the possibility of introducing quarterly limited review of cost details, in case of listed companies, may be examined in consultation with SEBI.

50. On the issue of sharing any part of cost management trends/information/data with the shareholders, the Expert Group noted that there was no consensus among the different stakeholders/interest groups. On this issue, CII has said that the cost management trends may form part of the "Management Discussion & Analysis" part of the Annual Report as currently also done by many companies. The ICWAI Council has said that as part of good corporate governance practice, data should be shared with the shareholders. However the data once shared, becomes public information and cost data is sensitive in the competitive environment and therefore, it is proposed that key-performance indicators may be shared with the shareholders in the Annual Report. SEBI said that the possibility of circulation of cost auditor's report along with important efficiency parameters and also the suggestions made to the shareholders may be explored. Like this, varied suggestions were made, which were evaluated by the Working Group.

RECOMMENDATION NO. 22: After evaluating the pros & cons, the Working Group-III recommended that circulation of selected information to the shareholders of the company, containing cost trends, key performance indicators, risk assessment or key risk indicators, CSR details, trends or factors like external economic conditions and internal efficiency, etc., as part of the management analysis section of the annual report to meet with the overall

objectives of good corporate governance, should be left to the discretion of the management. ICWAI should work out a model format in consultation with SEBI. This would align with the findings of IFAC survey on external financial reporting. The Expert Group endorses this. The Expert Group also recommends that in line with the earlier issue of appointment of cost auditors in the AGM, this issue may also be re-examined separately.

51. As unanimously opined by all stakeholders/interest groups, as part of their replies to the questionnaire, the Expert Group strongly believes that the above mechanism would provide complete confidentiality of sensitive cost data of companies; provide fuller utility to all stakeholders; and considerably reduce the company's cost of compliance.

CHAPTER-14:

COST ACCOUNTING STANDARDS

52. In order to promote uniformity & consistency in the preparation and presentation of cost statements under different statutes & under WTO, there is an urgent need to integrate, harmonize and standardize the cost accounting principles and practices. Further, the Expert Group has recommended complete shift for maintenance of cost accounting records by the corporate sector from the existing rule/format based mechanism (that is backed by Cost Accounting Records Rules notified by the Government for each industry separately) to a principle based mechanism (that should be backed by the cost accounting standards and generally accepted cost accounting principles & practices).

RECOMMENDATION NO. 23: **Hence, the Group recommends issue of Cost Accounting Standards based on the generally accepted cost accounting principles & practices presently followed by the industries in India.**

The Group recommends that all the Cost Accounting Standards (CAS) issued / to be issued should be aligned with the following key objectives:

- **To provide a structured approach to measurement of costs in manufacturing, process or service industry;**
- **To integrate, harmonise and standardize cost accounting principles and practices;**

- **To provide guidance to the users to achieve uniformity and consistency in classification, measurement, assignment and allocation of costs to products and services;**
- **To arrive at the basis of computing the cost of product, activity or service where required by legal or regulatory bodies;**
- **To enable practicing member to make use of Cost Accounting Standards in the matter of attestation of General Purpose Cost statements; and**
- **To assist in clear and uniform understanding of all the related issues by various user organisations, government bodies, regulators, research agencies, academic institutions, etc.**

53. The Group noted that the revised framework of CAS already adopted by the Cost Accounting Standards Board (CASB) of ICWAI with the following structure viz., Introduction, Objective, Scope, Definition, Principles, Assignment, Presentation and Disclosures, is aimed to bring the CAS on a principle based approach and is in line with the current requirements of the users of the Cost Accounting Standards. This is also in line with the internationally accepted framework for issue of Accounting Standards.

RECOMMENDATION NO. 24: Accordingly, the Group recommends that all the existing Cost Accounting Standards may also be restructured as per this revised framework and re-issued.

54. The Group noted that the all the CAS already released so far has proved to be of great use to the industry and regulators. CAS-4 has already been approved and notified by the Central Board of Excise & Customs (CBEC) and has been very useful in settling long pending cases of valuation of captive consumption between the department and the assessees. Similarly, the Competition Commission of India (CCI) in their draft regulations on “determination of cost of production” has extensively referred to and drawn upon the CAS-1 to 4. The members in profession, industry, regulators and other users are also drawing reference to CAS 1-5, wherever there is a need for determination of cost of production, cost of equalised transportation costs etc., under different statutes.

RECOMMENDATION NO. 25: In view of this, the Group recommends that the revision of existing CAS as per the revised framework should be done in consultation with the concerned legal and/or

statutory authority in the government so that the adoptability of use of these revised standards by such organisations is not disturbed.

55. The Group expressed that the Cost Accounting Standards issued/to be issued by ICWAI would require proper understanding by all users to achieve uniformity and consistency in measurement, assignment and allocation of costs to products and services and also in the matter of preparation & presentation of cost statements. These would also be used & referred to by various regulatory authorities and statutes.

RECOMMENDATION NO. 26: Therefore, the Group recommends that within the revised framework of CAS, ICWAI should issue Application Guidance Note for each Cost Accounting Standard. The application guidance note should provide the explanatory notes and interpretations of various terminologies and methodologies referred to in the cost accounting standards with suitable illustrations and formats for presentation of cost statements.

56. The Group noted that the CASB has identified 39 areas for developing the Cost Accounting Standards, which include the 5 standards issued so far. Of these, 21 areas relate to components of cost and the balance 18 are on cost accounting methodologies. The Group also noted that the areas for which the Cost Accounting Standards have been identified are broadly in line with the Cost Accounting Records Rules (CARR) already framed by the Government and in vogue for different industries. The Group has already recommended repeal of all the existing CARR and in place, Government to prescribe maintenance of cost accounting records by the corporate sector based on the generally accepted cost accounting principles and cost accounting standards. This requires immediate need to have the desired number of cost accounting standards facilitating repeal of CARR.

RECOMMENDATION NO. 27: Therefore, the Group recommends that ICWAI should assign utmost priority for issue of all the CAS already identified.

57. Further, the Group noted that majority of these areas relate to operation of companies engaged in the production, processing, manufacturing or mining activities. The Group has already

recommended that all companies (except the exempted categories) should be asked to maintain cost accounting records and be also subjected to cost audit. This includes companies engaged in infrastructure activities or those rendering services, etc; of this the proposed Companies Bill, 2008 has already included infrastructure activities.

RECOMMENDATION NO. 28: Therefore, the Group recommends that CAS may also be issued for all those areas (excluding the common areas already included in the list of 39) that are of use by the infrastructure or service sector companies.

58. All the Accounting Standards are meant to promote uniformity & consistency in the preparation and presentation of account statements. Therefore, these are issued as well defined documents by integrating, harmonizing and standardizing the generally accepted accounting principles and practices followed by different business entities. In view of this, the internationally accepted practice is to issue any such standards after having detailed consultations with all the stakeholders and wider sections of society.

RECOMMENDATION NO. 29: In this regard, the Group recommends that Cost Accounting Standards Board and the Council of ICWAI should also follow the same process and issue the Cost Accounting Standards in consultation with all stakeholders viz. industry associations, companies, government organisations, regulatory authorities, user agencies, professional bodies, professional accountants in public practice, professional accountants in business, etc.

59. The Group expresses that all business organisations in a country should be subjected to harmonized principles of accounting. The Group further noted that both the financial accounting statements and cost accounting statements emanate from same set of books of account maintained by an organisation.

RECOMMENDATION NO. 30: Therefore, the Group recommends that there should be complete alignment, synergy & harmonization between the Cost Accounting Standards and Financial Accounting Standards.

RECOMMENDATION NO. 31: The Group further recommends that the Cost Accounting Standards Board of ICWAI, in consultation with the Accounting Standards Board of ICAI, should prepare a list of such items which need harmonization in two sets of standards i.e. Accounting Standards and Cost Accounting Standards and update the list periodically.

RECOMMENDATION NO. 32: On specific cost related issues which require different treatment based on cost accounting principles, the Group recommends that any divergence should be disclosed as reconciliation between the Costing Profit & Loss Statement and Financial Profit & Loss Statement.

60. The Group noted that this is the era of globalisation. While large number of multi-national foreign companies have made investments in India; similarly, many Indian companies have also made significant global presence. Cross-border trade & commerce is on the rise. In this regard, global integration of accounting information & statements has become an absolute necessity. Hence, all the Indian Accounting Standards will be soon converging with the International Financial Reporting Standards (IFRS).

RECOMMENDATION NO. 33: Therefore, the Group recommends that all the Cost Accounting Standards will also have to be reviewed and aligned with the relevant issues in IFRS.

61. The Group further noted that many countries have already issued cost accounting standards for application by the business organisations, either in the matter of dealing with the state or for attaining a competitive edge over their counterparts in the world.

RECOMMENDATION NO. 34: The Group recommends that without sacrificing the basic objectives, the CAS should incorporate the best practices enshrined in the Cost Accounting Standards issued by different countries.

RECOMMENDATION NO. 35: The Group further recommends that CAS should also follow, wherever applicable, the principles enshrined in the current International Good Practice Guidance and the Management Accounting Guidelines issued earlier by International Federation of Accountants (IFAC).

62. The Expert Group has recommended that all companies (except the exempted ones) should be asked to comply with these cost accounting standards. For exempted companies, compliance of CAS may be optional. Any deviations to CAS should be disclosed in the cost accounting policies. To ensure this, all the Cost Accounting Standards issued/to be issued by ICWAI have to be accorded statutory recognition under relevant provisions of the Companies Act, 1956. The Group noted that US Federal Government has constituted an independent legislative body viz. Cost Accounting Standards Board. In few other countries, CASs are issued by their Ministry of Finance or Ministry of Commerce. The Group further noted that in India, National Advisory Committee on Accounting Standards (NACAS) has been constituted by the Government under section 210A of the Companies Act, 1956 advising the Central Government on the formulation and laying down of accounting policies and standards for adoption by companies or class of companies under the Act. This body has adequate representation from all the three professional institutes viz. ICAI, ICWAI and ICSI.

RECOMMENDATION NO. 36: Therefore, the Group recommends that either the existing mandate of NACAS may be modified or a similar body be set up advising the Central Government on the formulation and laying down of cost accounting policies and standards for adoption by companies or class of companies under the Act. The Group further recommends that till such time, the cost accounting standards issued by ICWAI may be recognised as that prescribed by the Central Government.

CHAPTER-15:

CONFIDENTIALITY OF COST DATA & COST OF COMPLIANCE

63. On the twin issues of *“confidentiality of company cost data”* and *“cost of compliance”*, Expert Group has noted the following key observation made by the Working Group-IV:

> *“The Expert Group in its initial proposal has suggested many radical changes in the existing mechanism. These measures, if finally recommended & implemented, would go a long way in meeting with the concerns of the companies/industry associations on confidentiality of cost data and considerably reduce the cost of compliance.”*

64. Keeping in view (a) the concerns expressed in the past by various companies and industry associations on these twin issues; (b) the observations/suggestions/recommendations made by the Working Group-IV; and (c) the opinions expressed by various stakeholders

& interest groups in the replies sent to the questionnaire and those expressed in various open-house consultative meetings; the Expert Group has deliberated on these issues in greater detail. The observations/recommendations of the Expert Group are as under.

65. As regards confidentiality of company cost data, even though a section of respondents said that the Government should not give any importance to the urge for confidentiality countering the stand of transparency and disclosure, still the Group noted that (a) the existing mechanism, introduced by the Ministry of Corporate Affairs (MCA) since late 2006, of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism built under MCA-21 has already ensured complete confidentiality of cost details of the company; and (b) the Group has recommended that only abridged statement containing product group-wise cost statements along with cost auditor's report should be filed with the Government; all other cost details, statements, schedules, etc. should remain with the company; and the revised structure should do away with providing detailed cost statements of individual products since the same compromises with the confidentiality and competitive edge of individual companies.

RECOMMENDATION NO. 37: **In view of this, the Group recommends that after implementation of various recommendations made by this Group for revised mechanism/framework of cost audit & reporting in the corporate sector, no further steps are required to ensure complete confidentiality of company cost data.**

66. On the issue of cost of compliance, the Group noted that the cost to a company arises at two stages, viz. (i) at the time of maintenance of cost accounting records; and (ii) at the time of audit of these records. On these issues, Expert Group noted the following observations made by the Working Group-IV:

> *"In the present framework of notifying Cost Accounting Record Rules (CARRs) for each industry/product separately together with various forms prescribed therein, considerable time and resources have to be spent in preparing the cost statements in the prescribed formats. Further, since there are separate Rules for each industry/product, companies engaged in the manufacture of multiple products have to comply with multiple rules. Hence, besides incurring huge cost in preparing cost records as per the notified rules/formats, it leaves no room for flexibility with the company irrespective of its size, scale or type of operations."*

> *"The present Cost Audit Report Rules & the formats contained therein seek considerable details in respect of all areas of activities/operations of the company/unit. Therefore, this entails a huge cost for companies in terms of time and money. Thus, these rules/formats need simplification. Filing of minute cost details and complexities in reporting have to be avoided. This would also avoid any possible misuse that may lead to decline in the competitive edge of companies, as observed by the Joint Select Committee which gave final shape to Section 233B of Companies Act, 1956."*
>
> *"The cost of compliance has principally three components viz. the cost auditor's fee; cost of collecting, collating and presenting the desired cost data/information in prescribed formats; and cost of time & effort spent by the company. While the first component i.e. the cost auditor's fee is generally not very high, but the other two elements entail huge direct & indirect cost."*

67. The Expert Group further noted that following views expressed by various interest groups/stakeholders in reply to the questionnaire:

    - Modified mechanism of moving away from rule/format based to principle based maintenance of cost data/records will provide due flexibility to the companies and reduce compliance cost.
    - Compliance is more important than the cost.
    - Since cost data is very much needed for internal purposes also, cost of compliance per se is not relevant.
    - More than the compliance cost, it is the flexibility which would benefit the companies.
    - Prescription based methods involve more costs, and hence the principle based accounting mechanism is favoured as the resultant benefits in terms of due flexibility and reduced compliance cost are possible only under the proposed principle based accounting.
    - There is a need to continue the cost audit mechanism. However, to save costs and to ensure complete confidentiality of company's sensitive cost data, present structure of cost audit report need to be simplified.
    - The modified mechanism of cost audit & reporting would provide complete confidentiality and fuller utility of sensitive cost data and would considerably reduce the cost of compliance.

RECOMMENDATION NO. 38: Keeping in view the aforesaid observations of WG-IV and the opinions expressed by various stakeholders

(including companies and industry associations), the Expert Group opines that after implementation of various recommendations made by the Expert Group for revised mechanism/framework of cost accounting records, cost audit and reporting in the corporate sector, there would be substantial reduction in the cost of compliance to the companies.

CHAPTER-16:

GOVERNMENT ORGANISATIONS AND SERVICE SECTORS

68. The Expert Group deliberated, in greater detail, on the observations/suggestions/recommendations made by the Working Group-VI, the global practice, the IFAC statements and the opinions expressed by various stakeholders/interest groups in the replies sent to the questionnaire and those expressed in various open-house consultative meetings and make the following observations/ recommendations.

69. The Expert Group noted that after liberalization, as per the report of the National Manufacturing Competitiveness Council of Government of India, the services sector has grown steadily and is accounting for 55% of the GDP compared to 27% of the industrial sector, out of which only 17% is by the manufacturing sector, which has relatively shown less growth. This has assumed greater importance after WTO has replaced the concept of GATT to GATIS encompassing vital service activities like Finance, Energy, Health, Education, etc. It is imperative that at this stage itself, a system of cost consciousness is created in these sectors so as to maintain efficiency, performance and propriety in their operations to be competitive with larger players entering these sectors from developed countries with greater resources and better efficiency of operations. These sectors, suffer seriously, from availability of authenticated and reliable, activity-wise, input-output data which are important to eliminate waste and improve efficiency. There is only aggregate financial data, which does not lend itself for analysis and dissection leading to control. The Group also noted that these observations concur with the findings of the Committee on Financial Restructuring and Reforms by Dr. Raghuram Rajan to the Ministry of Finance (2008). In view this, the Working Group-VI firmly believed and recommended maintenance of cost records, duly attested by an expert that will lead for a systematic appraisal and analysis of cost data by management as a means to improve the performance of these sectors. This will lead to application of Management Accounting Principles, apart from determination of cost of operations, by which the quality of the services will

improve, leading to higher contribution to the GDP, both by itself and by the manufacturing sector, to sustain competition.

70. The Expert Group further noted that given the enormous amount of resources required for the economic development and the fact that there is hard pressure on the availability of resources, it is very essential that the cost of resources used in all economics units are subjected to systematic accounting procedures and subjected to professional accreditation. The relationship between the input and output, in any economic activity, is traditionally upheld to develop Benchmarks for performance measurement and this input-output relationship has to be examined in all economic activities. This has to be done in a systematic manner so that the data is used for various policy decisions. Cost Accounting is one time-tested system of building input-output relationships. In view of the relevance of cost information and costing system, especially in non-company form of organizations and engaged in public services like Education, Healthcare, Water provision, Waste Management, etc., the objectives of a cost management system supported by cost audits by Qualified Cost Accountants would be (a) to provide independent, objective, accurate, and reliable capital and operating cost assessments usable for investment funding and project control; and (b) to analyze investment and development for the guidance of owners, financiers and contractors. These objectives would be an indicator to the concerned Ministries to take appropriate actions, including provision of statutory support to the decisions, to introduce proper Cost Management Systems and their Audits.

71. The Group noted that the goals of any system that needs to be operated in the context of the non-profit organizations in sectors like Health, Education, Local administration like Municipalities, etc. can be achieved only through mandatory regulations. Hence, it is felt that the rationality of instituting a systematic cost information mechanism in all these organization could be completed only with a statutory recognition. The cost data should be mandatorily subjected to cost audits by Cost Accountants so that objective feedback is received by the policy makers/stakeholders. The organizations should be required to maintain cost accounting system, as prescribed, duly supported by relevant statutes.

72. The Group noted the observations/recommendations made by the Committee on Subordinate Legislation (Fourteenth Lok Sabha) in its First Report submitted on 2nd December, 2004. The Committee said that service sectors such as Banking, Insurance, Health Services, Education, Hotel, etc. have admittedly “attained strategic importance to the economy and the public at large, particularly after opening up of the economy for private/foreign companies” and an authentic cost data base is of paramount importance to

various existing and new regulatory bodies, Competition Commission and Government Departments for fixation of user charges in respect of services provided by them and would go a long way in fulfilling their respective objectives.

73. The Group noted that the Working Group-VI has strongly recommended urgency to evolve sound Accounting and Cost Accounting systems in all segments of the economy to account for the economic activities and to measures costs involved therein; Cost Accounting Systems to be based on sound Cost Accounting Principles adjusted to the pattern of activities, and resources consumption in the segment being covered; the Ministry of Corporate Affairs to spearhead the process of inculcating Cost Accounting systems in all organizations where the need for cost information is strongly felt; the Institute of Cost and Works Accountants of India to be the agency for evolving suitable Cost Accounting systems and to undertake training of the human resources in organizations where the system is to be installed; and the introduction of Cost Accounting system should be made mandatory through a Regulatory authority, statutorily appointed, and the Costing system should be subject to periodical Cost Audit by the professional Cost Accountants.

74. The Group further noted that policy intervention, administered pricing, social pricing, funding plans, taxation laws, price control environment, transfer pricing, predatory pricing, tariff determination, WTO cases, regulatory framework, etc. have exerted a major influence in the evolution of cost accounting & assurance practices in various countries of the globe. Detailed requirements on cost accounting are put forward in judicial or even in a quasi judicial form. Education & research services, healthcare services, municipal services, social security services, public procurement, defence procurements, public supply contracts, public-private partnership contracts, toll roads/bridges, railways, postal authorities, telecommunication services, electricity generation & distribution, state asset administration, financial services, tourist services, environmental effects' costing, social pricing of goods, cross-subsidization impacts, pricing of agriculture inputs & outputs, etc. are major governmental and service sectors, across the globe, using cost accounting principles & practices.

75. The Group observed that apart from the practices adopted in various countries, the United Nations also propagated the concept of cost accounting and cost audit. In USA, the Treasury Department ordered for an annual cost-audit examination of the books and records of various companies dealing with the Government and other federal programmes/activities.

76. It was noted that as per IFAC, general principles of costing, design of costing systems and the cost information are important drivers of performance information and reporting in public and not-for-profit organizations. In a public sector context, using full cost information along with non-financial information on program outputs and outcomes can aid governments, managers, and other stakeholders to make decisions on service delivery. This can enable better evaluation of the merits of a public service policy or program. The extent to which cost accounting is used within governments has been published in a Study Paper on "*Perspectives on Cost Accounting for Governments, an International Public Sector Study*". As per this document, while the objectives of government are determined by the political process, cost accounting is one of a number of tools that may be used to achieve those objectives. It always provides important information to help improve the functions of government. The need for cost accounting is accentuated by today's pressures on governments to deal with shrinking budgets and meet demands for improved services. Governments must cut costs wisely and take cost-related steps to improve services. Even though cost accounting is today more of a management than an accounting exercise, IFAC believes that government financial officers and accountants have important leadership roles to play. They can provide much of the stimulus and knowledge needed to develop and implement cost accounting. They can provide "hands on" help to those in operating management who must participate in development and implementation if this management tool is to be used, and they can help to integrate the work of technical people, such as information systems experts. In addition, they can counsel senior management who must be involved in the resolution of basic issues concerning how cost accounting will be used and developed.

77. On the uses of Cost Accounting in Government, IFAC said that in addition to its historical function of determining values in the financial accounting process for inventories or other types of property, cost accounting has a number of primarily management functions, including budgeting; cost control and reduction; setting prices and fees; performance measurement; program evaluations; and a variety of economic choice decisions. When cost accounting is used in the commercial activities of governments, its applications in financial accounting and management functions need not be materially different than those in the private sector. Governments do not usually have profitability and return on investment objectives for their governmental activities. They lack these economic incentives to manage costs. Government managers must take the initiative to analyze cost behaviour and then, after careful consideration of all the consequences, take appropriate action.

Unless initiative is taken by government managers to analyze cost behaviour, inefficiencies may emerge, continue, and grow for a long time before the need for action becomes obvious.

78. The Expert Group noted that the cost information is used for preparing Budgets in New Zealand, United States, and Australia. Cost is also frequently the basis for transfer pricing between government units. For example, in the United States, unless otherwise specified by law, regulations require that prices charged to the public for government goods and services be based on market prices or the full costs incurred by the government. Canada has an initiative for cost recovery with respect to certain government goods and services provided to external users. Canada suggests that full cost is a good starting point for determining user fees. New Zealand has expanded the concept of pricing services to all activities of the government, whether sold, transferred between government units or distributed free to the general public. The United Kingdom encourages charging for services supplied between departments unless it is clear that the likely benefits would not justify the cost. Some governments, such as the United States, are showing increasing interest in performance measures. Other governments, such as the United Kingdom, have established systems for reporting this information. The cost of government programs, when combined with appropriate performance measurements and reported publicly, can help the public and legislators to evaluate the programs. Many countries use information on program costs as a basis for cost-benefit considerations. For example, Canada fosters the use of cost-benefit analysis by individual departments to improve the efficient allocation of resources among competing government programs. Making choices among alternative actions, such as whether to do a project internally or contract it out, requires cost comparisons between alternatives. Privatization decisions may involve comparing the incremental net cost or profit of continuing a government activity with the economic and other benefits of placing it in private hands. Cost studies of various types can help to decide whether to accept or reject a proposal for a government capital project, to continue or drop a government product or service, or to contract with a private sector vendor.

79. The Group noted that as per IFAC, the extent to which cost accounting is used within governments varies from country to country. Usage frequently depends upon the objectives of the various types of government organizations. State-owned enterprises organized for profit generally employ some form of cost accounting. Public utilities are an example of this type of organization. Non-profit revolving funds, whose objective is to

maintain capital through sales of goods and services, rather than through appropriations, frequently employ cost accounting. Internal inventory and service funds which provide goods and services to general fund organizations are examples of this type of organization. By comparison, relatively infrequent use of cost accounting systems is found in governmental organizations that provide goods and services to the general public without charge. Well-managed governments are turning to cost accounting as an essential component of the management of their activities. This move has been motivated by the need to deal with increasing debt levels and shrinking budgets and by related public criticism of government management. This increasing use of cost accounting is sometimes combined with the adoption of improvements in accrual accounting and the adoption of cost-based budgeting.

80. For example, in Taiwan, the development of cost accounting was linked to better mid-term and long-term budget planning. In Malaysia, cost accounting is an essential part of its “value for money” concept of Government management. The “value for money” concept has been in use for some time in the United Kingdom, but recent steps to adopt cost-based budgeting will likely improve its cost accounting systems. In Canada, fiscal pressures resulted in an emphasis on “stretching the tax dollar” and led to the issuance of guides on how to deliver services and to “make or buy” in a more economical or efficient manner. In New Zealand, fiscal exigencies led to the adoption of full accrual accounting as the basis for Government financial management and also to related initiatives for the development of cost accounting as a management tool. Despite the fact that the United States continues to budget largely on a cash basis, cost accounting is now beginning to be implemented across the government. This is the result of several pieces of legislation and related actions by the executive branch of government starting with the passage of the United States Chief Financial Officers (CFO) Act in 1990. In 1995, the United States published the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as recommended by the Federal Accounting Standards Advisory Board. This requires federal entities to accumulate full cost information. The reporting of full costs is required in the SFFAS No. 7, *Accounting for Revenue and Other Financial Sources*. The Federal Financial Management Improvement Act of 1996 added the force of law to these accounting standards and also to any systems requirements established by the U.S. Joint Financial Management Improvement Program (JFMIP). JFMIP issued cost accounting systems requirements for U.S. Government organizations in February 1997.

81. On the possible causes of increased use of cost accounting in the Government functioning, the Expert Group noted the IFAC's observations made in the year 2000, which said that adoption of accrual accounting as the basis for budgeting and management information, following the examples of New Zealand, the United Kingdom and Australia, will obviously trigger increased use of cost accounting and the development of supporting systems. Short of that, recognition of its need in "right sizing", eliminating inefficiencies and privatization will also spur increased use and related systems development. Managers of government programs, if they are informed of the managerial advantages, will likely provide impetus for increased use. Program managers can improve operational performance from three perspectives — quality/productivity, cycle time, and cost. If cost is brought into the managerial decision-making processes along with these other measures in a balanced fashion, then better decisions can be made. Because government decision-making is subject to a number of political pressures, how reported performance measures are viewed by users of those measures will affect the pace at which cost accounting is adopted. Relating costs and the outputs of government programs is not in principle more difficult than costing products or services in the private sector. This step alone has provided legislators and Government officials with decision-relevant information. It has also provided the general public with information about the efficiency of government. Whether to move quickly or progressively to implement cost accounting obviously depends on the particular circumstances of the government.

82. Further, the Expert Group noted the underwritten wider public opinion received as part of its country wide survey conducted through a well drafted questionnaire on the subject:

   - There was a general consensus among all the respondents that cost consciousness is important in all sectors of economy and even more important in non-competitive public services. These sectors, being consumers of public money, have to emerge stronger along with the growth of economy and therefore, their health is very important. It is an urgent need to improve productivity, build competence and reduce wastages & inefficiencies in utilisation of scarce national resources in these sectors in order to make available public services at reasonable cost. There is, thus, a clear need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors such as healthcare, education, banking, insurance, financial services, transportation, information technology, public utilities & essential services such as municipalities, electricity, water supply, city transport, etc.

and also to various Government projects/schemes, departmental undertakings, such as ordnance factories, railway locomotive/coaches manufacturing units, etc. All Government contracts and procurements should be covered forthwith. This would result in greater accountability of government expenditure. This would also improve transparency and uniformity across sectors.

- Similarly, everybody agreed that all Government/public agencies should determine user charges for utilities and services based on most efficient costs. These must be produced or generated in a cost effective manner avoiding wastage of scarce national resources. There should be some correlation between fees charged and cost incurred for which they should be brought under the ambit of cost accounting principles and cost audit. There is need to move towards user cost based pricing. Subsidies meant for the poor may be decided after being fully aware of the opportunity cost, social factors and the shadow price. Even where cross-subsidization is necessary, it should be transparent and made known to the public at large.

- On these issues, CII said that the cost accounting and cost audit framework must be extended to various government projects wherein the public spending is involved; all public service organisations should determine user charges based on most efficient cost; and the objectives of extending the cost accounting and cost audit framework to the services and other social sectors need to be debated first and then carefully decided. ICWAI Council said as the service sectors and other social sectors play a huge role in the national economy, these sectors should be mandatorily required to maintain structured cost accounting systems. This framework should also be extended to various State and Central Government projects/schemes and undertakings, local bodies, government corporations, departmental undertakings, etc. so as to infuse a sense of efficiency and effective spending of public money. All the public service organisations should determine user charges based on most efficient cost. Further, the infrastructure sector which includes roads, seaports, airports, railways, telecom, power projects, industrial parks, urban infrastructure, exploration, refining, mining, etc. is the backbone of the growth of any country. It is therefore felt that infrastructure sector needs to be included under the provisions of cost accounting and cost audit.

RECOMMENDATION NO. 39: Keeping the aforesaid observation in view, the Expert Group recommends as under:

(a) All the services and other social sectors such as healthcare, education, banking, insurance, financial services, transportation, information technology, public utilities & essential services such as municipalities, electricity, water supply, city transport, etc. should be brought under the mandatory mechanism of cost accounting and cost audit.

(b) The existing principles & practices of cost accounting and cost audit should also be extended to various Government projects/schemes, departmental undertakings, such as ordnance factories, railway locomotive/coaches manufacturing units, etc. and all the Government contracts and procurements should be covered forthwith.

(c) All the infrastructure sector activities which include roads, seaports, airports, railways, telecom, power projects, industrial parks, urban infrastructure, exploration, refining, mining, etc. are backbone of the growth of any country; hence needs to be included under the provisions of cost accounting and cost audit.

(d) All public service organisations should determine user charges based on most efficient costs. Subsidies meant for the poor may be decided after being fully aware of the opportunity cost, social factors and the shadow price. Even where cross-subsidization is necessary, it should be transparent and made known to the public at large.

(e) Most of these sectors, services, functions or activities presently either operate as extension of Government ministries/departments or are governed by various Central/State Government statutes and/or resolutions. These are operated in both the corporate form as well as non-corporate form of organisations. In all the non-corporate and/or not-for-profit organisations, the existing principles & practices of cost accounting and cost audit may be extended by the respective authorities by suitably amending their laws/statutes.

(f) Ministry of Corporate Affairs and the Chief Adviser Cost in the Ministry of Finance should take a lead role to spearhead the process of inculcating cost accounting systems in all these organizations/entities.

(g) The Institute of Cost and Works Accountants of India should play a supportive role in (a) evolving suitable cost accounting systems; (b) issue of relevant cost accounting standards &

guidance notes; and (c) in undertaking training of human resources in such organizations.

(h) The Controller General of Civil Accounts and the Accountant Generals, in consultation with the Comptroller & Auditor General of India, should take a lead role in (a) modifying the existing budgetary system of the Central/State Governments; (b) recasting the outcome budgets by correctly evaluating the costs & benefits of each program/activity; and (c) improving the public information system.

CHAPTER-17:

COMPANIES BILL, 2008

83. In sub-section (1), the word “infrastructure” has been added to the existing “class of companies” engaged in production, processing, manufacturing or mining activities. This term has no where been defined in the entire Bill. This has been defined by various statutes/authorities/commissions/committees in different ways. The Secretariat for Committee on Infrastructure in the Planning Commission has prepared a compilation, a copy of which is available in Annexure-XXIV. Based on the information contained in this compilation, there is need to give a clear definition of the term “infrastructure” in the proposed Bill.

84. In sub-section (2), the qualifications of the cost auditor have not been specified though sub-section (3) provides that a cost audit under this sub-clause shall be conducted by a cost accountant.

85. It appears from the construction of sub-section (3) that the intention is to provide for voluntary maintenance of cost records by any company, and in such case it has been made mandatory that the audit of such cost records be conducted by a cost accountant. However, the same intention is not reflected in the construction of sub-section (2) where the audit of cost records for any company is left to be ordered by the Central Government.

86. From the reading of sub-section (3), it is not clear as to whether this sub-section will operate only in case of such class of companies which are exempted by the Central Government from maintenance of cost accounting records or any company falling under the purview of sub-section (1) may also switch over to this voluntary option.

87. It is also not clear from a reading of sub-section (3) that once a system of maintenance of cost accounting records and cost audit has been adopted by a company, it remains in perpetuity as

would be the case in companies falling under the purview of sub-sections (1) and (2).

88. Sub-section (3) provides for audit of cost accounts in companies maintaining cost accounting records pursuant to a resolution passed by the company. This provision for cost audit may remain inoperative until a proviso is added to sub-section (1) allowing companies to maintain cost accounting records in pursuance to a resolution passed by them.

89. Further, in sub-section (3) it has been provided that the cost auditor shall be appointed by the Board on such remuneration as may be determined by the members in such manner as may be prescribed. From the reading of this provision, following issues have been observed:

(a) The mode of appointment of a cost auditor as specified under sub-section (3) has not been specified under sub-section (2).

(b) Since the shareholders are to decide conduct of cost audit through a resolution passed by them, therefore, the appointment of cost auditors by the Board runs contrary to the powers of the shareholders.

(c) It is not clear as to the term “members” mean members of the company or members of the Board. It is noted that “members” in the context of the Companies Act always means the shareholders of the company.

(d) While under sub-section (3) it has been provided that the manner of fixation of remuneration of the cost auditor shall be prescribed by the Central Government, no such provision exists for the cost auditor appointed under sub-section (2).

90. Sub-section (6) provides that the company shall furnish a copy of the cost audit report to the Central Government, prepared in pursuance of a direction under sub-section (2). No such provision exists for submission of such report to the Government in case of companies coming under the purview of sub-section (3). Further, no mechanism has been built in to know such companies complying with sub-section (3).

91. Even though the proposed Bill provides specifically for appointment of a firm of Chartered Accountants as auditor of a company as per the provisions of Section 124(2), no such provision has been made in case of a firm of Cost Accountants appointed as cost auditors.

92. Reference to section 126 in sub-section (4) need to be replaced with section 124.

93. The Expert Group noted that the provisions contained in the proposed Companies Bill, 2008 are not entirely in conformity with the various recommendations made in this Report. The modified structure/framework recommended by the Expert Group, if accepted, would entail restructuring of the proposed provisions. These are briefly enumerated in the ensuing paragraphs.

94. The Expert Group has recommended widening the scope of maintenance of cost accounting records and cost audit framework to all companies (except certain exempted categories) in a phased manner. Accordingly, it is not necessary for the Central Government to restrict its enabling powers under sub-section (1) by restricting the same to “class of companies” engaged in only production, processing, manufacturing, mining or infrastructure activities. Therefore, the Expert Group suggests that the provisions under sub-section (1) should not contain the words “engaged in production, processing, manufacturing, mining or infrastructure activities” and under the modified provisions of sub-section (1), the Central Government would be free to decide prescribing maintenance of cost accounting records in any “class of companies” as the situation prevailing in the economy.

95. Alternatively, as in the case of maintenance of financial records, the Central Government may seek an enabling power to exempt any company or class of companies from the maintenance of cost accounting records and widen the scope of sub-section (1) to all class of companies.

96. The Expert Group has recommended shifting maintenance of cost accounting records from a rule based mechanism to a principle based mechanism based on the cost accounting standards issued by ICWAI. The proposed provisions of the Bill need suitable modification to incorporate adherence to cost accounting standards by all companies maintaining cost accounting records, either under sub-section (1) or under sub-section (3).

97. The Expert Group has recommended that once a company falls within the purview of maintenance of cost accounting records, it should submit either a compliance report (in case of medium sized companies) or submit a cost audit report to the Central Government. Accordingly, the proposed provisions under sub-section (2) would require modifications by making it obligatory for all such companies covered under sub-section (1) to get their cost records audited by a cost accountant and submit the report to the Central Government as specified in sub-section (6). There would be a necessity to add a proviso to sub-section (2) to enable medium sized companies to file only a compliance report in such manner as may be prescribed.

98. In line with the recommendations made by the Expert Group, it is necessary to make a suitable provision in the Bill to disclose the particulars of cost auditors in the Board of Directors Report.

99. In view of the recommendations made above, the provisions of sub-section (3) would not be required.

100. Other modifications in the proposed provisions would be required in line with the analysis made above.

Shri Vinod Jain representing ICAI in the Expert Group has given his views on the report of the Expert Group. His views together with observations of the Expert Group thereon are enclosed herewith as Appendix-A.

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(Lalit Bhasin)

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(P. Murugesan)

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Appendix - A

Views of Shri Vinod Jain, Chairman, Committee on Management Accounting, ICAI and Member of the Expert Group set up by Government of India, on the draft report of the Expert Group, expressed during a meeting of the Expert Group held on 13.12.2008 at ICAI, New Delhi.

1. Shri Vinod Jain, while speaking on the issue of applicability of Cost Accounting Record Rules/Cost Accounting Report Rules (CARRs), said that such Rules should be applicable to a class of companies engaged in production, processing, manufacturing or mining activities only when there is involvement of public interest and the Regulators require details of utilisation of material, labour or other items of cost to monitor, regulate, administer the prices and for other purposes as a matter of statutory requirements.

2. There is no need to amend and apply these rules to all classes of companies in view of the fact that these rules were made applicable sometimes in 1965 to administer the prices in post independence India. However, since then sea-change can be noticed in the business environment of the country. There is over all fierce competition in the market and the principle of survival of fittest is now applicable. The companies have already become cost conscious and cost effective themselves and they have already adopted Cost Accounting principles and practices as well as modern technology and latest tools like ERP/SAP to survive in the competitive world. There should be a Self-Regulatory approach rather than imposition in the provision of applicability of CARRs. Hence, it is felt that there should not be any change as far as the case of applicability of CARRs is concerned, from the existing one.

3. The provisions of CARRs should be applicable to those organizations only where there is a question of subsidy, anti-dumping, administered prices, requirements of Regulatory bodies or in such industries where in view of public interest the Government consider it appropriate to prescribe compulsory maintenance of cost accounts.

4. With regard to maintenance of Cost accounting records, it is felt that, such records may be maintained as an integral part of financial records whereby, it should be possible to derive all kinds of relevant cost accounting data from integrated records only which should suffice the requirements of all statutory provisions. Usually, a separate set of cost accounting records may not be necessary. However, the management is free to design and adopt various kinds of forms/formats according to their own size, scale, type and the purpose etc., as an internal practice.

5. There should not be any legal mandate on the applicability of Cost Accounting Record/Report Rules (CARRs) i.e., on the maintenance and

the Cost Audit rather the Companies should be educated properly about the importance of costing system so that they voluntarily adopt the same for improving internal efficiency of the management. The burden of compliance audit should not jeopardize the day-to-day management function. The management should be left free to concentrate more on operational aspects rather than on compliance formalities.

6. With regard to confidentiality of cost data, we are of the opinion that the nature of cost data is very sensitive and the confidentiality of cost data is to be ensured. The cost auditor may submit a small report to the Government – MCA and a detailed report to the company Management. The cost auditor’s report may contain a report as well as findings for the information of management. There should be detailed guidelines/formats as to how to prepare the Cost auditor’s report in a structured form for the use by the management of the company. No part of Cost auditor’s report be disclosed to public at large. However, if the Board of Directors feels appropriate, they may disclose some indicators of Cost as part of their annual report.

7. The provisions of CARRs should be applied based on a multiple criteria on the basis of investment in Fixed Assets and the annual turnover. All those companies in whose cases the investment in fixed assets is upto the limits as prescribed for small and medium enterprises should be exempted from the purview of applicability of CARRs.

8. It is worth mentioning that ICAI would like to be closely associated with ICWAI in the matter of formulation of Cost Accounting Standards to make them fully convergent with IFRS and ensure smooth transition to new Costing system in tune with future accounting scenario in India. ICAI technical competence and resources are available for use by the Government and society. It is very important to use ICAI resources as financial accounting concept have undergone a comprehensive change and its impact on cost accounting and cost Audit will be significant.

9. It is also felt necessary that instead of applicability of CARRs, the companies should follow Cost Accounting Standards. Rather than applicability of Rules, there should be provision and applicability of principles of accounting as far as the case of maintenance of Cost Accounting records is concerned. Such Cost Accounting Standards should be formulated keeping in view:

   (a) GAAP – Indian as well as International;
   (b) IFRS;
   (c) International Accounting Standards;
   (d) Indian Accounting Standards; and
   (e) Best International Practices as adopted by PAIB.

10. There should not be any conflict/contradiction between the Cost Accounting and Financial Accounting Standards. Just like ICAI has issued Accounting Standards and Auditing Assurance Standards, there

is urgent need to formulate not only Cost Accounting Standards but at the same time, there should be formulation of Cost Auditing and Assurance Standards also. This will ensure both uniformity and standardization of principles and practices in the sphere of Cost Accounting and the Cost Audit.

11. The CASB of ICWAI along with ICAI should issue:
    - (a) Guidance Notes
    - (b) Monographs
    - (c) Research Reports/Study
    - (d) Statements
    - (e) Standards

12. The Guidance Notes issued by CASB of ICWAI in association with ICAI should be mandatory in nature.

13. At the initial stage the Cost Accounting Standards may be recommendatory in nature and later on they should be graduated to become mandatory.

14. There should be more emphasis on the maintenance of integrated accounting system to facilitate easy compilation of cost information and reduce cost of compliance.

15. The appointment of Cost auditor should be made by Board of Directors without seeking prior approval from the Central Government. The Cost Auditor should be rotated after 3 – 5 years. It is not necessary that the Cost Auditor should be appointed in Annual General Body meeting of shareholders. It is worth mentioning that the report of Cost Auditor will be used by the internal management in strategic decision making.

(Vinod Jain)

Observations of the Expert Group on the aforesaid views expressed by Shri Vinod Jain.

1. The Expert Group noted that majority of the views expressed by Shri Vinod Jain are in complete consonance with the Observations and Recommendations made by the Expert Group in this report.
2. All the recommendations made by the Expert Group are based on the recommendations made by various Working Groups, views expressed by all stakeholders as part of replies to the questionnaire and/or expressed in the country-wide open house meetings, and detailed deliberations held in various meetings of the Expert Group.
3. It is also important to note that eminent experts representing the Industry Associations; Regulatory Authorities; Academicians from leading B-School; leading Management Consultants; Presidents, Council Members and other Professionals from ICAI, ICWAI & ICSI; CFOs of top ranking Public & Private Sector Companies; and Senior Government officials were participated in the deliberations of the Expert Group / Working Groups and their views have been fully considered while making final recommendations in this report.
4. The Expert Group received response (more than 300) from various Regulatory Authorities and user departments/agencies (SEBI, CCI, NPPA, FICC, CERC, C&AG, PNGRB, CAC, Tariff Commission, Tea Board, DGAD, etc.); major private sector industrial conglomerates/ companies (Tata, Birla, Reliance, ITC, Mahindra, Bajaj, Jindal, Mallaya, Muthiah, TVS, Maruti Suzuki, Dabur, HUL, Ashok Leyland, Asian Paints, BPL Mobile, Cadila, Finolex, Ford, HML, Kirloskar, Nestle, NDPL, Subros, Sundaram, Swaraj, W.S. Industries, etc.); major industry associations (CII, FICCI, ASSOCHAM, IBA, PHDCCI, CCFI, etc.); Navratna/Miniratna PSUs (ONGC, IOC, BPCL, HPCL, GAIL, NTPC, NHPC, CIL, NLC, SAIL, RINL, BHEL, BEL, CEL, BEML, MTNL, NALCO, NMDC, NFL, NTC, PGCIL, GACL, etc.); IIMs, and ISB, Hyderabad; and leading management consultants. All of them have broadly agreed with the revised framework as proposed by the Expert Group.
5. The Expert Group noted that the views expressed by Shri Vinod Jain are in complete contradiction to the directions of the Government in constituting this Expert Group whereby the entire focus is on enhancing the competitiveness of Indian industry. The present mechanism, which Shri Jain has strongly favoured to be continued, is not suited to achieve this objective. The present economic upheavals across the globe also suggest strengthening of regulatory mechanism and shifting the focus from corporate governance to enterprise governance where the later includes both performance and conformance.
6. The modified framework of Cost Accounting Records and Cost Audit in the Corporate Sector as recommended by the Expert Group is based on the suggestions made by various stakeholders under the presently

changed economic and regulatory environment on key issues such as, the need to shift from Corporate Governance to Enterprise Governance; the need to focus on enhancing competitiveness of India Inc; the need to shift from the existing Rule based to Principle based mechanism; rules/formats to be replaced with the Cost Accounting Standards; Companies to be granted flexibility in maintaining the Cost Accounting Records and left free to choose appropriate Cost Management framework; enhance the existing exemption limits applicable to SSI units; reporting mechanism to be simplified and replaced with the compliance; maintain complete confidentiality of sensitive cost data by retaining the details with the Company; reducing the cost of compliance of the Companies; need to empower the Companies in appointment of Cost Auditors; and to suggest path for voluntary compliance of statutory framework for all companies reaching the highest level of Total Cost Management maturity.

7. The Expert Group has also recommended applicability of the modified framework not only for large size companies representing all sectors of economies, but has also suggested extending this framework to all the Government projects/schemes, departmental undertakings, contracts & procurements, infrastructure activities, public service organisations, etc. This would significantly improve the efficiency levels of all the bodies resulting in proper utilisation of National Resources. This would also enable the government to justifiably determine the fees, tariffs, duties, levies, charges, subsidies, etc.

8. The Expert Group does not agree with the views of Shri Jain either for continuation of the existing mechanism of CARRs or to their limited applicability. This suggestion is in contradiction to his own views expressed therein agreeing with the Expert Group for shifting from Rule based to Principle based mechanism and prescription of Cost Accounting Standards for compliance by all companies.

9. The Expert Group also does not agree with his views that on the one hand he is suggesting that in the present stage of maturity levels achieved by the Indian companies, companies should be fully exempted from the mechanism of Cost Audit, on the other hand, he has also given his views on the structure and distribution of Cost Audit Reports, mode of appointment of Cost Auditors, sharing of information with the shareholders, etc, which tantamount to self contradictions. The Expert Group does not support to such disjointed views of Shri Jain.

10. Shri Jain has expressed a view that the cost accounting standards should be framed by ICWAI in consultation with ICAI. The Expert Group opines that perhaps Shri Jain intends to say that the ICAI should be associated with this exercise. It may be noted here that the CASB of ICWAI has a member from the ICAI besides members drawn from various other professional bodies, academic institutions, industry

associations and regulatory authorities. Therefore, no such separate consultation with ICAI would be necessary as the composition of the Board takes care of such consultation process. The Expert Group in its recommendations has very clearly reiterated this view.

11. With regard to his views on synergy between the cost accounting standards and accounting standards, Indian GAAP, International Best Practices and IFRS, the Expert Group agrees with this view and has made a specific recommendation in this regard. In fact CASB of ICWAI has already approved a revised framework which requires CAS to be aligned with the aforesaid aspects.

12. Shri Vinod Jain's views that guidance Notes issued CASB of ICWAI should be mandatory in nature is impracticable. This goes against the very principle of providing Guidance Note to the stakeholders and not the Standards only which are mandatory in nature.

13. The Expert Group reiterates that all other views and suggestions made by Shri Vinod Jain have been fully incorporated in various observations & recommendations made in this report.

(B.B. Goyal)

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(K. Sridharan)

CHAPTER-1: CURRENT ECONOMIC SCENARIO

1.1 There is a global consensus that the financial crisis of 2008 is the worst since the Great Depression of the 1930s. The bursting of asset price bubbles, the collapse of many financial institutions, the freezing of credit, the contraction of effective demand, the economic slowdown that has spared no country or continent, recession across the developed world, the adverse effects on the livelihoods and food security of hundreds of millions of people in developing countries, deep forebodings of worse to come, and an underlying fear that the real economy will not turn round for some years have combined to depress people's spirits world-wide.

1.2 After several years of rapid and almost unhampered growth, the global economic landscape is changing. Rising food and energy prices, a major international financial crisis, and the related slowdown in the world's leading economies are confronting policymakers with new economic management challenges. Today's volatility underscores the importance of a competitiveness supporting economic environment that can help national economies to weather these types of shocks in order to ensure solid economic performance going into the future.

1.3 Towards this change, the Expert Group embarked upon a major challenge to find a place for cost linkages in the following three important determinants in the Indian & global milieu:

- Focus shift from Corporate Governance to Enterprise Governance;
- Competitiveness of Indian Industry and the Economy; and
- Regulatory Mechanism

1.4 Indian economy has been recording impressive growth rates since 1991. This can be partly attributed to the multi-sector structural reforms aimed at enhancing productivity, efficiency and international competitiveness of the economy. The reforms have been undertaken gradually with mutual consent and wider debate amongst the participants and in a sequential pattern that is reinforcing to the overall economy. The proportion of people living below the poverty line is declining. Due to openness, the size of the Indian economy has nearly trebled between 1990-91 and 2005-06. The Indian economy is thus now much more intertwined with the global economy.

1.5 The primary goal of the economic policies is to transform the country into an economic superpower through accelerated growth in manufacturing, IT, bio-technology and agro-industries. As a country already possessing nuclear weapons, India also seeks to expand the use of nuclear technology to generate more electricity, which its economy sorely needs. To qualify as a superpower, India would need to have a gross domestic product of at least US $3 trillion; the current figure is US $1 trillion. That means the annual economic-growth rate, currently around 7 percent, would need to be between 8 and 10 percent annually for the next decade, a formidable challenge. At the same time, India needs to pay greater attention to its agricultural sector, which accounts for two-third of the population. More rural co-operatives are sorely wanted by farmers, and also more agro-industries that would create jobs.

1.6 The fundamental objective of India's economic development needs to be poverty alleviation. The cohort of those living in extreme poverty is growing. That means some 400 million Indians earn less than the equivalent of US$2 a day, the largest such group in the world. The technology revolution and the development of energetic securities markets have not helped this cohort one bit. Manufacturing jobs are still concentrated in and around the major urban centres of Mumbai, Chennai, Delhi, Hyderabad, Bangalore, Kolkata, and Ahmedabad. That's partly because these cities offer educated workers who are willing to toil for relatively low wages. Even among the educated, there's an estimated 200 million population of unemployed. There is little coordination between federal and state governments on the question of poverty alleviation, let alone something as essential as a national job-creation scheme (Indian Economic Survey, 2002).

1.7 Although it's become fashionable to assert that economic growth in India will be mostly driven by an energetic private sector, the central issue today is that of good governance and how it will affect the country's economic prospects. Those prospects would appear to be promising, on the surface at least. With a population of 1.1 billion people, including a growing middle class of 400 million mostly urban residents, India has become the world's fourth biggest consumer market - after the United States, the European Union, and China.

Corporate Governance to Enterprise Governance

1.8 Nearly a year after the Enron revelations first surfaced, corporate governance dominates the political and business agenda. After a slew of scandals, most of them cantered in the US, politicians and regulators, executives and shareholders are all preaching the governance gospel. But has the pendulum swung too far? CEOs have to bear in mind the potential trade-off between polishing the corporate reputation and delivering growth—for all the headlines on corporate responsibility, are investors prepared consistently to sacrifice earnings for the sake of ethics?

1.9 Corporate governance is about how companies are directed and controlled. The balance sheet is an output of manifold structural and strategic decisions across the entire company, from stock options to risk management structures, from the composition of the board of directors to the decentralization of decision-making powers. As a result, the prime responsibility for good governance must lie within the company rather than outside it. Designing and implementing corporate governance structures are important, but instilling the right culture is essential. Senior managers need to set the agenda in this area, not least in ensuring that board members feel free to engage in open and meaningful debate. Not all board members need to be finance or risk experts; however, the primary task for the board is to understand and approve.

1.10 There is an inherent tension between innovation and conservatism, governance and performance. Asked to evaluate the impact of strict corporate governance policies on their business, 45% of the executives surveyed by the Economist Intelligence Unit for a report thought that M&A deals would be negatively affected because of the lengthening of due-diligence procedures, and 36% thought the ability to take swift and effective decisions would be compromised. State-of-the-art corporate governance can bring benefits to companies but also introduces impediments to growth. Transparency about a company’s governance policies is critical. As long as investors and shareholders are given clear and accessible information about these policies, the market can be allowed to do the rest, assigning an appropriate risk premium to companies that have too few independent directors or an overly aggressive compensation policy, or cutting the costs of capital for companies that adhere to conservative accounting policies. Too few companies are genuinely transparent, however, and this is an area where most organisations can and should do much more.

1.11 Today, if an organization has to survive and thrive in a commercial environment that is becoming increasingly global in its outlook, it has got to factor in the interests and concerns of every stakeholder in the business. And that includes not just the shareholder, but also the domestic and global customer, the vendor, the creditor, the lawmaker, the community in which the enterprise operates, and environmental groups. It is in this context that corporate governance has assumed greater significance, particularly with companies that are seeking to establish a global footprint.

1.12 The understanding of corporate governance has changed. Earlier one perceived corporate governance as a system that ensures that the manager (the CEO and his team) does not take decision for private gains and does not expropriate shareholders' wealth. Now it is understood to mean corporate governance in a broader sense. It is now perceived as a system that ensures optimal utilisation of resources for the benefit of shareholders while meeting societal expectations *(Asish K Bhattacharya, Business Standard-June 2, 2008)*.

1.13 Audits like Cost Audit and Corporate Social Responsibility (CSR) are elements of a corporate governance system. Some experts use the term enterprise governance to refer to this new concept of corporate governance. Enterprise governance substitutes corporate governance in the context of contemporary competitive scenario and increased consciousness to align the company to the global practices and standards. Corporate reporting system need to be strengthened through appropriate efficiency audit practices. In this connection it is significant to appreciate the need to position cost audit in the enterprise governance structure. Clause 49 of SEBI guidelines on Listing Agreements mentions about performance monitoring, it must be duly amended to focus and to conform to the cost audit structure so that companies report on the efficiency performance in more detail and to the benefit of the stakeholders in evaluating the company.

1.14 The IFAC report released in March 2008 observes *"Overall, respondents to the survey felt that the audit of financial reports has become better over the last five years; preparers and users were slightly less positive than other respondents"*. The survey reported that auditors now are more focused on the overall risk profile of the audited company rather than on a micro review of transactions and that they enjoy greater independence than before. However, many respondents are not happy with the auditor's communication with investors. They felt that excessive oversight and litigation has led to the *'compliance audit'* approach and the *'boiler plate'* audit report. Respondents expect that the financial auditor should be innovative and that they should apply their professional judgment. They look for more detailed report from the auditors.

1.15 A question that needs to be examined is that whether shareholders can ask for the detailed report that the financial auditor submits to the management/audit committee. And if they ask for the report, can the board of directors deny the same. Perhaps, it is high time that the government examines this issue, particularly in view of the fact that the financial auditor is appointed by shareholders and is accountable to them.

1.16 Cost audit, which has not received due attention has the potential to support enterprise governance. In India cost audit exists for over four decades. But, it has not been used to its full potential. Till date, only 44 industries/products have been covered by Cost

Accounting Record Rules, and cost audit orders have been issued in about 2,500 cases, covering about 2,000 companies.

1.17 In the era of price control and administered interventions, attested cost structure had a major role to play and hence the cost audit emphasized on this aspect. The cost audit had to play the key role of verifying and validating the cost figures in select industries before they were submitted to the government.

1.18 In the changed economic environment the emphasis should shift to efficiency review. Some argue that cost audit has become irrelevant in a market economy. They are not correct. It is true that government control is unwarranted in a market economy. But, in a market economy, regulators are required to frame right regulations in the interest of the industry as a whole and also in the interest of the consumers and other stakeholders.

1.19 Cost audit, supported by cost accounting standards, can provide relevant and credible cost and revenue data to regulators to support their decisions. Moreover, cost audit can provide relevant reports to the board of directors to strengthen its oversight function. Therefore, in a market economy, cost audit with changed emphasis on efficiency is as relevant as it was in a controlled economy.

1.20 In an environment where *'stakeholder theory'* of corporate governance is still rhetoric and management focus is on capital market, cost audit will help to protect the interest of stakeholders including investors. It will also help optimal use of national resources *(Asish K Bhattacharya, Business Standard-June 2, 2008)*.

1.21 It is pertinent to note the observations of IFAC, International Federation of Accountants, in its report *Financial Reporting Supply Chain* in March, 2008. The report is based on a detailed survey conducted by IFAC on the subject matter of the report. Among many views of respondents included in the report, some of them clearly bring out the significance of the need to focus on the business governance and the enterprise performance and not to stop at compliance of corporate governance principles. A view has been expressed that *"There is some fatigue about corporate governance". An external auditor comment*ed, *"Directors [are] spending more and more time in compliance issues and losing sight of operational issues"*. Another respondent recommended that boards take responsibility and *"review their agendas and see how much time they spend on the various topics like compliance versus strategy and find a balance"*. Furthermore, control processes should be more embedded in the business processes, and should be designed by people who have experience with the area of organization, people and processes.

Competitiveness of Indian Industry and Indian Economy

1.22 The enterprise governance is to focus in ensuring the competitiveness of the enterprise in the global context. This would strengthen the competitiveness of the Industry in which the enterprise is positioned and consequently the competitiveness of the Indian economy in the global context gets strengthened.

1.23 After several years of rapid and almost unhampered growth, the global economic landscape is changing. Rising food and energy prices, a major international financial crisis, and the related slowdown in the world's leading economies are confronting policymakers with new economic management challenges. Today's volatility underscores the importance of a competitiveness supporting economic environment that can help national economies to weather these types of shocks in order to ensure solid economic performance going into the future.

1.24 For the past several years, the World Economic Forum has based its competitiveness analysis on the Global Competitiveness Index (GCI), a highly comprehensive index for measuring national competitiveness, which captures the microeconomic and macroeconomic foundations of national competitiveness. Under the GCI, competitiveness is defined as the set of institutions, policies, and factors that determine the level of productivity of a country. The growth potential is reflected in the returns on investment which in turn depends on the productivity. Hence the productivity levels in an economy strongly influences the competitiveness of the economy, notwithstanding other influencing factors. The Institutional environment is one of the important determining factors in the measurement of competitiveness of the economy. It is the ways in which societies distribute the benefits and bear the costs of development strategies and policies, and it influences investment decisions and the organization of production.

1.25 Although the economic literature has mainly focused on public institutions, private institutions are also an important element in the process of creation of wealth. The significant corporate scandals that have occurred over the past few years, and the present global financial crisis, have highlighted the relevance of accounting and reporting standards and transparency for preventing fraud and mismanagement, ensuring good governance, and maintaining investor and consumer confidence. An economy is well served by businesses that are run honestly, where managers abide by strong ethical practices in their dealings with the government. Private-sector transparency is indispensable to business, and can be brought about through the use of standards as well as auditing and accounting practices that ensure access to information in a timely manner.

1.26 Market efficiency marks another important factor determining the competitiveness level of an economy. Countries with efficient goods markets are well positioned to produce the right mix of products and services given supply-and-demand conditions, as well as to ensure that these goods can be most effectively traded in the economy. Healthy market competition, both domestic and foreign, is important in driving market efficiency and thus business productivity, by ensuring that the most efficient firms, producing goods demanded by the market, are those that thrive.

1.27 The level of competitiveness an economy can work for depends on the stages of various determining factors. One can say that the maturity level of economies differ in achieving global competitiveness. But growth is a slow process which comes through stages of competitiveness. The first stage faced by most of underdeveloped economies in the world, is factor driven. It measures the rate and manner in which the resources endowments of the economy are exploited. The Global competitiveness index for different economies as computed by World Economic Forum in its study on global competitiveness is presented as an attachment to this chapter. India stands at the rank of 50 on a comparative study of competitiveness of different economies in the world.

1.28 In the context of evaluating the economic competitiveness, the significance of cost management in enterprises cannot be underestimated. In this connection the Confederation of Indian Industries (CII), through its Total Cost management (TCM) Division, had studied the cost management practices in different companies, both in the manufacturing and services sector. The study had evolved the concept of maturity levels of companies in cost management. It also suggested the mechanism of certification of cost management practices in companies so as to makes companies more efficiency driven and competition conscious. The first three levels of maturity are clear stages of development in competition ladder and essential for any company in the modern competitive era. They focus on basic cost information, appropriately computed cost centre wise, system based cost data support for decision making processes, and finally ensuring that the cost information system thus evolved is used in operationalising the strategies for measuring productivity, profitability etc. The significance of cost information is greatly emphasized in the process of gaining competitive strength by companies. Further in the ladder, the study brings out the emphasis on Total Cost Management approach by companies being competitive and in the process become a benchmark for cost management and competitiveness, for others in the industry. The five stages, forming part of the Maturity Model as evolved by CII-TCM division, are significant indicators of the relevance of the cost information and an assurance process required for its effective implementation. A copy of the CII-TCM Total Cost Management Maturity Model is enclosed as Annexure-XIII.

1.29 The Expert Group agrees with the conclusions of the study and the model so evolved. It is clear that an appropriate cost management system is required in all business units to remain competitive and the Government should ensure through a legal framework that companies do install such a cost management system in their respective governance, and also an effective assurance service mechanism so that the cost competitiveness of Indian industries is addressed through the assurance (Cost Audit) process which ultimately would ensure the competitiveness of the industry and the economy as a whole.

1.30 In this connection it is pertinent to note that the cost management is not totally new in Indian economy. Many big sized companies, having a presence in the global economy already are engaged in cost management practices at various degrees. They are already at a higher maturity levels, using the scale evolved by CII-TCM study. However, bulk of the Indian companies lack the facility as well as the perception to develop cost management systems, exposing themselves to great risks of global competition. If India's economic growth need to be ensured on the scale desired, it is essential that the competitiveness of the bulk of Indian companies should be addressed without delay and appropriate systems to ensure the same should be installed.

1.31 The current practices of costing in different Indian companies considerably vary, although all are subjected to an Audit mechanism ordered by the Central Government on a selective basis. While the Cost Accounting Records Rules (CARRs) for different industries have been prescribed under the Companies Act, 1956 the actual costing systems in companies vary from almost non-existent to an advanced and IT based costing system. Bulk of the companies in the manufacturing sector do not use recognised costing practices. Many do not have visible cost culture that would enable them to make progress towards cost management system. In these companies, while the turnover may be significant, the maturity level for cost consciousness is very low. The cost accounting records rules under the law may not be necessarily compatible with the company's financial system, making the former mere compliance process. Therefore, it is imperative that a cost system should be evolved that is universally adoptable in diversified industries in the country and also possess the feature of integrating with other systems of the company management. Such a system should be IT enabled and easily adaptable by companies of all sizes. The cost system so evolved should enable accessibility to cost information at all levels in the organisation, which is something feasible in the modern IT enabled environment. Companies should be seen and be encouraged to balance their strategies between compliance and performance and forced to move up in the levels of maturity with regard to cost management and therefore competitiveness.

1.32 The Management of companies should be encouraged to evolve decision making systems that use cost information and the cost of its product/service is based on cause and effect relationship between the inputs and outputs. The cost information system should effectively enable the management of companies to assess the business risks and respond to them comprehensively. Finally, cost information and cost management are important tools in companies to attain continuous improvements in the operations so as to slowly gain competitive positions and improve their returns. This would enable the stakeholders in the company to be satisfied. This is in complete alignment with the CII-TCM division's viewpoint that ERP packages, if implemented, without cost management modules at various user's end does not bring in the focus emphasized by a TCM framework.

1.33 In the table on competitiveness of different economies, presented in the appendix 1.1, the countries with index of above 5 are matured economies in terms of global competitiveness. Bulks of the economies, including India, are in the lower levels of maturity as far as the economic competitiveness is concerned and the imperative question what is the propelling force for effecting a movement towards higher level of maturity, given the forces operating in the global markets. Obviously, in developed economies there are no explicit legal interventions needed that make the companies to comply with laid out rules on cost information systems. However, in developing economies like India, legal interventions are required for making companies to appreciate the need for cost information systems as a source for gaining competitiveness and also to ensure such cost information systems are based on well recognised principles of accounting and costing techniques. In all developed economies, companies do use well advanced costing systems and many of the regulating authorities in those economies call for cost information from the companies, in the process of regulation. In the European Union, the regulators seek operators to submit authenticated cost information data while applying for tariff approvals. The point that is being emphasized is that legal intervention to ensure the maintenance of costing records and cost information based reporting becomes necessary even in matured economic systems and, hence, very essential in developing economies that are attempting to gain maturity levels in competitiveness. The recent experiences of collapses in Financial Markets and bankruptcy of leading operators in Financial Services Sector clearly emphasizes the need for close monitoring of the operation of companies even in a matured economy. In fact, the clause 49 under SEBI's conditions for Listing Agreement needs to be made more focused to ensure that companies do not fail due to lack of or inadequacy of cost information in the decision making processes. While there is widespread recognition of introducing an effective Enterprise Risk Management Systems in all companies, such risk management system would require good cost information system. Therefore, such a system should continue to exist to ensure that companies maintain appropriate cost information system and slowly mature in cost management mechanisms. A cost Audit system would ensure that such systems are in place in all companies.

1.34 There is general optimism today that India is poised to become a world power within this century. A general congratulatory frame of mind prevails that the high and rising rates of growth that has made this possible has been achieved through a by and large peaceful and democratic reversal of policies from the misdirected socialistic import-substituting-industrialization policies to the neo-liberal capitalist export-led economic growth policies. There is impatience with the pace of reforms, an annoyance with all those who seek to thwart/alter the direction of reforms and hinder the country's growth trajectory. One needs to understand first the macro economic trends and the role of the state in the country since Independence, second the international economic scene over this period, and third the changing socio-political forces in the country. One would then be in a position to analyze what the future is likely to be in regard to the economy.

1.35 *Mahalanobis* model dominated the economic policies till 1991. Thereafter, economic policy of the state has progressively jettisoned all the premises on which the *Mahalanobis* strategy was based, in favour of *neo-liberal* economic policies. However, economic policy has conformed to the interests of the big companies: the emphasis on raising rates of economic growth under the regime tends to be detrimental to the efforts in small sized companies, a tendency which is exacerbated because national income valuation is based on the exchange-value rather than the use-value of products. To ensure sustained economic development, it is essential to grow in a comprehensive manner across all industries and all forms of economic activities. The economy's competitiveness would require a holistic approach and not confined to a few capable big companies. Seen in this light, the relevance of ensuring maintenance of cost accounting records in all companies would be seen in correct perspective.

1.36 Many developing countries have sought, in the past, to overcome their primary economy status by diversifying into industrial production, thus altering their comparative advantage position – they were helped here because the depressed export demand for primary products reduced the clout of this section in influencing government policy decisions. Given that these countries were embarking on industrialization, they needed protection against the already established large (monopoly/corporate) enterprises in the developed countries – the infant industries argument was used first by the U.S.A. and Germany when they embarked on their industrialization programme in the late 19th century. This was the position in India as well, more so because many Indians felt that India could have been an industrial power but for colonial drain of resources and the deliberate forced deindustrialization of the country by the British.

1.37 Active government intervention was obviously the need of the hour. First, to change the colonial-feudal institutional structure in the economy, and second, to create a base which would enable the private sector to take-off industrially: the former was necessary to break whatever shackles on growth that existed because of production-distribution relations under a setup which was basically feudal-mercantilist on the one hand and colonial-capitalist on the other; the second was necessary because the private sector would not be able to produce competitively (relative to foreign capitalists) unless there existed the requisite infrastructural (social and economic) and heavy and basic capital goods base for efficient industrial production. Further, the fact is that these goods and services compete with imported products which means that their India-based production must be competitive not only against imports but also in the foreign markets against foreign producers. The reorientation of the economy from an import-substituting industrialization to export-led growth makes the improvement in the state of competitiveness even more necessary. This would require a directional movement of the industries and hence the need for reorienting the companies of all sizes towards the goal. The tools like cost management would go to strengthen this directional strategies of the Government and the latter would be correct in positioning appropriate legal system to ensure, among many other important mechanisms, that companies follow cost management techniques under a declared assurance system and ensure the competitiveness of their unit and thereby the competitiveness of their respective industry and the economy as a whole.

Regulatory Mechanism

1.38 The third factor of the current economic scenario that was addressed by the Expert Group was relating to regulatory mechanisms in the country. After the economic reforms introduced in 1991, it was evident that under the neo-liberal economic policies, the private sector units were to be given larger share in the economic activities. The reforms had achieved these targets to a large extent. The study by world economic forum on the competitiveness of different economies has clearly brought out this conclusion. The Report is a contribution to enhancing our understanding of the key factors determining economic growth, and explaining why some countries are much more successful than others in raising income levels and opportunities for their respective populations, offering policymakers and business leaders an important tool in the formulation of improved economic policies and institutional reforms *(The Global Competitiveness Report 2008-2009 © 2008 World Economic Forum)*. *Murray Rothbard* (an economic historian) et al, have shown that the *"Progressive"* movement of 1890-1920, the beginning of big government regulation of big business, was influenced by big business themselves. This is from his book *"The Case Against The Fed"*.

1.39 Economic regulation, a form of government intervention, is designed to influence the behaviour of firms and individuals in the private sector. Other forms include public expenditures, taxes, government ownership, loans and loan guarantees, tax expenditures, equity interests in private companies and moral suasion. Defined as the *“imposition of rules by a government, backed by the use of penalties, that are intended specifically to modify the economic behaviour of individuals and firms in the private sector"*, regulation in general is aimed at narrowing choices in certain areas.

1.40 A market is a social arrangement that allows buyers and sellers to discover information and carry out a voluntary exchange of goods or services. The neo-classical approach generated the view that a market could be defined as competitive when there was a significantly large number of sellers of homogenous products so that no sellers had enough of a market share to enable them to influence the product price by changing the quantity that they put into the market.

1.41 In the past most developing countries were characterized by significant government involvement in their economies marked by dominance of large state owned enterprises. Economic reforms were undertaken such as trade liberalization, opening up of economy, promoting FDI, and facilitating private sector participation. The thrust of economic reforms has been to allow for more competition. The underlying rationale is that competitive markets ensure efficiency resulting in best choice of quality, lowest prices and adequate supplies to consumers. The possibility of market failure underpins the economic rationale for state regulation of market economies.

1.42 Initially the regulation study was based upon Law and Sociology and later on the importance was given to Law and Economics. Regulation had long been an important topic in mainstream economics. Nobel Prizes were won for work on regulation, including a cluster awarded to economists from the University of Chicago who were critics of certain kinds of regulation. The spread of privatization around the world has created the renewed interest in regulation.

1.43 Multiple firms providing a good or service is less efficient (more costly to a nation or economy) than would be the case if a single firm provided a good or service. Industries where *fixed costs* predominate, creating *economies of scale* which are large in relation to the size of the market. Examples – Electricity, Telecommunications, Railways, Water Services, etc. The role of regulation is generally conceived as one of the maintaining the institution within whose framework the free market can continue to function, of enforcing, supplementing and removing the imperfections of competition.

1.44 Firms can be regulated in terms of their profits or prices, as well as their quality of service. The three general forms of regulatory instruments are:

- Cost of Service Regulations
- Price Cap Regulations
- Sliding Scale Regulations

1.45 Regulations can take different forms with different roles, viz.

- Health, safety regulations and environmental regulations can be rationalized on the basis of imperfect information and externalities.
- Economic regulation of public utilities can be explained by economies of scale and scope and need to protect the consumers from monopoly exploitation.
- Aspects of fiscal policy can be rationalized on the basis in terms of wealth and income redistribution.
- Regulatory intervention for universal service obligations, etc.

- Regulatory intervention to ensure proper allocation of economy's resources towards economic activities that ensures growth in the desired direction and to ensure the competitiveness.
- As an effort by the state to address social risk, market failure or equity concerns through rule based direction of individual and society.

1.46 Regulation is a complex balancing act between advancing the interests of consumers, competitors and investors, while promoting a wider 'public interest' agenda, minimum prices to benefit the consumer (maximize consumer surplus); ensure adequate profits are earned to finance the proper investment needs of the industry (earn at least a normal rate of return on capital employed); provide an environment conducive for new firms to enter the industry and expand competition (police anti-competitive behaviour by the dominant supplier); preserve or improve the quality of service (ensure higher profitability is not achieved by cutting services to reduce costs); identify those parts of the business which are naturally monopolistic (statutory monopolies that are not necessarily justified in terms of either economies of scale or scope); take into consideration social and environmental issues (e.g. when removing cross subsidization of services). These are five principles to determine the relevance and effectiveness of regulations.

1.47 In India, the importance of competition policy and related regulatory regimes has increased greatly since 1991 when a massive wave of liberalisation eliminated many controls on investment, capital market, foreign trade and prices. Prior to 1991, the public interest was sought to be served more through direct regulations that required the prior approval of government for many commercial decisions. Post-1991, in most sectors of the economy, the protection of public interest objectives rests with the laws governing competition and the regulatory regimes that have been set up for "natural" monopolies and network industries (where the production patterns of one producer are linked to that of others). This approach may, however, become ineffective when competition in natural monopolies cannot be ensured as such. Situations can also arise where there may be a number of players in the market but the market itself is so segmented that individual players become monopolists. The only way to get 'competitive outcomes' in such markets is to put effective regulation in place. Thus, regulation in different sectors becomes an integral component of competition policy. Cartels, in India as well as elsewhere, are found to be the most common practice in markets particularly in the intermediate products, i.e. cement, tyres, steel, etc., that are processed and that form input costs all along several stages of the supply chain with fairly sophisticated customers. Thus, a cement cartel may result in a distributor being overcharged, which is then passed on in higher prices from the distributor to a builder, and finally the householder.

1.48 In the social sectors to the need for regulation is strongly felt. Healthcare and education are critical soft infrastructural issues for economic growth. The healthcare sector is plagued with anticompetitive practices, which are mostly found at local level and need local solutions by way of local regulatory agencies supported by vigilant consumer activism. Strict regulation of all healthcare services is the need of the hour. Fee structures at private healthcare centres need to be formalized and monitored to prevent exploitation of patients. The education sector requires a paradigm shift in regulation and the debate has only just begun. The National Knowledge Commission has highlighted the extreme barriers to entry that exist in the field of higher education. This has resulted in an increase in the size and deterioration in the quality of existing universities, as there is no competition. Besides, it does not promote autonomy and accountability. The education sector requires two transformations: state must invest heavily to increase access to higher education and it should respect the autonomy of the institutions, so that a diversity of methods finds expression; and institutions should be allowed to have the flexibility so that talent can be retained in the country.

1.49 While regulation has significant relevant in the current economic scenario, cost data fed regulational issues are also many and worth considering while examining the relevance and usefulness of cost data of companies. For tariff fixation/approvals in public utilities like electricity, for ensuring objective subsidy policy, to ensure operational regulation within competitive practices are some of the areas that would require adequate cost audit systems. Admittedly, these factors are not addressed in financial reporting mechanisms. In fact, the nuances of competitive regulation would require elaborate cost data for ensuring that anti-competitive policies are not followed. For example, in anti-trust practices or predatory pricing practices, the cost data of concerned business units need to be examined for proper examination and adjudication. The regulatory mechanisms would greatly require a cost audit system in position as a pre-condition to positioning such regulatory mechanisms. In fact, the WTO agreement provides for different kinds of anti-competitive practices to be regulated by member countries through appropriate laws. Anti-dumping is one of such important areas where authenticated cost data would be extensively required for investigation into anti-dumping complaints and taking legal action against dumping practices. Non-existence of required cost data would be a handicap to the concerned companies as well as to the Government in its investigation. In a way such cost data has become imperatively mandatory under the WTO regime. The existing costing practices are poor in providing structured mechanisms for a good analysis of the cost information. Hence there is an urgent need to evolve mechanisms to ensure structured cost data in companies in all the sectors and a structured system to provide assurance service through cost audit mechanisms.

Conclusion

1.50 The above paragraphs have highlighted the current economic scenario and in that context the relevance and significance of cost information systems in companies and the cost audit mechanism to ensure that cost information systems are existing in the form desired so that cost related competitiveness of industries and the Indian economy is ensured.

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Appendix 1.1

Global Competitiveness Index Rankings

Country/Economy	**GCI 2008-2009 Rank**	**GCI 2008-2009 Score**	**GCI 2007-2008 Rank**
United States	1	5.74	1
Switzerland	2	5.61	2
Denmark	3	5.58	3
Sweden	4	5.53	4
Singapore	5	5.53	7
Finland	6	5.50	6
Germany	7	5.46	5
Netherlands	8	5.41	10
Japan	9	5.38	8
Canada	10	5.37	13
Hong Kong SAR	11	5.33	12
United Kingdom	12	5.30	9
Korea, Rep.	13	5.28	11
Austria	14	5.23	15
Norway	15	5.22	16
France	16	5.22	18
Taiwan, China	17	5.22	14
Australia	18	5.20	19
Belgium	19	5.14	20
Iceland	20	5.05	23
Malaysia	21	5.04	21
Ireland	22	4.99	22
Israel	23	4.97	17
New Zealand	24	4.93	24
Luxembourg	25	4.85	25
Qatar	26	4.83	31
Saudi Arabia	27	4.72	35
Chile	28	4.72	26
Spain	29	4.72	29
China	30	4.70	34
United Arab Emirates	31	4.68	37
Estonia	32	4.67	27
Czech Republic	33	4.62	33
Thailand	34	4.60	28
Kuwait	35	4.58	30
Tunisia	36	4.58	32
Bahrain	37	4.57	43
Oman	38	4.55	42
Brunei Darussalam	39	4.54	n/a
Cyprus	40	4.53	55
Puerto Rico	41	4.51	36
Slovenia	42	4.50	39
Portugal	43	4.47	40

Global Competitiveness Index Rankings

Country/Economy	**GCI 2008-2009 Rank**	**GCI 2008-2009 Score**	**GCI 2007-2008 Rank**
Lithuania	44	4.45	38
South Africa	45	4.41	44
Slovak Republic	46	4.40	41
Barbados	47	4.40	50
Jordan	48	4.37	49
Italy	49	4.35	46
India	**50**	**4.33**	**48**
Russian Federation	51	4.31	58
Malta	52	4.31	56
Poland	53	4.28	51
Latvia	54	4.26	45
Indonesia	55	4.25	54
Botswana	56	4.25	76
Mauritius	57	4.25	60
Panama	58	4.24	59
Costa Rica	59	4.23	63
Mexico	60	4.23	52
Croatia	61	4.22	57
Hungary	62	4.22	47
Turkey	63	4.15	53
Brazil	64	4.13	72
Montenegro	65	4.11	82
Kazakhstan	66	4.11	61
Greece	67	4.11	65
Romania	68	4.10	74
Azerbaijan	69	4.10	66
Vietnam	70	4.10	68
Philippines	71	4.09	71
Ukraine	72	4.09	73
Morocco	73	4.08	64
Colombia	74	4.05	69
Uruguay	75	4.04	75
Bulgaria	76	4.03	79
Sri Lanka	77	4.02	70
Syria	78	3.99	80
El Salvador	79	3.99	67
Namibia	80	3.99	89
Egypt	81	3.98	77
Honduras	82	3.98	83
Peru	83	3.95	86
Guatemala	84	3.94	87
Serbia	85	3.90	91
Jamaica	86	3.89	78
Gambia, The	87	3.88	102

Global Competitiveness Index Rankings

Country/Economy	**GCI 2008-2009 Rank**	**GCI 2008-2009 Score**	**GCI 2007-2008 Rank**
Argentina	88	3.87	85
Macedonia, FYR	89	3.87	94
Georgia	90	3.86	90
Libya	91	3.85	88
Trinidad and Tobago	92	3.85	84
Kenya	93	3.84	99
Nigeria	94	3.81	95
Moldova	95	3.75	97
Senegal	96	3.73	100
Armenia	97	3.73	93
Dominican Republic	98	3.72	96
Algeria	99	3.71	81
Mongolia	100	3.65	101
Pakistan	101	3.65	92
Ghana	102	3.62	n/a
Suriname	103	3.58	113
Ecuador	104	3.58	103
Venezuela	105	3.56	98
Benin	106	3.56	108
Bosnia and Herzegovina	107	3.56	106
Albania	108	3.55	109
Cambodia	109	3.53	110
Côte d'Ivoire	110	3.51	n/a
Bangladesh	111	3.51	107
Zambia	112	3.49	122
Tanzania	113	3.49	104
Cameroon	114	3.48	116
Guyana	115	3.47	126
Tajikistan	116	3.46	117
Mali	117	3.43	115
Bolivia	118	3.42	105
Malawi	119	3.42	n/a
Nicaragua	120	3.41	111
Ethiopia	121	3.41	123
Kyrgyz Republic	122	3.40	119
Lesotho	123	3.40	124
Paraguay	124	3.40	121
Madagascar	125	3.38	118
Nepal	126	3.37	114
Burkina Faso	127	3.36	112
Uganda	128	3.35	120
Timor-Leste	129	3.15	127
Mozambique	130	3.15	128
Mauritania	131	3.14	125

Global Competitiveness Index Rankings

Country/Economy	GCI 2008-2009 Rank	GCI 2008-2009 Score	GCI 2007-2008 Rank
Burundi	132	2.98	130
Zimbabwe	133	2.88	129
Chad	134	2.85	131

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CHAPTER-2: CONSTITUTION OF THE EXPERT GROUP

2.1 Sections 209(1)(d) and 233B of the Companies Act, 1956, incorporated in 1965, are the backbone of cost accounting and cost audit in the Indian corporate sector. Since then, the framework put to practice, through promulgation of Cost Accounting Records Rules and Cost Audit Report Rules by the Government, has inculcated a sense of cost consciousness in large number of industries/companies. This mechanism, to a very large extent, has helped them to face the fierce competitive forces arising out of post-1991 liberalization and globalization. It served well the legal and non-legal requirements of various regulatory authorities, government agencies, tariff/price fixation bodies, research organisations, etc. But the fast changing business and economic scenario, both internal and external challenges, and the need for convergence/synchronization of global accounting practices require a change in the performance management systems including the cost management and reporting framework . Towards this end, there is definitely a need felt to review the existing scheme/framework of cost accounting in the Indian corporate sector.

2.2 Cost accounting, through the determination and allocation of costs to various products, provides a valuable service to the managements of companies in cost analysis and control. This way, it can help improve efficiency in the use of materials, labour and plant, maximize production and increase profitability. At the same time, cost analysis furnishes useful information in respect of important matters such as gross margin, differential costs, replacement costs, etc. Cost analyses are useful to the Regulators of public utilities and provide a basis for comparing claims and assessing the validity of issues arising out of international trade.

2.3 Cost accounting is an integral part of the management process. It serves as an aid or a tool to the management in respect of its functions relating to cost control and cost analysis. The growing pressures of global competition, technological innovations, volatility in exchange rate and input prices and change in business processes have made cost management much more critical and dynamic than ever before. Cost is a strategic issue. Often, the very business model itself may need to change to ensure that the organisation remains competitive both for sustenance and growth. Because strategic issues are increasing in importance to management, cost management has moved from a traditional role of product costing and operational control to a broader, strategic focus: strategic cost management.

2.4 The present competitive economic environment has made all the organizations more conscious about the need to bring efficiency and economy in their operations. “Cost Leadership” and “Total Cost Management” is the present day mantra. Cost control and cost reduction is an on-going exercise for the management to gain competitive edge over others and for survival. Large number of companies and manufacturers keep necessary cost data even where no Rules as such are prescribed. Therefore, it is considered necessary to review the existing provisions of cost accounting and cost audit under the Companies Act, 1956 and to make it more beneficial to various regulators, government departments/bodies to protect the interest of consumers and investors and to protect the industry from unfair trade practices (like anti-dumping, subsidies & counter-veiling measure, cartels, etc.) under WTO agreements. In addition, the ground realities under which these rules were framed need to be reviewed in the present economy where all businesses would like to be competitive, reduce cost and strive for growth and improve their share in the market. In the above background, the redefined objectives will have to synchronize with the cost base strategies. Consequently, the objectives should strive to migrate the corporate sector faster to a minimum floor level of acceptable costing practices as a matter of national discipline. The proposed framework should thereafter allow the corporate sector to build their competitiveness further by choosing the appropriate cost management practices.

2.5 Cost accounting has not remained static to be a mere system of “cost measurement” or “cost determination” – it has turned more and more towards “cost management”. Cost management is the use of cost information to improve efficiency, performance and profitability of an organization; to meet the requirements of the present global competitive environment; and to improve sustainability. Cost management requires both material cost and cycle time costs to be benchmarked, with close online monitoring; business process re-engineering; fixing targets and not budgets; management by objectives; control by self-assessment and fixing accountability.

2.6 Cost audit methodology as structured originally under Section 233B and the existing Cost Audit Report Rules, therefore, needs realignment with cost management perspectives. What needs to be done is to redefine the audit objectives without losing the legal backup and the mandatory force it gives for compliance. Instead of the attestation perspective, which was emphasized earlier for price control, the efficiency review aspect should be blown in full force to align with cost management and enable better enterprise governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness. There is need to revisit the current methodologies of cost auditing and reporting frameworks. Ultimately, cost audit should catalyze and facilitate the cost competitiveness of India Inc. Present formats of Cost Audit Report need to be restructured. Feedback on Cost Audit Report is essential. Industry-wide cost standards/benchmarks should be made available to the industry to enable them to maintain uniformity and enhance value for money.

2.7 It is imperative that in the present economic environment, determined by increasing competition both domestically and internationally, efficiency and economy be brought about in the operations of the manufacturing sector to catalyze and facilitate the cost competitiveness of the manufacturing sector in India. It is equally necessary to enable the industry and the Government to address issues arising from unfair trade practices such as dumping, subsidies & cartels, etc. in the International Trade.

2.8 To enable development of relevant cost accounting methodologies and standards to increase the competitiveness of the Indian manufacturing sector and to advise the Government on suitable measures for the same, Government of India, Ministry of Corporate Affairs vide their Order no. 2/1/2008-CL.V dated 21st January 2008 constituted an Expert Group comprising of:

1.	Shri B.B. Goyal, Adviser (Cost), Ministry of Corporate Affairs	Chairman
2.	Shri P. Murugesan, General Manager, Maruti Suzuki India Limited, Gurgaon representing Confederation of Indian Industry	Member
3.	Shri Lalit Bhasin, Chairman, Corporate Affairs Committee, representing the PHD Chamber of Commerce and Industry and The Federation of Indian Chambers of Commerce & Industry	Member
4.	Shri S.C. Aggrawal, Chairman & Managing Director, SMC Global Securities Limited, New Delhi representing The Associated Chambers of Commerce and Industry of India	Member
5.	Shri Amarjit Chopra, Chairman, Accounting Standards Board, Institute of Chartered Accountants of India, representing ICAI	Member
6.	Shri Chandra Wadhwa, President, Institute of Cost & Works Accountants of India representing ICWAI	Member

7.	Shri M. Gopalakrishnan, Chairman, Cost Accounting Standards Board, ICWAI	Member
8.	Shri Ravindra Mathur, Director (Cost), Cost Audit Branch, Ministry of Corporate Affairs	Member Secretary

2.9 The Institute of Chartered Accountants of India vide their letter no. M-526/40/2008 dated 12th February 2008 informed the Ministry of Corporate Affairs that the Council of the Institute has constituted a separate Committee on Management Accounting commencing from the year 2008-09. They, therefore, requested to include the name of Shri Vinod Jain, a member of the Council and also Chairman of the Committee on Management Accounting on the captioned Expert Group, in place of Shri Amarjit Chopra. As requested, Ministry of Corporate Affairs vide their order dated 19th February 2008 stated that Shri Vinod Jain, Chairman of the Committee on Management Accounting is included as Member of the Expert Group, as representative of ICAI in place of Shri Amarjit Chopra, Chairman, Accounting Standards Board.

2.10 Further, Ministry of Corporate Affairs vide their order dated 15th May 2008 stated that Shri G.G. Mitra, Joint Director (Cost) is included as Member Secretary of the Expert Group, as representative of Cost Audit Branch, Ministry of Corporate Affairs in place of Shri Ravindra Mathur, Director (Cost), Cost Audit Branch, Ministry of Corporate Affairs.

2.11 The Group was asked to undertake the following tasks:

(i) Review the Cost Accounting Record Rules and their continued relevance in the contemporary competitive environment as per the presently prescribed structure / format, and make recommendations for requisite modifications and / or alternative structures;

(ii) Review the existing Cost Audit Report Rules and formats prescribed therein, and recommend appropriate modifications to make them more relevant to the needs of different stakeholders including company management, shareholders, regulators, etc;

(iii) Review the existing system with a view to make suggestions for addressing the concerns of the industry with regard to confidentiality of company cost data and cost of compliance;

(iv) Review and, if required, give suggestions for redrafting the existing Cost Accounting Standards in the Indian context in light of international best practices, and to align them with the international cost accounting standards issued by International Federation of Accountants (IFAC).

2.12 The Group was asked to complete its task latest by 30th September, 2008. It was also said that interim reports may be submitted by the Group at its discretion. Later, Ministry of Corporate Affairs vide their order dated 3rd October 2008 said that the period for submission of the report by the Expert Group to the Ministry of Corporate Affairs is extended by a period of three months till 31.12.2008.

2.13 Copies of the Ministry of Corporate Affairs' orders dated 21.01.2008, 19.02.2008, 15.05.2008 and 03.10.2008 are placed as Annexure-I to IV.

2.14 The Group decided not to submit any interim report and submitted its final report to the Ministry of Corporate Affairs in December, 2008.

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CHAPTER-3: BACKGROUND

3.1 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 entire 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.

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

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

> *organization efficient and economical, by providing the minimum of labour and material and getting the full capacity of the machine output. The cost accountant, therefore, is concerned solely and mainly with the internal economy of the industry, and renders services essential to the day-to-day management of the undertaking."*

3.3 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.

3.4 Simultaneously, 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. Cost audit and authentic cost data was considered an important instrument 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.

3.5 These developments resulted in inserting sections 209(1)(d) and 233B in the Companies Act, 1956, by the Companies (Amendment) Act, 1965 (31 of 1965). These provisions relate to maintenance of cost accounting records and audit of cost records. Sections 209(1) and 233B read as under; full text of these sections is available at Annexure-V & VI.

> ***Section 209(1):*** *Every company shall keep at its registered office proper books of account with respect to -*
>
> *(a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place;*
>
> *(b) all sales and purchases of goods by the company;*
>
> *(c) the assets and liabilities of the company; and*
>
> *(d) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost*

> *as may be prescribed, if such class of companies is required by the Central Government to include such particular in the books of account.*

Whereas clauses (a), (b) and (c) of sub-section (1) of Section 209 deals with maintenance of financial books of account, clause (d) deal with the maintenance of cost accounting records.

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

3.6 The justification for mandatory cost accounting records and cost audit has been well explained and documented in the Notes on clauses, Report of the Joint Select Committee and Parliamentary Debate that led to adoption of Companies Amendment Bill, 1965 incorporating above-mentioned Sections 209(1)(d) and 233B. The primary aim was not to detect frauds and dishonesty in the corporate sector but to prevent it and also make the corporate sector more efficient through the scheme of detailed cost accounting and efficiency audit. The scheme was intended to serve the best interest of the company itself and also of all other stakeholders including various Government agencies. One of the major objectives was to provide authentic data to the Government on which various elements of costs and profits that could be allowed to the manufacturers of controlled goods.

3.7 Clause (d) of sub-section (1) of section 209 was inserted by section 20 of the Companies (Amendment) Act, 1965. The Objects and Reasons in the Bill stated:

> *"The object of the amendment of sub-section (1) of section 209 is to ensure that in respect of companies engaged in production, processing, manufacturing or mining activities which may be specified by notification issued by the Central Government, proper records relating to utilisation of material and labour are available, which would make the efficiency audit possible."*

3.8 Ramaiya's Guide to the Companies Act elaborates that "*Efficiency audit*" is possible only when a system of cost accounting is adopted and costing records maintained for purposes such as the following:

- To furnish accurate cost of jobs, materials, finished products, comparing present cost with previous cost experience;
- To make accurate periodical cost statements for information and guidance of the management;
- To help determining price of finished products by furnishing all relevant data;
- To evaluate production processes with cost data;
- To analyse each production activity whether it is value-added or non-value added and to link-up with cost data;
- To help planning operations and control stock;
- To determine efficiency of operations by furnishing data as to cost volume of production etc.;
- To distribute overhead costs in a rational manner; and
- To help, continuous study and reporting as to material cost prices, quality of material, transportation costs, plant idleness, production capacity overhead costs etc., quality of labour, labour costs, waste, depreciation in all its aspects such as machine deterioration, accelerated depreciation, etc.

3.9 The Joint Select Committee in their Report said:

> *"The Committee feel that a company may be required under the proposed clause (d) of sub-section (1) of section 209 to include the prescribed particulars in its books of account only if it pertains to a class of companies engaged in production, processing, manufacturing or mining activities and all other companies belonging to that class are required to include such particulars in their books of account."*

3.10 Explaining the provision, notes below the section, as they appear in the Ramaiya's Guide, said as under:

- The concept and scope of cost audit in India is much wider as the definition lays much emphasis on the evaluation of efficiency of operations and the propriety of management actions and decisions, executive programs and policies. In this sense, cost audit appears to be synonymous with efficiency audit.
- Cost accounting is a continuous process and cost records should be such as to enable a comparative analysis of expenses, variations and changes, both with reference to actual costs and standard costs.
- The cost accounting records should be kept in such a manner that it should be possible to compute properly the cost of

production and the cost of sale. The books should also contain the prescribed particulars of various elements of cost, e.g. material, labour, etc. Where a company is a multi-product company and is engaged in manufacturing products other than, or in addition to, the product covered by the Cost Accounting Records Rules, the record should be kept in such a manner that the cost of other products is not included in the cost of production of the product covered by the Rules.

- A company may, if it so chooses, keep particulars relating to utilisation of material, labour or other items of cost in one set of books along with the financial accounts. This section does not insist on having separate books for maintaining particulars relating to costs referred to in clause (d) of sub-section (1) thereof.

3.11 Section 233B was inserted by section 23 of the Companies (Amendment) Act, 1965, in order to enable Government to issue necessary directions for conducting cost audit of companies engaged in production, processing, manufacturing or mining activities. The Notes on clauses stated that the purpose of the section was to "*enable Government to issue necessary directions for conducting cost audit of companies engaged in production, processing, manufacturing or mining activities*" (*clause* 24).

3.12 During the Rajya Sabha Debate, Smt. Tara Ramchandra Sathe (Hon'ble MP for Maharashtra) stated as under:

> "*What is Cost Audit? The Cost Audit is quite different from the Financial Audit. It is to see whether the labour is sufficient or not, whether the industry has provided efficient labour or the labour which is required by that industry is less than what is required, whether every material and every part of the machinery is used to the optimum, whether any material is wasted, etc.*
>
> *As we all know, we are short of material, there is so much material is imported, when we are short of foreign exchange. In these circumstances, it is very essential that there should be cost audit. In fact, it should be introduced in almost all the industries, but the Government is trying this in certain cases only. So by this we will know whether there is a proper utilization of the material or not. It is very essential, no doubt, and in factories and industries, everywhere, this cost audit should be emphasized." (Proceedings of Rajya Sabha, 14th September, 1965 Columns 3944 and 3945)*

3.13 In his reply, the then Hon'ble Finance Minister of India, Shri T.T. Krishnamachari stated that:

> *"while we have made it obligatory or rather semi-obligatory to employ Cost Accountant, it is our intention to ask certain industries to have a cost accountant's report."* (ibid column 3974)

3.14 Highlighting the absolute necessity of cost accounting and cost audit in all companies in due course, he added:

> "w*hen we can have sufficient number of Cost Accountants so as to make it obligatory for every company, every producing concern and every manufacturing concern, to have a cost accountant's* report." (*ibid column 3974*)

3.15 Reiterating the future vision of the Government, he further said:

> "*we are really making it possible for the institution of Cost Accountants to grow so as to enable the Government some time later to make every manufacturing company employ a Cost Accountant, and have a cost accountant's report in regard to the cost of product that it produces.*" (*ibid columns 3974*)

3.16 On the issue of inclusion of Chartered Accountants in the proviso to sub-section (1) of section 233B, the Joint Select Committee said:

> *"It was represented to the committee that the number of cost accountants in practice in this country is extremely limited and that, therefore, cost audit, if it was to be extensive, will have to be entrusted to chartered accountants also. The committee are of the opinion that this difficulty could be got over by providing specifically that the chartered accountants who may possess the prescribed qualifications should also be allowed to undertake cost audit under this clause."*

3.17 On filing of cost auditor's report, Joint Select Committee, in Para 23 of their report, said:

> *"The Committee have also noted that since cost audit was likely to reveal certain information which are regarded as confidential by the companies, the cost audit report should be filed with the Company Law Board [substituted in 1975 with Central Government] and not with the Registrar and a copy of the report should be sent to the company."*

3.18 After the aforesaid amendments in the Companies Act, 1956, section 209(1)(d) was implemented by the Government in stages by notifying Cost Accounting Records Rules (CARRs) in 44 industries. List of these 44 industries is available at Annexure-VII. Vested with the powers under section 233B, Government ordered for audit of cost accounting records in large number of companies falling within the scope of these 44 industries. In order to regulate the operation of section 233B, Government also notified Cost Accounting Report Rules.

3.19 Small scale industrial undertakings, as defined in the Industries (Development and Regulation) Act, 1951 were granted exemption from the requirement of maintaining cost accounting records even if they belong to a class of companies for which CARRs are prescribed subject to the following conditions (*Notification Nos. GSR 425(E) to 467(E), F. No. 52/19/97-CAB dated 03.08.1998*):

(a) the aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does *not exceed limit as specified for a small scale industrial undertaking* under *the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and*

(b) the aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crore of rupees."

3.20 The existing provisions under section 209(1)(d) and 233B of the Companies Act, 1956 were reviewed by the "Expert Committee on New Company Law" (chaired by Dr. J.J. Irani) set up by the Ministry of Company Affairs, which made its recommendations to the Ministry in May, 2005, which are reproduced below:

> *"At present, the Companies Act contains provision relating to maintenance of Cost Records u/s 209(1)(d) and Cost Audit u/s 233B of the Companies Act in respect of specified industries. The Committee felt that Cost Records and Cost Audit were important instruments that would enable companies make their operations efficient and exist in a competitive environment.*
>
> *The Committee noted that the present corporate scenario also included a sizeable component of Government owned enterprises or companies operating under administrative price mechanism or a regime of subsidies. It would be relevant for the Government or the regulators concerned with non-competitive situations to seek costing data. The Committee, therefore, took the view that while the enabling provision may be retained in the law providing powers to the Government to cause Cost Audit, legislative guidance has to be taken into account the role of management and addressing cost management issues in context of the liberalized business and economic environment. Further, Government approval for appointment of Cost Auditor for carrying out such Cost Audit was also not considered necessary."*

3.21 Provisions of section 209(1)(d) of the Companies Act, 1956 and the existing coverage of industries under CARRs were reviewed by the

Committee on Subordinate Legislation (Fourteenth Lok Sabha) in its First Report (Chapter-III) submitted on 2nd December, 2004. The Committee said as follows:

> *"3.12 The Committee regret to note that even 38 years after enactment of the relevant provisions empowering the Government to prescribe Cost Accounting Records Rules (CARRs), these have not been framed to cover all major industries/projects. CARRs have so far been notified only in respect of 47 industries. The slow pace of framing rules negates the very purpose of the important provisions of the legislation passed by the Parliament. Though it has been contended that the legislation is "enabling" and is not "mandatory", the Secretary, Department of Company Affairs indicated during evidence that at one point of time priority had been assigned to certain industries in the preparation of CARRs. He admitted that out of the prioritized industries for which CARRs should have been in position, five major industries have been left out, notably among them being the Coal Industry. It is strange that the Department of Company Affairs could not ascertain the reasons why CARRs could not be framed for a major industry such as "Coal" all these years. The Secretary, Department of Company Affairs has assured that the Department would now be writing to Ministries concerned regarding formulation of CARRs and prioritize Industries/Services on the basis of urgency expressed by them. The Committee would like to be apprised of the action taken in this regard and the time frame laid down by the Department for completing the task.*
>
> *3.13 Service sectors such as Banking, Insurance, Health Services, Education, Hotel, etc. have admittedly "attained strategic importance to the economy and the public at large, particularly after opening up of the economy for private/foreign companies". It has been stated that an authentic cost data base is of paramount importance to various existing and new regulatory bodies, Competition Commission and Government Departments for fixation of user charges in respect of services provided by them and would go a long way in fulfilling their respective objectives. The existing provisions of the Companies Act, however, do not require formulation of CARRs for service industries. The Committee feel that absence of 'enabling' provision in the Companies Act should not be a reason for not prescribing CARRs for service industries. If the need for cost audit is otherwise found to be vital for service industries, the Committee emphasize that expeditious action should be taken to remove the lacuna in the Companies Act by suitably amending it.*

> *3.14 The Committee are concerned to note that the Department of Company Affairs do not have a definite idea about the relevance and significance of CARRs in the present day scenario of liberalization and globalization. The Department have held out two different views before the Committee. In a note submitted to the Committee, the Department opined that the main objective of cost audit when introduced was mainly to meet Government requirements for regulating the price mechanism in certain industries and that in the present scenario authentic cost data base is not only essential for the industries to improve upon their performance and face competitive environment but is useful to various Government agencies, revenue authorities, regulatory bodies, banks and financial institutions for meeting their respective objectives. The Secretary, Department of Company Affairs, however, quoted during evidence another school of thought according to which the competitive regime which is now in vogue calls for companies to be competitive, cost conscious and secretive if they have to on a continuous edge. This view advocates dilution of CARRs to the extent of eliminating them from the statute. The Committee note that one of the objects of the Companies (Second Amendment) Bill, 1964, [which on enactment became Companies (Amendment) Act, 1965] as stated in the Statement of Objects and Reasons appended to the Bill, was "to strengthen the provisions relating to investigation into the affairs of Companies and to provide for more effective audit in dealing with cases of dishonesty and fraud in the corporate sector". In view of a number of cases of financial irregularities in the corporate sector recently coming to light, the Committee finds it difficult to subscribe to this school of thought. The Committee feels that holding divergent views and lack of clear policy about CARRs is not conducive to the functioning of the Department. The Committee urge that the Department of Company Affairs in consultation with Ministries and regulators concerned should examine thoroughly from all angles the need and importance of the Cost Accounting Records Rules in the present day scenario and lay down clear, coherent and unambiguous policy guidelines in regard to CARRs."*

3.22 With reference to the aforesaid recommendations made by the Committee on Subordinate Legislation, Ministry of Corporate Affairs, in August 2006, framed internal Policy Guidelines on Cost Accounting Record Rules and Cost Audit which would guide the Ministry in its approach to the subject within the existing provisions of the Companies Act, 1956. Highlights of these guidelines are:

- There should be total freedom to the companies to maintain their own cost records.
- All the existing CARRs should be reviewed and those not found relevant should be repealed.
- Future application of CARRs should be in selective industries to be guided by factors such as price control, subsidy payment, products produced by PSUs, infrastructure sector, defence sector, recommended by sector regulator, administrative Ministry or industry association, etc.
- Exemption limit to be raised from Rs.10 crore to Rs.20 crore.
- Formats/Proformae prescribed under various CARRs may be reviewed and simplified.
- Existing system of compliance by Statutory Auditors under CARO to be reviewed periodically.
- Cost Audit Report Rules, 2001 to be reviewed.
- Confidentiality of cost data to be maintained.
- ICWAI to play pro-active role in
    - o Creating awareness about importance of “Cost control measures” in efficient running of corporates/enterprises;
    - o Framing cost accounting standards for different products, processes and services; and
    - o Suggesting “standard costs”.

3.23 In continuum of these internal policy guidelines framed by the Ministry, Government of India, Ministry of Corporate Affairs vide their Order no. 2/1/2008-CL.V dated 21st January 2008 constituted an Expert Group to review the existing mechanism/framework of Cost Accounting Records Rules, Cost Audit Report Rules, Cost Accounting Standards, Confidentiality of company cost data and cost of compliance.

3.24 These guidelines were examined by the Expert Group. The Group is of the opinion that these guidelines need to be evolved as a complete policy with regard to cost accounting records and cost audit in the corporate sector. Broad issues that require examination are:

- Whether to continue the scheme in terms of products/industries or adopt the class of companies as contained in the Companies Act?
- Whether there is need to continue prescribing CARRs for every product/industry or leave it free to the companies to maintain

their cost records in the manner they deem necessary depending upon the size, scale, type, purpose, etc.

- What approach to be followed with respect to essential services? What should be the criteria for exempting a company from cost audit?
- How to maintain the confidentiality of cost data?
- Should all stakeholders be given access to the cost audit report, in full or in part?
- The new policy should help in improving the existing system of Investor Protection, Enterprise Governance, Segmental Reporting, Transfer Pricing, etc; all requirements under WTO agreements on Anti-dumping, subsidies, safeguards, valuation, etc; providing necessary cost data to all the regulators, tariff or price fixation bodies, subsidy administration, fixation of cost-based user charges, CCI, SFIO, revenue authorities, banks & financial institutions, etc.
- The rationale of revising the exemption limits to Rs.20 crore and not Rs.50 or Rs.100 crore.
- How to treat companies within the exempted limit but having high level of public participation?
- Will the limited cost data be of any help in carrying out economic analysis, assessing competitiveness, free trade agreements, predatory pricing, working out standard costs, etc.?
- Will the nation not suffer due to the inefficient running of any company and its' eventual closure by loss of funds by small investors; loss of production in the country; loss of potential revenue inflow to the Government; and loss of employment.
- What should be the time frame for ICWAI to frame Cost Accounting Standards and suggest Standard Costs?
- Whether these Cost Accounting Standards to be made mandatory?
- What is the guarantee that selective coverage of products/industries for cost accounting and cost audit will not result in increasing the existing sense of discrimination resulting in these units or industry associations pressurizing the government to withdraw the provisions selectively made applicable on them.

3.25 The Expert Group decided to have an independent and thorough review of the existing mechanism/framework and address all these key issues so as to suggest a revised scheme to the Government that should be based on a sound and balanced approach taking into account the important needs/requirements of all the stakeholders.

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CHAPTER-4: METHODOLOGY

4.1 As per order of the Ministry of Corporate Affairs, the Expert Group was assigned the following tasks:

- Review the Cost Accounting Record Rules and their continued relevance in the contemporary competitive environment as per the presently prescribed structure/format, and make recommendations for requisite modifications and/or alternative structures;
- Review the existing Cost Audit Report Rules and formats prescribed therein, and recommend appropriate modifications to make them more relevant to the needs of different stakeholders including company management, shareholders, regulators, etc;
- Review the existing system with a view to make suggestions for addressing the concerns of the industry with regard to confidentiality of company cost data and cost of compliance;
- Review and, if required, give suggestions for redrafting the existing Cost Accounting Standards in the Indian context in light of international best practices, and to align them with the international cost accounting standards issued by International Federation of Accountants (IFAC).

4.2 The Order of MCA also said that the Group may invite any other expert or representative of any trade or industry association as special invitee and take up such other consultations as may be considered necessary.

4.3 The Group held its first meeting on 25th February 2008 and the second meeting on 14th March 2008 in New Delhi. In these meetings, detailed discussions were held with respect to the terms of reference, need to co-opt experts on the subject, and the methodology to be followed.

4.4 As regards the terms of reference, the Group deliberated upon various key issues with the sole objective of making the scheme more effective for both the internal and external stakeholders. The new mechanism should focus on improving resource management system, promoting enterprise governance in the corporate sector, shift from the existing rule-based to principle-based cost accounting system, aligning with the cost accounting standards and international best practices.

4.5 It was opined that in view of the growing share of services sector in the GDP of the economy and its state of evolution in meeting the societal needs, there is need to extend the existing principles &

practices of cost accounting and cost audit to the services and other non-corporate sectors such as healthcare, education, insurance, financial services, public utilities such as municipalities, electricity, etc. The Expert Group contemplated extending this framework to various Government projects/schemes so as to infuse a sense of efficiency and effective spending of public money. The cost-benefit analysis of each project/scheme is required to be clearly made known to the public at-large through each Ministry/Department's outcome budgets. Therefore, a consensus view emerged that the terms of reference of the Expert Group may not be limited to manufacturing sector only but should also include the service sectors as well.

4.6 The Expert Group noted that the existing framework of Government continuing to prescribe separate cost accounting records for each and every product/industry for maintenance of cost records by the companies runs counter to the present environment of reforms. Rather, the prescription of cost records should be principle based and focused to the entire gamut of corporate sector and not restricted to individual product/industry. For uniformity, this should be linked to the cost accounting standards. Therefore, there is an urgent need to issue Cost Accounting Standards by ICWAI for all areas of costs and these should be designed in alignment with IFRS to move towards globalization. With regard to cost audit report, the Group argued in favour of its simplification.

4.7 The Group was informed that ICWAI has so far issued five Cost Accounting Standards (CAS). The Group was further informed that CASB of ICWAI has adopted modified methodology/framework for the development of Cost Accounting Standards, which is fully aligned with the guidelines issued by the International Federation of Accountants (IFAC) and also with the best-practices followed in various developed/developing countries. The Group noted that all the CAS would be principle based and where necessary, these would be amplified to provide clarity on rule-based approach through the application guidance.

4.8 Referring to section 209(1)(d) of the Companies Act, 1956 which is the backbone of the existing scheme of cost accounting in the corporate sector, the Group noted that as per the Act, the requirement can be divided into three parts, viz. (a) class of companies engaged in production, processing, manufacturing or mining activities; (b) particulars relating to utilization of material or labour or to other items of cost; and (c) cost records that may be prescribed by the Central Government. As per the implementation mechanism adopted by the Government, even if a company is manufacturing multiple products, Government may order maintenance of cost records only for one product and not for the entire company. In such situation, the company would still be forced to maintain cost records for all the products so as to correctly apportion/allocate various common expenses. Further, it is also observed that in case of multi product companies, more than one Cost Accounting Record Rules become applicable to the company. Consequently in such companies, more than one Cost Audit Orders have been issued for different products. At the same time, for a particular industry covered under the scheme, cost audit orders have not been issued for all the companies. This multiple application of CARR to the same company and/or selective coverage of industries/companies for audit have caused complexities, sense of discrimination and high cost of compliance to the companies.

4.9 Therefore, a moot question was made as to why the Cost Accounting Record Rules should be prescribed only for 44 industries. The Group argued in favour of rationalization of the existing scheme so as to ensure its' universal application. The Group also stressed that although the section calls for production, processing, manufacturing or mining activities, keeping in view the emerging economic scenario in future, Government may like to include many companies engaged in such other activities that do not clearly fall under the scope of production, processing, manufacturing or mining activities. For example, companies engaged in providing infrastructure facilities, bio-tech products, construction or real estate development, health services, education services, turnkey services, transportation, public utilities, retail trade, etc.

4.10 Extending further, the Group noted that Government is entering into Free Trade Agreements (FTA) with various countries. To choose products under FTA, we need basic cost data. Similarly, in India, regulatory mechanism is being strengthened for each and every sector. Availability of detailed cost data is a pre-requisite for the effective functioning of any regulator. Today, more than 80% of international trade disputes relate to transfer pricing which in-turn requires cost data to determine the arms' length price. Bench-marking and assessment of competitiveness for different industries requires cost data. Competition Commission has already asked for cost data for many sectors.

4.11 Therefore, the Expert Group emphasized that the application of this section cannot be made restrictive. It was, thus, proposed that the terms of reference of the Expert Group may be extended to all sectors of economy including the services sectors as well, which was duly endorsed by all the members.

4.12 Based on the discussions held, the Expert Group made following initial observations/decisions with regard to the revised strategy/broad framework for the application of sections 209(1)(d) and 233B of the Companies Act, 1956 relating to maintenance of cost records and cost audit in the corporate sector:

a) The entire mechanism of cost accounting and cost audit should change from the existing rule-based to principle-based. Revised mechanism should address issues like deregulation, changing dynamics of economy, regulatory framework, WTO requirements, unfair trade practices, etc. and above all, cost competitiveness of India Inc. and global benchmarking. This should result in value addition to the industry.

b) Section 209 of the Companies Act, 1956 primarily relate to maintenance of books of account by the companies that includes cost records as well. Separate Rules (CARR) prescribing any formats only for cost records or two set of accounting formats are not required. As such, necessary cost data should emanate from the same set of accounting data/records.

c) Companies should be left free to maintain requisite accounting records and to follow relevant method of cost management depending upon their size, scale & type of operations. However, for sake of uniformity, such records should adhere to the generally accepted cost accounting principles and cost accounting standards. CII-TCM Group has also suggested complete adherence by all companies to the cost accounting standards.

d) Since maintenance of cost records is an integral part of the books of account kept by the companies, hence scope of section 209(1)(d) of the Companies Act, 1956 regarding maintenance of cost records may be widened to cover all class of companies, including companies providing services, consultancy, etc. or those engaged in trading activities. For this, the harmonized ITC commodity description and coding system as given the Ministry of Commerce may be followed.

e) The term “class of companies” as included in section 209(1)(d) may be included in section 233B and used for the purpose of coverage of companies for cost audit. For this, the Group may suggest minimum threshold limit based on size of capital base, annual turnover, etc. The concerned Working Group may also examine feasibility of exempting certain specific category of companies such as SME companies, section-25 companies, companies limited by guarantee and associations not for profit, etc. from the ambit of cost audit.

f) Existing Cost Audit Report Rules and the formats prescribed therein may be reviewed. In place, a simple abridged form of cost statement requiring minimum but important disclosures may be prescribed. In addition, guidelines for undertaking detailed cost data analysis may also be suggested for the benefit of company management.

g) Only the abridged cost statement along with the cost auditor's report may be filed with the Government i.e. MCA. In addition, any Government organisation or the Regulators may directly seek such additional cost details from the relevant companies as may be prescribed by them. No part of cost details may be circulated to the shareholders. However, the Working Group may examine the possibility of circulating only the cost auditor's report together with important efficiency parameters and also the suggestions made, if any, to the shareholders.

h) Cost auditors may continue to be appointed by the Board of Directors. However, the existing provision of seeking prior approval of Central Government may be dispensed with.

i) ICWAI should develop all the cost accounting standards at the earliest. These should be fully aligned with GAAP and IFRS. Cost accounting standards already developed by various other countries such as USA, Japan, EU countries, etc. may also be examined.

j) Existing mechanism of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism under MCA-21 has already ensured complete confidentiality of cost details of the companies.

k) The aforesaid suggested changes would, to a large extent, reduce compliance cost to the companies.

l) If the existing provisions in the Companies Act, 1956 do not meet with the aforesaid revised requirements, suitable changes in the Act may also be suggested.

4.13 On the issue of co-opting any other expert or industry representative, CII vide their letter dated 20th February 2008 informed the Group that they have a Total Cost Management (TCM) Division based at Hyderabad to promote cost management in the industry and to spearhead the activities of the TCM division, CII have formed a TCM Working Group, which is represented by the Industry and Cost Management Experts. CII made a request to consider inducting a representative from the CII-TCM Working Group to this Expert Group to contribute to the Group's initiatives from the perspective of cost management. After deliberating upon their request, the Group decided that the CII-TCM Working Group Chairman and CFO & Executive Director, Tata Consultancy Services, Shri S. Mahalingam, shall be the Co-opted Member on the Expert Group and in case of his unavailability, he may nominate any other alternate member from the CII-TCM Working Group to attend & participate in the Expert Group deliberations. Shri Mahalingam later nominated Shri A.N. Raman, Member, CII-TCM Working Group and Consultant – ABC to represent him at this Expert Group. Further, as requested by CII, Shri A.N. Raman was inducted in addition to the existing CII representative on the Expert Group – Mr. P. Murugesan, General Manager (Finance), Maruti Suzuki India Limited.

4.14 Since the task given to the Expert Group required in-depth understanding and expert inputs, and in view of the large volume and complexity of the issues involved, it was decided by the Expert Group to request few industry experts, academicians, professionals, etc. to associate with this task as Co-opted Members/Resource Persons/ Special Invitees, so that with their long association with the industry, expertise on the subject and vast experience, the Group is able to develop relevant cost accounting and cost audit methodologies in the corporate sector so as to enhance its competitiveness and also enable the Government & Regulators to play an effective role. After obtaining their consents, the following experts were co-opted:

1. Shri S.C. Vasudeva, Government nominee on ICWAI. He has been associated with the ICAI for more than 20 years and has long experience as Chairman of the Accounting Standard Board and of the ICAI Task Force on Convergence with IFRS.
2. Dr. M.B. Athreya, Management Adviser. He has been a senior faculty at most of the premier B-schools in India and abroad. (He shared his views only through e-mails)
3. Dr. Asish K. Bhattacharyya, Professor-Finance & Control, Indian Institute of Management, Kolkata.
4. Dr. C.P. Gupta, Professor-Finance, Management Development Institute, Gurgaon.
5. Shri D.K. Sarraf, Director (Finance), Oil & Natural Gas Corporation Limited, New Delhi.
6. Shri P. Thiruvengadam, Senior Director-Management Consultancy Services, Deloitte Touche Tohmatsu India Private Limited, Bangalore.

7. Shri K. Sridharan, Chief Finance Officer, Ashok Leyland Limited, Chennai.

4.15 In order to maintain continuity in the Group and to be fully abreast with its deliberations, it was also decide to co-opt the then sitting Vice President of ICWAI, Shri Kunal Banerjee. Since 22nd July 2008, Shri Banerjee has been elevated as President of ICWAI.

4.16 In addition, following experts were also associated with the Expert Group as Chairman/Members of various Working Groups constituted by the Expert Group; details of these Working Groups are given in the ensuing paragraphs.

1. Shri R. Krishnamoorthy, Member, Central Electricity Regulatory Commission, New Delhi.
2. Shri Pawan Kumar Ruia, Chairman, Ruia Group of companies, Kolkata.
3. Shri J.K. Puri, Former Chief Adviser Cost, Department of Expenditure, Ministry of Finance, New Delhi.
4. Shri V. Kalyanaraman, Past-President, South Asian Federation of Accountants (SAFA), Chennai.
5. Shri A.K. Kapoor, Adviser (Cost), Department of Food & Public Distribution and former-Adviser (Cost), Ministry of Corporate Affairs, New Delhi.
6. Shri K. Narasimha Murthy, Director, IDBI & IFCI, Hyderabad.
7. Shri I.P. Singh, Director (Cost), Defence Research & Development Organisation, New Delhi.
8. Shri S.A. Murali Prasad, Director, SAM Consultancy Services Private Limited, Chennai.
9. Shri D.V. Joshi, Past-President, ICWAI, Pune.
10. Shri A.R. Ramanathan Iyer (since deceased), Former Member, Company Law Board & CERC and leading Cost Consultant, New Delhi.
11. Dr. D. Jagannathan, Former-Principal, Dayal Singh College, New Delhi.

4.17 In order to have detailed deliberations and focused attention on various issues involved in each of its terms of reference and the need to extend the existing principles and practices of cost accounting and cost audit to the services and other social sectors and also to various Government projects/schemes, departmental undertakings, etc., the Expert Group constituted six Working Groups comprising members drawn from government, industry, professional bodies, academicians, experts, etc. It was decided while each Working Group is free to decide its methodology; they should be guided by the broad strategy & framework as discussed by the Expert Group. These Working Groups are as under:

Working Group-I: This Working Group was headed by Shri B.B. Goyal, Adviser (Cost), MCA & Chairman, Expert Group. This Group was assigned the task to hold consultations with various interest-groups and/or persons, both within & outside the Government, as per the revised framework suggested by the Expert Group. Other members of this Working Group were:

1. Shri Chandra Wadhwa, President, ICWAI
2. Shri S.C. Aggrawal, representative of ASSOCHAM
3. Shri A.N. Raman, Member, CII-TCM Working Group
4. Shri S.C. Vasudeva, Government Nominee, ICWAI
5. Dr. C.P. Gupta, Professor-Finance, MDI, Gurgaon
6. Shri K. Sridharan, Chief Finance Officer, Ashok Leyland Limited

Working Group-II: This Working Group was headed by Shri Lalit Bhasin, leading Advocate at Supreme Court of India & Chairman, Corporate Affairs Committee, representing the PHD Chamber of Commerce and Industry and Federation of Indian Chambers of Commerce & Industry in the Expert Group. This Group was assigned the task to review the existing Cost Accounting Record Rules and their continued relevance in the contemporary competitive environment as per the presently prescribed structure/format, and make recommendations for requisite modifications and/or alternative structures. Other members of this Working Group were:

1. Shri Kunal Banerjee, Vice-President, ICWAI
2. Shri D.K. Sarraf, Director (Finance), ONGC
3. Shri A.R. Ramanathan Iyer (since deceased), Cost Consultant
4. Shri I.P. Singh, Director (Cost), Ministry of Defence

Working Group-III: This Working Group was also headed by Shri B.B. Goyal, Adviser (Cost), MCA & Chairman, Expert Group. This Group was assigned the task to review the existing Cost Audit Report Rules and formats prescribed therein, and recommend appropriate modifications to make them more relevant to the needs of different stakeholders including company management, shareholders, regulators, etc. Other members of this Working Group were:

1. Shri Chandra Wadhwa, President, ICWAI
2. Shri A.N. Raman, Member, CII-TCM Working Group
3. Shri K. Sridharan, Chief Finance Officer, Ashok Leyland Limited

4. Shri Pawan Kumar Ruia, Chairman, Ruia Group of Companies
5. Shri K. Narasimha Murthy, Director, IDBI & IFCI
6. Shri S.A. Murali Prasad, Director, SAM Consultancy Services

Working Group-IV: This Working Group was headed by Shri P. Murugesan, General Manager-Finance, Maruti Suzuki India Limited, representing Confederation of Indian Industry (CII) in the Expert Group. This Group was assigned the task to review the existing system with a view to make suggestions for addressing the concerns of the industry with regard to confidentiality of company cost data and cost of compliance. Other members of this Working Group were:

1. Shri Kunal Banerjee, Vice-President, ICWAI
2. Shri Vinod Jain, representative of ICAI
3. Shri A.K. Kapoor, Adviser (Cost), D/o Food & Public Distribution
4. Shri Ravindra Mathur, Director, MCA & Member-Secretary

Working Group-V: This Working Group was headed by Shri M. Gopalakrishnan, Chairman, Cost Accounting Standards Board, ICWAI. This Group was assigned the task to review and, if required, give suggestions for redrafting the existing Cost Accounting Standards in the Indian context in light of international best practices, and to align them with the international accounting standards issued by the International Federation of Accountants (IFAC). Other members of this Working Group were:

1. Shri Vinod Jain, representative of ICAI
2. Shri S.C. Vasudeva, Government Nominee, ICWAI
3. Dr. Asish K. Bhattacharyya, Professor-F & C, IIM, Kolkata
4. Shri P. Thiruvengadam, Senior Director, Deloitte Touche Tohmatsu India Private Limited, Bangalore
5. Shri R. Krishnamoorthy, Member, CERC

Working Group-VI: This Working Group was headed by Shri V. Kalyanaraman, Past-President, SAFA. This Group was assigned the task to review & draft the proposed framework of Cost Accounting and Cost Audit in the Non-Corporate Sector, Public Utilities, Government Projects & other Services, etc. Other members of this Working Group were:

1. Shri S.C. Aggrawal, representative of ASSOCHAM
2. Shri J.K. Puri, Former Chief Adviser Cost, Ministry of Finance
3. Shri D.V. Joshi, Past-President, ICWAI
4. Dr. D. Jagannathan, Former-Principal, Dayal Singh College

4.18 The Expert Group, in association with ICWAI, collected details of cost accounting principles and practices being followed by various developed, developing and neighbouring countries. The countries covered are USA, UK, France, Germany, Canada, Australia, Japan, Korea, China, Pakistan, Sri Lanka and Bangladesh. Lot of information about these country practices has been received from the resource persons. These have been assimilated in the form of a White Paper, which is being separately issued by ICWAI. These country practices have been discussed in a separate chapter of this Report.

4.19 Further, the Expert Group, in association with ICWAI, has also collected all the relevant papers issued by the International Federation of Accountants (IFAC). IFAC has issued an Exposure Draft on *Costing to drive organizational performance*. This exposure draft is likely to be finalized and issued as final document by the end of next month. This paper is found highly relevant to the present exercise of the Expert Group. Details of IFAC papers, as found relevant have also been discussed in a separate chapter of this Report.

4.20 Expert Group has collected relevant details relating to investment in plant & machinery, type of operations, scale of turnover, etc. of nearly three lakh companies who have filed their Annual Reports in MCA-21. This massive data was scrutinized so as to know the number of potentially covered companies for cost accounting and cost audit, under different possible scenarios. Details of this exercise have been given in a separate chapter of this Report.

4.21 The Expert Group examined various representations received by the Ministry of Corporate Affairs from different industry associations and/or sectoral organizations. All these representations relate to scope of sections 209(1)(d) and 233B, cost of compliance, confidentiality of cost data, etc. The Group noted that all these issues are already being addressed. However, details of these representations have been discussed in detail in a separate chapter of this Report.

4.22 As regards holding consultations with various stakeholders, the Group noted that all the sectoral/state level industry associations are members of apex organisations such as, CII, FICCI, ASSOCHAM, etc. who are already represented on the Expert Group. Therefore, no such consultations with any individual industry/trade association were considered necessary. Further, it was decided that the CEOs/CFOs of large public or private sector companies may be consulted to elicit their views on the issues involved. The Group decided to also have consultations with the Regulators, user Ministries/Departments & other organizations; with the select ex-Presidents of ICWAI and other eminent Cost Accountants in-practice or in employment; and also with other eminent experts, academicians, etc. Further, such consultations should, preferably, be held on a pre-designed questionnaire on the relevant issues.

4.23 Accordingly, a Questionnaire on the existing and revised framework of cost accounting and cost audit in the corporate sector initially proposed by the Expert Group was devised. This was circulated to all the stakeholders. Further, in order to ensure clear understanding of the all the related issues, it was also decided to hold personal discussions/consultations in open-house meetings of the Expert Group to be held at select cities in the country. Details of the replies received from various stakeholders and views expressed at the open-house consultations have been given in a separate chapter of this Report.

4.24 Reports of all the Working Groups were received and deliberated upon. Final recommendations of the Expert Group are discussed and summarized in the respective chapters.

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CHAPTER-5: CONSULTATIONS WITH STAKEHOLDERS

5.1 The Order of MCA dated 21st January 2008 said that the Expert Group may invite any other expert or representative of any trade or industry association as special invitee and take up such other consultations as may be considered necessary.

5.2 Expert Group co-opted few industry experts, academicians, professionals, etc. as Members/Resource Persons/Special Invitees, details of which have been given in the previous chapter.

5.3 As regards holding consultations with various stakeholders, the Group decided to do it through a pre-designed questionnaire on the relevant issues. With a view to elicit response from all the stakeholders, it was decided to widely circulate this Questionnaire to all the interest groups such as user ministries/departments, regulators, companies (public, private & co-operative), academicians/experts, management consultants, practicing professionals, all the central council members and past presidents of ICWAI, etc. Further, in order to ensure clear understanding of the all the related issues, it was also decided to hold personal discussions/consultations in open-house meetings of the Expert Group to be held at select cities in the country.

5.4 This job was assigned to Working Group-I headed by the chairman, Shri B.B. Goyal, Adviser (Cost), Ministry of Corporate Affairs. Other members of this Working Group were:

1. Shri Chandra Wadhwa, President, ICWAI
2. Shri S.C. Aggrawal, representative of ASSOCHAM
3. Shri A.N. Raman, Member, CII-TCM Working Group
4. Shri S.C. Vasudeva, Government Nominee, ICWAI
5. Dr. C.P. Gupta, Professor-Finance, MDI, Gurgaon
6. Shri K. Sridharan, Chief Finance Officer, Ashok Leyland Limited

In addition, all other Hon'ble members of the Expert Group also participated in the open-house consultative meetings.

5.5 As decided, Working Group-I devised a detailed Questionnaire on the existing and revised framework of cost accounting and cost audit in the corporate sector initially proposed by the Expert Group, also including therein issues relating to confidentiality of company cost data and cost of compliance, cost accounting standards and the need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors and also to various Government projects/schemes, departmental undertakings, etc. A copy of the questionnaire is placed at Annexure-XI.

5.6 The aforesaid questionnaire was circulated to the following seeking their views on the questions set-out therein:

a. Various user ministries/departments and other government organisations, viz. Ministry of Finance, Department of Expenditure, Central Board of Direct Taxes, Central Board of Excise & Customs, Ministry of Defence, Ministry of Commerce & Industry, Anti-dumping Directorate & DGFT, Tariff Commission, Ministry of Food & Public Distribution, Comptroller & Auditor General of India, Ministry of Health & Family Welfare, etc.

b. All the concerned regulators in the manufacturing and service sectors, viz. TRAI, CERC/DERC, PNGRB, NPPA, FICC, SEBI, RBI, UGC, AICTE, IRDA, CCI, Tea/Coffee Board, etc.

c. CEOs/CFOs of large number of public, private & cooperative sector companies, giving due representation to the manufacturing & service sectors; regions; companies covered as well not-covered under section 209(1)(d) and 233B of the Companies Act, 1956; very large, large & medium size companies; cooperative organisations, etc.

d. Various eminent academicians/experts drawn from IIMs, leading B-schools, universities, colleges, research bodies/organisations, large consultancy firms, etc.

e. All the sitting Central Council Members and past-Presidents of ICWAI;

f. Presidents of other professional bodies, viz. ICAI and ICSI; and

g. Leading practicing cost accountants.

5.7 The Working Group also held a view that simply seeking replies from all concerned on the questionnaire, without any one-to-one consultation, may lack clarity and thus may lead to confusion. Therefore, on the basis of issues listed out in the aforesaid questionnaire, the Working Group decided to hold detailed consultations with various stakeholders. Series of such meetings/consultations were held with important authorities such Comptroller & Auditor General of India, Competition Commission of India, Chief Adviser Cost, Ministry of Finance, NPPA, Anti-dumping Directorate, etc. Further open-house consultations were also held at the following places in the country that were widely participated by representatives of all the interest groups/stakeholders. Entire proceedings of each sitting were recorded.

Date Participated	**Place**	**Nos.**
21.05.2008	Kolkata	27
23.05.2008	New Delhi	56
26.05.2008	Mumbai	15
27.05.2008	Pune	19
02.06.2008	Chennai	40
03.06.2008	Hyderabad	41
04.06.2008	Bangalore	28

5.8 Apart from participation in the open-house consultations, as requested, written responses were received from a large number of stakeholders viz. user ministries/departments, regulators, companies (public, private & cooperative), academicians/experts, management consultants, practicing professionals, central council members and past presidents of ICWAI, etc. In addition, various practicing cost accountants have, on their own, sent their views on the various questions listed out in the EG-Questionnaire. Surprisingly, even though CII and ICWAI are fully represented in the Expert Group with two Members from each of them and have been actively involved in the issue of questionnaire, discussions with various organisations, open-house consultative meetings, still they have also responded to the questionnaire separately. A list of all the respondents is placed at Annexure-XII.

5.9 These responses have been tabulated and analyzed by the Working Group-I. Majority of all the respondents, including various regulators & user departments/agencies (SEBI, CCI, NPPA, FICC, CERC, C&AG, PNGRB, CAC, Tariff Commission, Tea Board, DGAD, etc.); Navratna/Miniratna PSUs (ONGC, IOC, BPCL, HPCL, GAIL, NTPC, NHPC, CIL, NLC, SAIL, RINL, BHEL, BEL, CEL, BEML, MTNL, NALCO, NMDC, NFL, NTC, PGCIL, GACL, etc.); major private sector industrial conglomerates/ companies (Tata, Birla, Reliance, ITC, Mahindra, Bajaj, Jindal, Mallaya, Muthiah, TVS, Maruti Suzuki, Dabur, HUL, Ashok Leyland, Asian Paints, BPL Mobile, Cadila, Finolex, Ford, HML, Kirloskar, Nestle, NDPL, Subros, Sundaram, Swaraj, W.S. Industries, etc.); major industry associations (CII, FICCI, ASSOCHAM, IBA, PHDCCI, CCFI, etc.); IIMs, and ISB, Hyderabad; ICWAI and leading management consultants have broadly agreed with the revised framework as proposed by the Expert Group. Many respondents have made valuable observations/ suggestions that have been duly incorporated at suitable places in the report. There are very few respondents, mostly practicing cost accountants, who have not agreed with the views of the Expert Group; their views have also been suitably incorporated.

5.10 Gist of the responses received, as per the report of the Working Group-I, is as under. This is based on the discussions in open-house meetings held by the Group in select cities in the country and also the written replies received so far.

MAINTENANCE OF COST RECORDS:

a. As regards maintenance of cost records by the corporate sector, there is an over-whelming agreement for shifting the same from existing rule/format-based to principle-based having universal application. It is said that in a rule-based system, lawmakers and regulators try to prescribe in great detail exactly what companies must do and must not do. This system relies on stating specific requirements or prohibiting certain actions by law. Principle-based approach provides more flexibility and opportunities to the companies to be more creative in finding solutions to the unpredictable and complex problems as this system merely states broad objectives and then puts the onus on the companies to meet with the stated objectives. Presently, more nations are moving towards principle-based system from rule-based system. Thus, the respondents have argued that in the present competitive scenario having rapid changes in all dimensions, different needs of the industry can be met only from principle based costing system that would result in its value addition, flexibility and innovations. They have suggested that ICWAI should issue standards with regard to various cost accounting principles. Such standards should be on similar lines as the accounting standards issued by the Institute of Chartered Accountants of India. This would facilitate uniform compliance by all entities. Once the cost accounting principles are well defined through the cost accounting standards, the companies should be allowed to use their own formats instead of those prescribed by the Government. At best, ICWAI may suggest formats for guidance. In addition, to cater to certain industry specific requirements, ICWAI should also issue guidance notes clearly explaining the specific terms/principles for their use/interpretation on uniform basis.

b. On this issue, the ICWAI Council said that the Central Government has been prescribing different "rules" for different products from 1965 onwards despite the fact that cost accounting principles remains same across the products/industries. Prescription of such rules under this methodology has led to prescription of multiple formats for different products/industries resulting in companies maintaining the multiple and non-integrated records. Moreover, all this is done more from the compliance point of view rather than maintaining the same as a part of management information tool and as an aid to management for improving efficiency into the system. With the changes in the business environment, the companies have shifted from a single product to multi product companies present in several business segments and each is usually designated as SBU (Strategic Business Unit). The consolidation of businesses and the need for global integration based on size have given rise to global corporations, which have made the Indian operations as SBUs. The IFRS (International Financial Reporting Standards) also talks about Cost of Sales and Gross Profit reporting, for reportable segment of business. Under this environment, the “made and filled up” approach for cost information by the companies cannot be perceived to be compliant with the objectives of maintenance of cost accounting records, as originally intended by the law makers. Such approach also leads to a dichotomy between the cost information maintained by the Company for internal purposes and that used for legal or statute purposes. Therefore, the existing mechanism can be considered as the rule/format based methodology which has to be consistent with a principle based approach. The existing Rules are based on a prescriptive approach for different types of industries. The principle of arriving at the cost of a product should be the same irrespective of the type of industry. Only the measurement, assignment and reporting mechanism may differ from industry to industry. The cost accounting principles have been in existence for a long time and similar to the financial accounting they have to be structured and codified into cost accounting standards. Therefore, the Council of the ICWAI feels that there should be maintenance of Cost Records on the basis of cost accounting principles having universal application across industries.

c. Those who do not agree to this change argued that the existing Cost Accounting Record Rules (CARRs) are well established and also principle based. Hence, there is no need to change. They suggested maintaining status quo with more number of companies covered for cost audit under the existing CARR or at best prescribing one common CARR for all the manufacturing and service sector industries/ companies.

d. The respondents in majority have agreed to the maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards in place of the existing CARRs. However, statutory rules have a legal & binding force that is necessary for the maintenance of cost records by the corporates. Therefore, it has been suggested that the Government should prescribe maintenance of cost records by all companies based on generally accepted cost accounting principles and cost accounting standards that should be fully synchronized, to the extent possible, with Indian GAAP and also a universal summarized reporting format for all classes of industries/companies. Law should make it mandatory for all companies to follow the cost accounting standards.

e. But a general view is that it should be done in a phased manner. Since the requisite cost accounting standards covering all the elements of cost, as presently included in the CARRs, are not in-place and it is likely to take considerable time, a state of vacuum should not be created for the interregnum period. Therefore, all the existing CARRs that carry almost identical provisions may be replaced with a single combined CARR, covering all companies engaged in the production, processing, manufacturing or mining activities, simply referring to maintenance of requisite cost records based on the generally accepted cost accounting principles and cost accounting standards. In addition, ICWAI should issue simplified format/proformae for preparation and presentation of requisite cost data/information for the benefit of industry & professional fraternity.

f. The ICWAI Council has also said that the existing cost accounting record rules should not be repealed till the appropriate and relevant principle based cost accounting standards and guidelines are in place. The ICWAI Council would take on the responsibility of providing standards and guidelines for treatment of different items of costs and a general guideline for cost determination in view of the above suggestion. The CARR can be suitably modified to be applicable to all companies engaged in production, processing, manufacturing or mining activities instead of prescribing industry wise cost records on an arbitrary basis. Considering the fact that “class of companies” should not restrict itself to a particular product/industry, there is an urgent need to introduce rules having a universal application. This can only be achieved if the maintenance of cost accounting records is prescribed to be maintained in accordance with generally accepted cost accounting principles and cost accounting standards.

g. Another school of thought argues that there being diversity and design of product, cost statements must be industry specific e.g. cost statements for Engineering, Chemicals, Electricity, Petroleum and service sector cannot have uniformity. There must be mandatory prescription for “Product/Industry specific” formats of cost statements, which may be issued by ICWAI with the statutory backing under the Companies Act like Accounting Standards Board under section 211. There is a dichotomy in understanding of the existing provisions by the Government as well as of the entire professional fraternity. While on the one hand, separate industry/product specific Cost Accounting Record Rules including the formats/proformae have been prescribed, on the other, there are only one combined Cost Audit Report Rules incorporating one single set of common formats/proformae for presentation of same cost data/information and these common formats/proformae are applicable to all companies (covered by cost audit) across industries. Therefore, it is not true that separate rules and/or formats are needed for each industry/product. However, certain regulated industries such as electricity, telecommunications, petroleum & natural gas, etc. may require separate guidelines suiting to the requirements of their regulators. The Group is of the view that such guidelines should be issued by the apex-body i.e. ICWAI in consultation with the concerned regulatory body and industry association.

h. It is also a general consensus among all the respondents that all companies should maintain cost records as an integral part of books of accounts. Further, the respondents reaffirmed the Expert Group's view that in a highly competitive environment, it is the management's prerogative to choose appropriate cost management methodology. Since maintenance of cost records and the cost data/information, through the determination and allocation of costs to various products/services, provides a valuable service to the managements of companies in cost analysis, control and decision making and in this way, it helps to improve efficiency in the use of materials, labour and other resources, optimize production and realize greater profits. In addition, the cost records serve as an important tool in the hands of regulators and other Government departments/agencies to protect the interest of consumers and investors and the society as a whole and to protect the industry from unfair trade practices (like anti-dumping, subsidies & counter-veiling measure, cartels, etc.) under WTO environment. Therefore, all companies, without any exception, should maintain cost records as an integral part of books of account. However, companies should choose appropriate method of cost management depending upon their type of operations and the business model.

i. With regard to the maintenance of cost records, ICWAI Council has opined that in line with the existing provisions, all companies having investment in fixed assets up to Rs.5 crore or turnover up to Rs.10 crore should be exempted from the provisions of section 209(1)(d) of the Companies Act, 1956. However, the CII in their reply has said that small and medium sized companies should be exempted from maintaining the cost accounting records as an integral part of books of account and exemption should be based on a specified turnover, say companies whose turnover is less than Rs.50 crore.

j. Cost records to be kept as an *integral part* of the books of account should not be construed asking companies to necessarily maintain *integrated* books of account. This is only meant to explain that the basic record of incomes or expenses is same in any business environment. However, it is the final flow of summarized results for a period or as on a date that are generated from these basic records for the purpose of preparing financial statements such as balance sheet, profit & loss account, cash/fund flow statement, etc. and as well as for preparing cost statements such as cost of production/service or cost of sales, margin, etc. These basic records are also put to use by the internal & external stakeholders for monitoring, analysis, performance evaluation and decision making. Therefore, while the freedom to follow integrated accounting system should exist with the company itself; but for ensuring uniformity & consistency, the records should adhere to the generally accepted cost accounting principles and the cost accounting standards issued or to be issued by ICWAI; provide necessary data required to be furnished under the Cost Audit Report Rules; and should be capable of satisfying the requirements of regulatory bodies and other Government departments/agencies.

k. Section 209(1)(d) of the Companies Act, 1956 states that in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particular in the books of account. Since the proposal of the Expert Group to extend principle based maintenance of cost records as an integral part of books of account to all companies has been widely welcomed, it cannot be done without amending the existing legal provisions in the Act. Hence, a suggestion is made that in the first phase, it should be extended to all companies (excluding the exempted ones) engaged in the production, processing, manufacturing or mining activities. Later, after the Act is suitably amended, the same can be extended to the remaining class of companies.

l. Further, it has been generally agreed that the above mechanism of moving away from rule/format based to principle based maintenance of cost data/records will provide due flexibility to the companies and reduce compliance cost.

Maintenance of cost data/records as part of books of account never entails any additional cost. Maintaining integrated accounting records under ERP system and compilation of cost statements in computerized accounting environment does not involve any major cost. In fact, it is their view that compliance is more important than the cost. In this regard, a view emerged that since cost data is very much needed for internal purposes also, cost of compliance per se is not relevant. Thus, most of the companies are of the view that more than the compliance cost, it is the flexibility which would benefit them the most. Prescription based methods involve more costs, and hence the majority of respondents have favoured principle based accounting mechanism as the resultant benefits in terms of due flexibility and reduced compliance cost are possible only under the proposed principle based accounting.

AUDIT OF COST RECORDS:

a. As regards cost audit, majority of respondents have general agreement with the revised structure broadly proposed by the Expert Group. Their specific views have been duly incorporated in the respective paras.

b. As regards fixing a threshold limit for exemption from cost audit, there are divergent opinions. For example, the suggested limits based on annual turnover varies from Rs.10 crore to Rs.250 crore; size of paid-up capital or net worth or investment in fixed assets varies from Rs.5 crore to Rs.50 crore; and level of public participation (including through Banks/FIs/MFs) in share capital as well as loans varies from 10% to 50%. In general, majority respondents have favoured an exemption limit comprising Rs.5-10 crore investment in fixed assets and/or Rs.25-50 crore annual turnover. No such exemption to be granted to the listed companies. While a few have suggested retaining the existing limits or as fixed for SSI units under the Industrial (Development & Regulations) Act, 1951; others have suggested no exemption for any size/scale of companies i.e. making it mandatory for all companies. A few have even suggested fixing industry-wise specific exemption norms. Generally speaking, fixing multiple criteria has not found favour among all types of respondents.

c. In particular, SEBI has favoured exemption based on paid-up capital or net worth for unlisted companies and no exemption for the listed ones. Tea Board has argued for no exemption to any tea company. Other user organisations have either argued for no exemption or to only SSI units as per Industrial (Development & Regulation) Act, 1951. Without specifying any limits, CII has said that the exemption should be based on a combination of aforesaid factors. ICWAI in their reply has said that all such companies coming under the purview of cost accounting records but having investment in fixed assets up to Rs.10 crore or turnover up to Rs.50 crore should be exempted from the provisions of cost audit.

d. The respondents have widely welcomed the suggestion regarding e-filing a combined cost audit report with the Government (i.e. MCA) containing only a simple abridged cost statement and the respective regulators to be left free to directly seek such additional cost details from the relevant companies as may be prescribed by them. Only abridged statement containing product group-wise cost statements along with cost auditor's report should be filed with the Government. This will avoid filing information which is of less utility. This will also remove apprehensions regarding confidentiality of cost data. The abridged cost statement may be standardized so that uniformity is maintained across various companies/products/ services. The revised structure should do away with providing detailed cost statements of individual products since the same compromises the confidentiality and competitive edge of individual companies. The cost statement in the report should be limited to disclosure of broad elements of cost for a family of products duly reconciled with the financial books. It is suggested that the cost audit report to be submitted to the Government should certify that the systems are as per generally accepted cost accounting principles and should contain material changes in the system, abnormal/non-recurring costs and also the audit observations with respect to the cost and productivity. There should be e-filling of Form-I, cost auditors' certificate and cost sheet. There should not be e-filling of para 1 to 28. The present e-form should be modified suitably to allow filing of one report for a company instead of filing it unit-wise and product-wise. A three tier system has been suggested viz. (i) a short report giving assurance to the stakeholders that organization has satisfactory Cost Management practices, (ii) a more detailed report may be sent to Government, and (iii) a very exhaustive report could be given to the company.

e. On the issue relating to review of the existing structure of cost audit report and e-filing with the government, the ICWAI Council in their reply has said that a complete revised structure of the cost audit report addressing the key concepts of Cost Competitiveness, Corporate Governance, efficient resource management, investor protection, consumer protection, tariff and price fixation and regulatory issues has to be made. The revised structure is necessary in view of the following issues:

  a) Redefining “class of companies” and moving away from the product/industry concept of applicability of cost records to making cost records applicable to all companies engaged in production, processing, manufacturing or mining activities. This would necessitate restructuring the cost audit report for submission to authorities (Central Government) so that a company engaged in manufacturing diversified products as well as service is not required to submit multiple cost audit reports.

  b) Considering preparation of separate report structures for submission to the Central Government (abridged form) and a detailed report for submission to the company.

f. The Council further said that in view of the fact that a large number of companies are engaged in manufacturing/processing of diversified products, the report structure should be such that the report for submission to the Central Government through e-filing should provide summary cost statement of a family of products/segments along with key performance indicators. The cost statement in the report should be limited to disclosure of broad elements of cost for a family of products duly reconciled with the financial books. The summary should be prepared only after the detailed cost accounting records are prepared. A detailed report with product-wise and unit-wise details should be submitted to the Company certified by the cost auditor. An abridged certified report should be filed with the Central Government. The present e-form should be modified suitably to allow filing of one report for a company instead of filing it unit-wise and product-wise. Provision should be made in the form to enable multiple segments to be reported separately and a consolidated reconciliation format.

g. As far as the issue relating to regulators & other Government agencies seeking additional information from the companies is concerned, respondents have given various suggestions. Government and regulators have powers to call for any type of information required to discharge their functions directly from the companies. Therefore, MCA should only seek simple abridged cost statement and the regulators may be left free to directly seek such additional cost details as may be required by them. The regulators should ask only the relevant data/information and ensure complete confidentiality of the sensitive cost details. Additional disclosures required by a regulatory authority should be based on legal/quasi legal requirement where they have a role in guiding the relevant industry like fixing tariffs, prices etc. It has also been suggested that the Financial Institutions/Banks/SFCs may be empowered to seek requisite cost audit data/records to protect the public money invested.

h. Regarding appointment of cost auditors, there seem to be no consensus among the respondents. Cutting across the type of respondent, there is almost equal voting in favour of all the three modes of appointment viz. retaining the existing arrangement; appointment by the Board of Directors without any Central Government approval; and appointment by shareholders in the AGM like statutory auditors. Among the companies and regulators, about 50% have voted for appointment by the Board of Directors without any Central Government approval; about 35% have favoured appointment by shareholders in the AGM like statutory auditors; and balance 15% are in favour of retaining the existing arrangement. Among the practicing cost accountants, while 50% have demanded appointment by shareholders, about 30% favoured existing arrangement and balance desired appointment by BOD. Suggestions have been made that the Board of Directors may appoint the cost auditor and report the same in the Directors' Report to the shareholders or report to the Central Government. Few have also suggested appointment by the Government or the MCA out of a panel maintained for this purpose, like appointment of statutory auditors by the C&AG in Government companies. It has also been suggested that in order to ensure transparency, efficiency, and credibility of the systems followed by the company and also to ensure better compliance, companies should be encouraged to rotate the cost auditor after every 3-5 years.

i. Among the important ones in favour of appointment of cost auditors by the shareholders in AGM, SEBI has said that the shareholders are the real owners of a company and they should be given right to appoint cost auditors as cost audit would be useful to them in making performance analysis, inter-firm comparison, etc. Therefore, SEBI recommended that shareholders in AGM should appoint the cost auditors and the existing provision of seeking prior approval of Central Government may be dispensed with. CCI opined that the Board of Directors may appoint cost auditors with the consent of shareholders in AGM. CERC also said that cost auditors should be appointed by the shareholders in AGM. ICSI and Chief Adviser Cost have also favoured this view. Contrary to this, the

CII has said that the Board of Directors can appoint the cost auditor without any approval of the Central Government.

j. ICWAI Council is of the view that the cost auditor should be appointed in the AGM. As part of good corporate governance practice, data should be shared with the shareholders. World over the Corporate Governance is getting transformed into Enterprise Governance and sharing of performance efficiency information with the shareholders is a part of the transformation. The financial statements, which are now submitted to the shareholders, combine all types of income and expenses whether related to the business or not into a single statement camouflaging the real performance of the corporate. The real long term accretion to the shareholder wealth can only be through normal business profits and not once in a while non operational income. Since the cost statements exclude all such non cost items the summary cost information product segment wise will be a major revealing factor helping corporate governance.

k. As regards granting any special powers either to minority shareholders or to the secured creditors seeking special audit of cost records of the company, even though few respondents have answered in affirmation and have also suggested fixing particular limits, majority have not agreed to grant of any such special powers to them as they feel that sufficient provisions already exist in the Companies Act, 1956 to safeguard the interests of minority shareholders and/or the secured creditors. Contrary to the majority view, SEBI has said that under certain special circumstances 10% shareholders and the secured creditors may be vested with the power to get cost records audited. Such special circumstances should be spelled out clearly to avoid subjective interpretation and misuse of such power. Few companies have also subscribed to this view. Similarly, it has also been argued that Financial Institutions/Banks/SFCs may be empowered to seek a special audit of the cost records to protect the public money invested.

l. Similarly, there is no agreement on sharing any part of cost management trends/information/data with the shareholders. While many respondents have said "YES" in reply to the question, a few others have either said "NO" or offered different views. On this issue, CII has said that the cost management trends may form part of the "Management Discussion & Analysis" part of the Annual Report as currently also done by many companies. The ICWAI Council has said that as part of good corporate governance practice, data should be shared with the shareholders. However the data once shared, becomes public information and cost data is sensitive in the competitive environment and therefore, it is proposed that key-performance indicators may be shared with the shareholders in the Annual Report. SEBI said that the possibility of circulation of cost auditor's report along with important efficiency parameters and also the suggestions made to the shareholders may be explored. Among the suggestions received from other respondents are:

- As part of good corporate governance, circulation of selected cost information also as part of the management analysis section of the annual report.
- Shareholders have the right to know about cost management trends as cost has direct link with profitability and shareholders' value.
- Limited report containing key performance indicators, risk assessment, mitigation, fuel/energy efficiencies, R&D expenditure and arm's length pricing of product may be circulated to the shareholders.
- Management observations on cost audit reports may form part of discussion of Director's report or requisite cost data may be attached as annexure to the director's report.
- As per the current report, para 4, 18, 19, 22 & 24 may be provided to the shareholders.
- The cost audit report may be appended to the annual report and circulated to the shareholders.
- Shareholders can be informed of the trends or factors like external economic conditions and internal efficiency.
- Concise, meaningful and abridged statement may be presented to the shareholders.
- Only comparison from previous years may be circulated in percentage terms without any absolute figure.
- Steps taken by the company towards better cost management may be mentioned to the shareholders.
- As a part of management discussion and analysis given in Annual Reports, the company should be encouraged to comment on the cost trends/pressure on margins and any abnormalities in cost incidence.
- May be considered as this will facilitate the shareholders to have knowledge of the cost and pricing policy of the organisation.

- Circulation of cost management trends may be recommendatory but should not be mandatory.
- A suitable annexure to the Director's Report can be introduced in the printed balance sheet which will give the broad consumption and efficiency parameters. This type of information will replace the particulars of conservation of energy given in the balance sheet. Alternatively, a separate annexure may be attached to the profit & loss account as an integral part which will give all the particulars duly verified by the cost auditor.
- Summarized cost audit report with disclosures and suggestions of cost auditor should be circulated. It is not necessary to circulate the cost records details.
- Broad details containing cost auditor's report together with important efficiency parameters may be circulated.
- Companies should have discretion on information to be shared with the shareholders since cost date is sensitive in the competitive environment.
- Shareholders are concerned with the profitability of the company and not the internal details like cost. Moreover, it can hamper the secrecy of sensitive information.
- No part of the cost details should be circulated to shareholders as this will result in shift of management perspective from control to compliance.

m. Regarding periodicity of cost audit, majority opinion (including by CII) is in favour of annual audit only. Few companies and regulators have suggested half-yearly or quarterly audit or limited review may be in case of listed companies. Few have suggested that initially this may be left to the discretion of company management. There is another suggestion to recommend quarterly internal audit of cost records.

n. On this issue, SEBI has said that in case of listed companies, it may be quarterly linked with the corporate governance and segmental reporting in line with requirement of quarterly reporting of financial results and in case of unlisted companies, it may be yearly. The ICWAI Council in their reply has said that the real assessment of the improvement in performance or otherwise can be judged only when there is a trend analysis over the quarterly reporting system is done. This will also be a fair disclosure of performance of different segments of the company over the period and enable comparison of one segment against the other. While the annual review will only have a compliance focus, the quarterly limited review will have a performance management focus. The inefficiencies disclosed by such limited review may be more useful to the company for cost control and cost reduction. However, Cost Audit should be conducted annually irrespective of whether it is a listed company or not. A limited review of key parameters that appear in the cost audit report should be considered by the Audit Committee on a quarterly basis for listed companies.

o. There is complete agreement among all the respondents that the above mechanism would provide complete confidentiality and fuller utility of sensitive cost data. In fact, it has been said that the Government should not give any importance to the urge for confidentiality countering the stand of transparency and disclosure.

COST ACCOUNTING STANDARDS:

a. Almost all the respondents have agreed that for ensuring a complete shift from the existing rule-based to principle-based cost accounting & audit mechanism and also for the sake of uniformity in preparing accepted cost statements under WTO and other Statutes, there is an urgent need for the country to have Cost Accounting Standards (CAS) based on generally accepted cost accounting principles. It is their view that without having detailed CAS, maintaining uniformity and consistency in cost accounting practices may not be possible. However, till such time all CAS are in place based on GACAP, a new set of generally accepted cost accounting principles have to be laid down. Few have also suggested issue of cost accounting standards even if the existing system of rule based records to continue. In other words, CAS may be complimentary to the rules and not necessarily substitution to the rules, as CAS cannot replace CARR.

b. Therefore, the Expert Group proposal that all companies should be asked to comply with such cost accounting standards have found favourable response from almost all the respondents. However, adequate time to be given to the companies to comply with such accounting standards. In addition, they have suggested that ICWAI should issue industry specific guidance notes on cost accounting methodologies. Besides companies, the respondents have also suggested that all forms of organisations or commercial entities, except those exempted from the purview of cost audit, should comply with such cost accounting standards. For exempted companies, compliance of CAS may be optional. Any deviations to CAS should be disclosed in the cost accounting policies.

c. Similarly, the suggestion that ICWAI should assign topmost priority for issue of cost accounting standards in consultation with all stakeholders has also been agreed to. In fact it has been said that ICWAI should begin this exercise immediately, in anticipation of the Expert Group Report and without waiting for formal announcement of Government policy on the subject. Hence, ICWAI should follow a time-bound programme to issue CAS for all sectors of the economy. It has been clearly said that the ICWAI should issue CAS only after ascertaining the views & in consultation with the companies, industry associations, other recognized accounting bodies such as ICAI, etc. and should also follow overall global standards. However, a few have suggested setting-up of an independent body/board for this purpose. It has been further suggested that issue of cost accounting standards may be made by amendment of the section 210A of the Companies Act, 1956 and NACAS should be renamed as National Advisory Committee on Accounting and Cost Accounting Standards or an independent legislative established Board similar to the CASB constituted by the US Federal Government.

d. To a proposal made by the Expert Group that all the cost accounting standards should be aligned with the cost accounting standards issued by other developed countries, international best practices, IFRS, and other IFAC guidelines, almost all the respondents have answered in affirmation. In addition, it has been suggested that while in the era of globalization, convergence is very much required, but the proposed cost accounting standards should not be in conflict with the existing financial accounting standards, generally accepted accounting practices (GAPP) followed in India and the provisions of the Companies Act, 1956. In other words, international standards and guidelines may only be taken as a reference to frame CAS, but largely these should align with only such guidelines that are adopted by Indian GAAP. Few respondents have cautioned that with regard to the common aspects, there should not be any conflict between the Cost Accounting Standards and the Financial Accounting Standards.

e. On these issues, the CII has said that there is need for cost accounting standards based on generally accepted cost accounting principles and except for the exempted companies, maintenance of cost records should be based on cost accounting standards that are developed by ICWAI through an industry-wise consultative process. ICWAI Council said that there is definitely an urgent need to have cost accounting standards. With the entire world of accounting moving towards convergence, the preparation of cost statements on uniform basis based on cost accounting standards will stand the scrutiny of WTO and other statutes and also emerge as a key dispute resolution mechanism in the international arena also. Keeping in view the dynamics of the emerging business environment, the Cost Accounting Standards Board of the Institute has come out with a revised framework of cost accounting standards. All companies should be asked to comply with such cost accounting standards. It will help the companies in compiling their costs in a more structured manner and thereby helping them in achieving cost efficiencies. A mechanism should be devised to make the cost accounting standards mandatory for all costing or pricing statements through legal dispensation in the similar lines of National Advisory Committee on Accounting Standards (NACAS). The Council of the ICWAI has already accorded top-most priority to this issue.

OTHER RELATED SECTORS:

a. There is general consensus among all the respondents that cost consciousness is important in all sectors of economy and even more important in non-competitive public services. These sectors, being consumers of public money, have to emerge stronger along with the growth of economy and therefore, their health is very important. It is an urgent need to improve productivity, build competence and reduce wastages & inefficiencies in utilisation of scarce national resources in these sectors in order to make available public services at reasonable cost. There is, thus, a clear need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors such as healthcare, education, banking, insurance, financial services, transportation, information technology, public utilities & essential services such as municipalities, electricity, water supply, city transport, etc. and also to various Government projects/schemes, departmental undertakings, such as ordnance factories, railway locomotive/coaches manufacturing units, etc. All Government contracts and procurements should be covered forthwith. This would result in greater accountability of government expenditure. This would also improve transparency and uniformity across sectors. However, a few have suggested exempting sensitive sectors like defence, atomic energy, etc. from the ambit of cost audit. It has been further suggested that as such organisations are beyond the purview of the Companies Act, separate legislation/notification may be required to extend the principles & practices of cost accounting and cost audit to the services and other social sectors. In view of severe dearth of knowledgeable and qualified experts, this may be done over a period of time in a phased manner. Views of relevant segments may also be obtained. It has been suggested that the C&AG should comment on the adoption of proposed cost standards and rules by the public entities to protect the interests of people who are really the stakeholders in the economy. It may be noted that the Indian Banks Association has disagreed with the extension of such mechanism to the banking sector.

b. Similarly, everybody has agreed that all Government/public agencies should determine user charges for utilities and services based on most efficient costs. These must be produced or generated in a cost effective manner avoiding wastage of scarce national resources. There should be some correlation between fees charged and cost incurred for which they should be brought under the ambit of cost accounting principles and cost audit. There is need to move towards user cost based pricing. Subsidies meant for the poor may be decided after being fully aware of the opportunity cost, social factors and the shadow price. Even where cross-subsidization is necessary, it should be transparent and made known to the public at large.

c. On these issues, CII has said that the cost accounting and cost audit framework must be extended to various government projects wherein the public spending is involved; all public service organisations should determine user charges based on most efficient cost; and the objectives of extending the cost accounting and cost audit framework to the services and other social sectors need to be debated first and then carefully decided. ICWAI Council has said that the service sectors and other social sectors play a huge role in the national economy. Cost is a reality and all such public utilities and other services should be provided in a cost effective manner. This can come about only if these sectors are also mandatorily required to maintain structured cost accounting systems. Hence, for the overall interest of the economy, principles and practices of cost accounting and cost audit should be extended to all these sectors. This framework should be extended to various State and Central Government projects/schemes and undertakings, local bodies, government corporations, departmental undertakings, etc. so as to infuse a sense of efficiency and effective spending of public money. The public service organisations should determine user charges based on most efficient cost.

d. The ICWAI Council has further said that the importance of the service sector can be measured by the fact that service sector contributes to 56% of the GDP as compared to a contribution of 25% by the Manufacturing sector and 19% by the Agricultural sector. This shows that only one fourth of the national economy engaged in manufacturing activities would be required to maintain cost accounting records as per the existing provisions of section 209(1)(d) provided applicability of such records is extended to the entire manufacturing and mining sector. The export of services is also increasing in the globalization era. As per the Draft Regulation 2(1)(f) of CCI (determination of Cost of Production) Regulations, the definition of product includes both goods and services. This also indicates that the service sector is getting more and more importance and contributing towards the growth of the GDP. Further, the infrastructure sector which includes roads, seaports, airports, railways, telecom, power projects, industrial parks, urban infrastructure, exploration, refining, mining, etc. is the backbone of the growth of any country. It is expected that the country needs about US$400 billion to create the required development of the infrastructure sector. Under BOT Agreement, the users of such services are required to pay a fee in the form of toll tax which is based on the project cost. In addition, there is an acute shortage of houses in India and the new houses are being constructed under private public partnership. It is therefore felt that infrastructure sector needs to be included under the provisions of section 209(1)(d) of the Companies Act, 1956.

5.11 The Expert Group has noted the replies received, deliberated upon the observations/suggestions made by various respondents and has accordingly finalized its recommendations.

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CHAPTER-6: CORPORATE STRUCTURE & COMPETITIVENESS OF INDIA INC.

Corporate Structure of India Inc.

6.1 Every year, Ministry of Corporate Affairs presents before the Parliament an Annual Report on the working & administration of the Companies Act, 1956. Last such report relate to the year ended 31st March, 2007. Details given in this chapter are mainly based on the data/information contained in this report and Annual Report of MCA.

6.2 There were in all 7,50,354 companies at work as on 31st March, 2007, as summarized in the Table below. Out of this, the number of companies with liability limited by shares were 7,43,678 i.e. 99.1% of the total number of companies. As per available information, total number of registered companies in India was 8,78,777 as on 31st January, 2008. Going by this trend, their number might have crossed 9 lakh by the time of submission of this Report.

Table No. 6.1

Sno.	Type of Company	No. of Companies
I	Companies Limited by Shares	
	(a) Government Companies-Public Limited	1,098
	(b) Government Companies-Private Limited	571
	(c) Non-Govt. Companies-Public Limited	89,556
	(d) Non-Govt. Companies-Private Limited	6,52,453
	Sub-Total (I)	**7,43,678**
II	Companies with Unlimited Liability	520
III	Companies limited by Guarantee and Associations not for profit	3,846
IV	Foreign Companies (as defined under section 591 of the Companies Act)	2,310
	Grand Total	**7,50,354**

6.3 The number of companies with liability limited by shares registered during the last five years from 2002-03 to 2006-07 is given in Table below. This shows that every year, the number of companies is growing by a growing percentage.

Table No. 6.2

Year	No. of Companies		Authorised Capital (Rs. Crore)
	Numbers	**Increase**	**Amount**
2002-03	24,051	14.2%	5,602.76
2003-04	30,076	25.1%	17,143.49
2004-05	40,059	33.2%	11,476.97
2005-06	54,020	34.9%	19,582.21
2006-07	51,708	-4.3%	72,510.90

6.4 From the data in this table, it may be seen that while the total number of companies registered during 2006-07 declined by 4.3%, but their size of capital base was almost 4 times to that of those registered during the preceding year. This means, the tendency is towards large size companies being incorporated in the Indian economic plateau that function more like global multi-nationals.

6.5 Table below gives the data on growth of the corporate sector by showing the total companies with liability limited by shares at work during the operation of the Companies Act, 1956. It may be observed that while their number has grown by almost 25 times during this period, their scale of authorised capital has grown by more than 600 times, indicating tremendous growth in the average size of each company.

Table No. 6.3

Year	No. of Companies		Authorised Capital	
	Numbers	**Increase**	**Amount (Rs. Crore)**	**Increase**
1957	29,357		1,077.6	
1960	26,897	-8.4%	1,618.7	50.2%
1965	26,221	-2.5%	2,842.8	75.6%
1970	29,009	10.6%	4,090.5	43.9%
1975	40,580	39.9%	8,200.8	100.5%
1980	56,493	39.2%	14,606.6	78.1%
1985	1,09,309	93.5%	30,596.7	109.5%
1990	2,02,128	84.9%	64,643.4	111.3%
1995	3,53,292	74.8%	1,36,018.7	110.4%

Year	No. of Companies		Authorised Capital	
	Numbers	Increase	Amount (Rs. Crore)	Increase
2000	5,42,434	53.5%	3,18,810.3	134.4%
2005	6,79,649	25.3%	6,54,021.6	105.1%
2006	7,32,169	7.7%	6,19,152*	NA
2007	7,43,678	1.6%	6,49,490**	NA

*For 4,80,006 number of companies as compiled from MCA21.

**For 4,86,059 number of companies as compiled from MCA21.

6.6 In terms of state-wise distribution, there appears highly skewed presentation with top 10 states having 89% of the total number of companies with liability limited by shares at work as on 31-03-2007. These ten states are Maharashtra (1,67,059), Delhi (1,39,976), West Bengal (91,103), Tamil Nadu (59,553), Andhra Pradesh (50,010), Gujarat (49,279), Karnataka (38,590), Uttar Pradesh (26,410), Rajasthan (21,453), and Kerala (17,593).

6.7 In terms of industrial activity, distribution of companies with liability limited by shares registered as on 31st March, 2006 is as under:

Table No. 6.4

Sno.	Industrial Classification	Public	Private	Total
1	Agriculture & Allied Activities	3871	16068	19939
2	Mining & Quarrying	734	6842	7576
3	Manufacturing	23371	172848	196219
4	Electricity, Gas & Water Companies	907	2987	3894
4	Construction	2990	42965	45955
5	Trade, Hotels and Restaurants	6247	89120	95367
6	Transport, Storage & Communication	1457	21034	22419
7	Finance, Insurance, Real Estate & Business Services	22444	159687	182131
8	Community, Personal & Social Services	3065	30278	33343
10	Unclassified	25568	111195	136763
	Total	**90654**	**653024**	**743678**

6.8 As per the details given above, total number of registered companies, as on 31st March 2007, with liability limited by shares and engaged in manufacturing, mining & quarrying, and electricity, gas & water activities were 2,07,689. In addition, large number of companies appeared in other categories of industrial classification (including the newly formed “unclassified” category) that are covered by provisions of section 209(1)(d) of the Companies Act, 1956. With the increase in total number of registered companies to more than 9 lakh by the time of submission of this report, it is estimated that the companies engaged in manufacturing, mining & quarrying and other related activities may be around 4 lakh. Since the mortality rate in manufacturing sector is comparatively low, still not more than 75% companies are expected to be operational as on date. An estimated analysis of these companies based on investment in fixed assets and annual turnover indicate that while only 2% companies may have investment in fixed assets of more than Rs. 10 crore, in terms of turnover of more than Rs. 50 crore, their percentage may go up to 3%.

6.9 The statutory documents filed by companies may be broadly classified under three categories viz. (i) Annual Returns under sections 159 and 160; (ii) Balance Sheets and Profit & Loss Accounts under section 220; and (iii) other documents. In all, 16,25,717 documents were filed by the companies with the Registrars of Companies during the year 2006-07. The number of documents filed during the last three years are given below:

Table No. 6.5

Nature of Document	**2004-05**	**2005-06**	**2006-07**
Annual Returns	3,32,896	3,16,520	3,13,689
Balance Sheets and Profit & Loss Account	3,39,932	3,17,326	3,17,778
Other (Misc.)	8,07,117	9,67,369	9,94,250
Total	**14,79,945**	**16,01,215**	**16,25,717**

6.10 During the period 2002-03 to 2006-07, resources raised through equity issues increased considerably from Rs.1,257 crore in 2002-03 to Rs.27,622 crore in 2006-07. Similarly, total amount raised in debt issues, taking both public issues plus private placements put together, went up steeply from Rs.69,561 crore in 2002-03 to Rs.1,45,571 crore in 2006-07. Resources raised by corporate sector during the last five years are given below:

Table No. 6.6

(Rs. Crore)

Year	**Equity**	**Debt**	**Total**
2002-03	1,257	69,561	70,816
2003-04	18,948	68,225	87,172
2004-05	24,388	87,272	1,11,660
2005-06	27,382	96,473	1,23,750
2006-07	27,622	1,45,571	1,73,193

6.11 As per Chapter-VIII of the 51st Annual Report on the Working & Administration of the Companies Act, 1956 for the year ended 31st March 2007, corporate sector today is one of the major driving forces of economic development of the country. The growing importance of corporate sector demands greater transparency and availability of corporate data in terms of comprehensiveness, reliability and timeliness. The corporate sector is studied for various aspects like its size and composition, growth & restructuring and financial performance focusing on capital structure, profitability measures and debt repayment capacity to ascertain financial vulnerability of Indian companies. Further, the growth potential of a country is measured through the estimates of gross domestic saving and investment. The estimates of Gross Domestic Savings (GDS) for the Indian economy is compiled for three major institutional sectors viz., public sector, private corporate and household sector, wherein the contribution of private corporate sector was 15 to 17 percent during the tenth plan period.

6.12 As per this Report, Ministry of Corporate Affairs has launched a major drive on the data management (e-filed through MCA21), mining and its value exploitation by way of introduction of value added series. As an initial step, the paid-up capital, one of the important and extensively used population parameter of the sector, has been compiled for 4,86,059 companies, aggregating to Rs.6,49,490 crore as on 31st March 2007; sector-wise details are given in table below:

Table No. 6.7

Sl. No.	**Industrial Classification**	**No. of Companies (Numbers)**	**Paid-up Capital (Rs. Crore)**
1	Agriculture & Allied Activities	12,134	10,399
2	Mining & Quarrying	5,009	18,864
3	Manufacturing	1,35,741	2,09,296

Sl. No.	Industrial Classification	No. of Companies (Numbers)	Paid-up Capital (Rs. Crore)
4	Electricity, Gas & Water Companies	2,621	57,763
4	Construction	31,138	40,846
5	Trade, Hotels and Restaurants	71,784	36,257
6	Transport, Storage & Communication	16,041	21,783
7	Finance, Insurance, Real Estate & Business Services	1,23,995	1,06,131
8	Community, Personal & Social Services	24,169	39,844
10	Unclassified	63,427	1,08,307
	Total	**4,86,059**	**6,49,490**

Global Outlook for Cost Competitiveness

6.13 A nation's competitiveness is the sum up of individual firm's competitiveness. In the context of a sustainable competitive infrastructure which a nation builds, the result is nothing but enduring competitiveness of the nation in the entire globe. The Accounting literature framework postulates that the competitive environment is a determinant of the form that firm's Cost and Management Accounting (CMA) practices take and the intensity with which they are used. Several studies have been carried out vindicating the economic upheavals and the associated dramatic changes in the CMA practices of individual firms.

6.14 A substantial body of literature documents the decline in competitiveness of US industry ever since middle of 1980s. One of the major causes of this decline in US competitiveness was that the Japanese manufacturers had managed to produce high quality and cost competitive products with fewer workers and lower inventory levels than comparable US firms. To determine how the Japanese achieved such an enviable competitive position, many researchers studied the Japanese people and Japanese management practices. All these surveys indicated an entirely different framework which managed activities that created value and rendered the competitive advantage for the nation. In the working paper submitted by Oriol Amat, Lohn Blake and Philip Wraith, reference has been made to Wasley's report on New Zealand around 1975. *Numerous medium sized companies in Australia and New Zealand were not deploying* *management accounting techniques which utilized all the principles identified as basic ingredients of management accounting. It has been, however, observed that when companies were in a position of declining profitability and/or declining market with competition increasing rapidly, that management took a greater interest in those techniques.* The New Zealand industries protected by import laws were not the greatest users of the management accounting concepts. Amat et al (1994) sees *the end of the system of protection that had shielded Spanish industry from international competition until the mid 1970s as a major force for the development of management accounting systems in Spain thereafter. In Argentina the removal of tariff barriers with the country's 'Mercosur' partners (Brazil, Paraguay and Uruguay) has been seen as stimulating competition and consequently increasing the demand for strong cost management.* In Brazil, it has been noted that the industries that have led the way in developing innovative approaches to costing have been those which do not enjoy protection, starting with the textile industry in the 1950s.*The competitive pressures of a global economy are cited in Bhimani to* explain *the growing interest in advanced CMA techniques in both Germany and Italy.* An extensive survey was conducted recently in some of the companies numbering roughly 181 in the *Estonian manufacturing sector which is basically the Eastern European economic region.* This survey was conducted by scholars from the University of Tartu. The responding companies in Estonia represented 15 different branches of manufacturing such as energy supplying, wood industry, food industry, tobacco, chemicals, metal, textile, etc. The categories of information that have been included into the survey cover various aspects of CMA such as cost measurement and appraisal in financial accounting, cost element accounting, cost centres accounting, costing methods, pricing principles, budgeting, and internal performance measurement systems.

Competitiveness of India Inc.

6.15 World Economic Forum in their Global Competitiveness Report 2008-09, has defined *competitiveness* as *the set of institutions, policies, and factors that determine the level of productivity of a country.* The level of productivity, in turn, sets the sustainable level of prosperity that can be earned by an economy. In other words, more competitive economies tend to be able to produce higher levels of income for their citizens. The productivity level also determines the rates of return obtained by investments in an economy. Because the rates of return are the fundamental drivers of the growth rates of the economy, a more competitive economy is one that is likely to grow faster over the medium to long run. The concept of competitiveness thus involves static and dynamic components: although the productivity of a country clearly determines its ability to sustain a high *level* of income, it is also one of the central determinants of the returns to investment, which is one of the key factors explaining an economy's *growth potential.*

6.16 The Global Competitiveness Index (GCI), albeit simple in structure, provides a holistic overview of factors that are critical to driving productivity and competitiveness and groups them into twelve pillars:

- First pillar: Institutions
- Second pillar: Infrastructure
- Third pillar: Macroeconomic stability
- Fourth pillar: Health and primary education
- Fifth pillar: Higher education and training
- Sixth pillar: Goods market efficiency
- Seventh pillar: Labour market efficiency
- Eighth pillar: Financial market sophistication
- Ninth pillar: Technological readiness
- Tenth pillar: Market size
- Eleventh pillar: Business sophistication
- Twelfth pillar: Innovation

6.17 As per the WEF's Global Competitiveness Report 2008-09, **India,** at 50th place of GCI, derives substantial advantages not only from its market size (ranked 4th for its domestic market size and 5th for its foreign market size) but also from its strong business sophistication (ranked 27th) and innovation (ranked 32nd). The country is endowed with strong business clusters and many local suppliers, and ranks an impressive 3rd for the availability of scientists and engineers and 27th for the quality of its research institutions. However, India's overall competitive position is weakened by its macroeconomic instability (109th) with the government running one of the highest deficits in the world (ranked 127th), unsustainable levels of Government debt (ranked 113th), and fairly high inflation. Health and primary education is another area of concern, with poor health indicators (ranked 105th for both infant mortality and life expectancy), related to the high prevalence of diseases such as tuberculosis and malaria. Educational enrolment rates also remain low at all levels, with the primary educational system in particular getting poor marks for quality. Certain labour market efficiency indicators are also poor, including female participation in the labour force (ranked 122nd) and the facility with which firms can hire and fire employees (ranked 104th).

6.18 There are no two opinions that to survive, endure and prosper in today's hypercompetitive environment, enterprises of all sizes need to explore strategies to build competitiveness. A number of management scholars and thinkers have evolved strategies for improving competitiveness. Marketers generally perceive product/service *'Differentiation'* offers competitive advantage. It was contended that differentiation not only helps marketers to maintain sizeable profit margins but also encourages loyalty. This accord with another view that strategy is about *doing things differently from rivals*. However, innovation is not a onetime breakthrough but a continuous process. To achieve competitiveness, while earlier theories emphasized on Total Quality in Management (TQM); the modern thinkers give equal weightage to the Total Cost Management (TCM). While the core attribute of TQM is its focus on customer and takes a total system view in linking the various business processes to provide a flexible response to customers; that of TCM is on cost management. Towards this, recent innovations suggested new tools and techniques such as Activity Based Costing, Target Costing, Lifecycle Costing, Quality Costing, Value Engineering, Supply Chain Management, Balanced Scorecard, Performance Pyramid, Lean Accounting, Theory of Constraints, Throughput Accounting, Kaizen Costing, Customer Valuation, Strategic Cost Management, and so on and so forth. In line with TQM argument, it is argued that TCM holds the key to competitive advantage.

6.19 The greatest evidence of business success is the increase in wealth. Indian investors have made a grand success in this sphere. Very recently Forbs magazine has released the list of richest persons in the world. India ranks 4th in the list. Among the numbers of billionaires (US$100 crore) in the world, India is 4th next after USA, Germany and Russia. Among the Asian countries, India ranks top in this context. After two consecutive years, Japan loses her first position for the first time. This is a clear example of the economic development of India and it indicates that India is destined to acquire the economic superiority in the days to come.

6.20 In the top of the list we find the name of Laxmi Narayan Mittal. It could be well argued that Mr. Mittal and his business are well established in Europe for long days. But the names, e.g., Wipro of Azim Premji or Reliance of Mukesh and Anil Ambani or Bharati telecommunication of Sunil Bharati Mittal are truly Indian in all respects. Their Indian origin is beyond question. This is the face of India in the 21st century. This Indian economy may retain the rate of growth at 9% of national income has got a resistance to come back within 3 months after the stock market crash and forex reserves got over saturated. It is possible for this new India to snatch its own demand in the world business summit.

6.21 Six reasons have been identified why Indian mega corporation are not a pipe dream:

1. Sensex is poised to increase manifold in ten years' time.
2. Billion-dollar cross-border transactions: mega-sized outbound acquisitions will provide the impetus for non-linear growth by virtue of which even today's mid caps have a chance of pole-vaulting into the $100 billion league in 8-10 years.
3. There is tremendous value still locked in Indian companies: The process of de-merging allied business, listing emerging ones and merging related activities has only just begun.
4. The PSU goldmine: Right from ONGC to NTPC and State Bank of India to yet–unlisted public sector behemoths like BSNL, Oil India and Life Insurance Crop, there's huge value waiting to be dug out.
5. Younger Companies will disrupt current rankings: Those with real estate/SEZ projects, insurance activities and forays into sunrise sectors like retailing have a real chance of hot-footing it into the big league. Unlisted companies like BSNL, Coal India, ONGC Videsh, LIC, HUDCO, and Airport Authority of India are worth noticing. Companies that are still small but with huge potential for appreciation includes, Tata Motors, Tata Power, Satyam Computer, Tech Mahindra, etc.
6. With the economy set to grow annually at 8-9 percent over the long-term, companies riding on domestic consumption are on the right track.

6.22 It has been explored that a new breed of competitors is emerging to reshape the world where Asia is attracting 60 per cent of the investments going to developing countries and China has become the first recipient of direct investment and the 4th largest exporter of manufactured goods in the world. In this scenario, it is good to do a reality check on where India stands. As mentioned earlier, according to the Global Competitiveness Report (GCR) 2008-2009 released by the World Economic Forum (WEF), India is ranked 50th place on the World Economic Forum's Growth Competitiveness Index. India has slipped by two positions compared to the preceding year. Therefore, at the industry level & at the nation level, clearly much needs to be done to enhance competitiveness to meet the onslaught of competition from around the world.

6.23 In 2002, Confederation of Indian Industry (CII) introduced its theme for 2002-03 as "Competitiveness of India Inc." and set a target for all those representing Indian Inc. to ensure that India reaches the top 20 on the World Economic Forum's Growth Competitiveness Index by 2010. "India Inc." stands for India as a whole – representing government at the national and state level and representing Indian industry. Therefore, the focus lies on two key elements of competitiveness, viz. Competitiveness of the nation as a whole; and Competitiveness of Indian Industry. Few factors that would greatly help in enhancing India's competitiveness are, Mergers & Acquisitions; Six Sigma & Lean Enterprise; Greater Urbanization; Dispersal of Wealth; and Creation of Knowledge & Effective Workforce.

Observations/Recommendations of the Expert Group

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

Base Level : Plethora of legacy practices of cost accounting/ management

Level II : A National standard level of cost accounting discipline

Level III : A self driven level of world class cost/management accounting

6.25 The Expert Group is of the view that migrating through above levels should be at great speed and especially Level II will require statutory drive through standard cost accounting practices for the entire corporate sector. Once an enterprise crosses Level II into Level III it will be in a mode of voluntary adoption of all cost and management accounting guidelines to be issued by professional bodies either for internal financial management or for external reporting. A typical case is in Japan where corporates disclose voluntarily the environment costs to shareholders under the guidelines issued by Ministry. **As the Expert Group has subsequently recommended, phased introduction of cost**

accounting and cost audit framework in all companies to achieve the highest levels of competitiveness, the Expert Group also recommends that only such companies maturing into higher levels of adoption of best cost and management accounting practices/guidelines may be permitted voluntary compliance. This can be diagrammatically represented below:

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CHAPTER-7: ACCOUNTING STANDARDS, INDIAN GAAP AND IFRS

7.1 In today's complex economic environment, the measurement and presentation of financial statements is critical for allocation of economic resources. Throughout the world, various accounting bodies are engaged in the task of formulating and implementing accounting policies and practices to show true and fair view of the financial statements. Financial reporting system supported by strong governance, high quality standards, and firm regulatory framework is the key to economic development. Indeed, sound financial reporting standards underline the trust that investors place in financial reporting information and thus play an important role in contributing to the economic development of a country. Accounting Standards are in the nature of a structural framework within which credible financial statements can be prepared. The standards developed should be confined to principles, and not become detailed rules. A single set of high quality written standard of financial accounting and reporting applied to all companies (at least the publicly traded ones) in the world will make the financial reports comparable, and thus assist investors and other users of financial statements make informed decisions.

7.2 Institute of Chartered Accountants of India as the accounting standards formulating body in India, has made efforts to formulate high quality Accounting Standards. As the World continues to globalise, discussion on convergence of national accounting standards with International Financial Reporting Standards (IFRS) has increased significantly. At present, there are 28 Accounting Standards in India as notified under the Companies (Accounting Standards) Rules 2006. The Accounting Standards require more and more financial transparency and accountability in all parts of the world.

Necessity of International Accounting Standards

7.3 The forces of globalization prompt more and more countries to open their doors to foreign investment and as businesses expand across borders, the need arises to recognize the benefits of having commonly accepted and understood financial reporting standards. In this scenario of globalization, India cannot isolate itself from the developments taking place worldwide. IFAC has introduced the IFRS to bring uniformity in the reporting of the companies throughout the globe to show true and fair view of the uniformly understood financial statements. As the world globalizes, more than 100 countries currently permit the use of or have a policy of convergence with the IFRS. China and Canada have announced their intentions to adopt IFRS from 2008 and 2011 respectively. USA has also taken up various steps with International Accounting Standards Board for convergence of US GAAP and IFRS. It has become imperative for India also to make a formal strategy for convergence with IFRS with the objective to harmonize with globally accepted accounting standards. In India, a decision has been taken by the Accounting Standards Board of ICAI to aim for convergence with the IFRS, to the extent possible as per Indian conditions, with the objective to formulate sound financial reporting standards.

7.4 Convergence of Indian GAAP and IFRS will bring uniformity in reporting, ease of understanding, ease of fund raising abroad, reduction in cost of compliance, and lower cost of capital.

7.5 IFRSs are principle-based standards and thus they have distinct advantage that the transactions cannot be manipulated easily to achieve a particular accounting perspective. The Financial Accounting Standards Board (FASB) of USA has already taken up a convergence project with the IASB for broadly adopting the principle-based approach instead of rule-based approach. IFRSs lay down treatments based on the economic substance of various events and transactions rather than their legal form.

7.6 The accounting framework in India is deeply affected by laws and regulations. India has multiple regulators for setting and compliance of accounting standards. For example, a listed bank has to follow the accounting norms/standards prescribed by SEBI, RBI, ICAI, Companies Act and the Banking Regulation Act. Some of the accounting requirements prescribed by these authorities may be inconsistent with each other and some are definitely inconsistent with IFRS.

7.7 The success of convergence to IFRS in India will depend on how well the regulators cooperate. At the moment, if the law conflicts with any requirement of an accounting standard, the law overrides the accounting standard. For instance, the presentation of financial statements as per the Companies Act, 1956 conflicts with the requirements of IFRS. Similarly, there are conflicts with the judicial pronouncements. Besides the Companies Act, 1956, other regulators in India like SEBI, RBI and income-tax department needs to accept IFRS in lieu of their sets of rules of accounting as the Ministry of Corporate Affairs has already announced the intent to move towards IFRS by the year 2011.

7.8 On the line of the International Accounting Standards, the Indian Accounting Standards and Indian GAAP have undergone a significant review in the last 10 years. Several new accounting concepts, accounting treatments and accounting methodologies and disclosures have been inbuilt into the Indian Accounting Standards and Indian GAAP. In view of the changes in the Indian Accounting Standard and Indian GAAP, it would be wise to consider necessary modifications, if any, in the existing principles and practices of cost accounting. Accordingly, the Cost Accounting Standards should also align with the Indian Accounting Standards, Indian GAAP and IFRS.

7.9 Further, the Cost Accounting Standards also need to address the issues of appropriate disclosures and explanations, wherever the cost accounting concepts materially differ from financial accounting concepts, as considered in terms of Indian Accounting Standard, Indian GAAP and IFRS. It is also necessary that reconciliation is made between the profit & loss statements prepared under the financial accounting and the cost accounting framework. Such reconciliation would be significant for the shareholders to evaluate operational performance and assess the competitiveness of their company.

7.10 A detailed study is required to identify areas having differential treatment under the financial accounting and cost accounting frameworks. For example, areas such as Valuation of Inventories, Depreciation Accounting, Accounting for Fixed Assets, Accounting for Foreign Exchange Variations, Employee Benefits, Borrowing Costs, Segmental Reporting, Related Party Disclosures, etc. have differential treatment under both the frameworks. Therefore, in a relevant chapter of this report, the Expert Group has already recommended that the ICWAI, in consultation with ICAI, should prepare a list of such items requiring differential treatments and disclosures and update it periodically.

7.11 Comprehensive changes are happening in the financial accounting and reporting framework and transition from historical accounting to fair value accounting, as envisaged under IFRS, accounting standards will have a significant impact on various items of cost and revenue. Therefore, a fundamental review in the treatment of cost accounting concepts, methodologies, treatments and disclosures need to be determined to consider India suited cost accounting principles and practices that will be in convergence with the framework to be followed by the cost accounting institutions all across the world as well as the International Federation of Accountants. ICWAI has already recognized the need of such modifications and convergence with the IFRS with the modified framework of cost accounting standards. ICWAI is also ensuring complete harmony of cost accounting standards with the accounting standards and Indian GAAP. ICAI has to fully support these efforts of ICWAI.

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CHAPTER-8: GLOBAL COST ACCOUNTING PRACTICES

8.1 This Chapter is based on the country specific information provided by various resource persons, published information available in various books, articles, study papers, etc, and the White Paper prepared by ICWAI on the Global Cost & Management Accounting Practices.

8.2 The state of art of Cost & Management Accounting (CMA) in any country is contextual true to the nature of the subject. CMA has to fit into a context appropriately if it has to be meaningful as well as useful. In this regard relevant practice is more appropriate than best practice. In a working paper submitted by Oriol Amat, Lohn Blake and Philip Wraith, the following have been listed as the key drivers of variations in CMA practices across nations:

- Government
- Taxation policies
- Price Controls
- Protection and competition
- The CMA profession
- Academics
- Ownership of the firm
- Bonus schemes
- Inflation, and
- Other country influences.

8.3 Governments of various countries have traditionally played a major role in the evolution of cost accounting practices. Policy intervention, administered pricing, social pricing, funding plans and so on and so forth could be the reasons for such a role. As a result they have put forward detailed requirements on cost accounting in judicial or even a quasi judicial form. For example, the USA had set up the Cost Accounting Standard Board to deal with the variations in the war claims that came up during the Vietnam War. Greece had hired in early 1980 teams of cost accountants to make product cost calculations at a minor level to prevent profiteering.

8.4 Taxation laws in various countries exerted a major influence on the adoption of cost accounting standards. Germany had a tradition of binding detailed cost calculations even through the accounting link. The Finnish tax laws prescribed the valuation of inventory on variable costing basis and thus promoted the marginal cost accounting practices in the country. In Italy, a national propensity for tax evasion has given rise to distrust particularly in small firms leading to prescription of cost records which may be accessed by the authorities to detect tax evasion.

8.5 Price control environment in various countries have also made a major influence on cost accounting practices. This is particularly during the post world war environment in United Kingdom and in some European countries like Germany, Denmark and Finland. In the following paragraphs we discuss in detail the evolution of the cost accounting standards and practices in a legal environment.

8.6 THE FUNDAMENTAL DRIVING PRINCIPLE WOULD BE THE MATURITY AND CORPORATE DISCIPLINE TO ADHERE TO STANDARDS. IN MATURED CONTEXT THEY ARE VOLUNTARY BUT IN AN EVOLUTIONARY PHASE THEY HAD ALWAYS BEEN MANDATORY.

United Kingdom

8.7 It has been argued that cost accounting in UK only became integrated into the main body of accounting knowledge incidentally after the outbreak of the First World War. This was achieved by a new clause embodied in the Defence of the Realm Act in 1916, enabling costs to be ascertained by examining manufacturers' figures. The shortage of expertise for such an undertaking ultimately led cost accounting to be brought to the attention of manufacturers.

8.8 For all significant project proposals, the UK Government expects the use of Full Economic Costing as a more accurate way of helping to determine whether an activity or a project is worthwhile and sustainable. The UK Treasury's *Green Book, Appraisal and Evaluation in Central Government*, applies to government departments although full economic costing is required in other public sector/non-for profit organizations such as in the University sector (from 1 September 2005 Research Councils pay 80 per cent of the Full Economic Costs of research in Higher Education Institutions). The Green Book states that for substantial proposals, relevant costs are likely to equate to the full economic cost of providing the associated goods and services. The Full Economic Cost should be calculated net of any expected revenues for each option.

8.9 In some regulated industries, regulators may require accounts, statistics, business plans, capital expenditure projections, or operating expenditure calculations from participants. These are used to compile an overall picture of the sector, for general monitoring, and sometimes to set price-caps and other price controls. The focus of the Regulatory bodies is on the efficient and fair working of the markets they oversee, and hence their scope is wider than accounting information. The usual approach in the UK is that a piece of legislation would establish the purpose and scope of the regulatory body, and the regulatory body itself would determine the exact nature of the information it requires. There would be penalties for the submission of false or inaccurate information, and the regulator may conduct selective checks on a proportion of the information it receives. In some cases, there may be a legal requirement to report some data – for example, there is a legal requirement for pension schemes to report breaches of pensions law to the Regulator. The controls to ensure accuracy of data vest more in the relationship between the regulator and the entities – the regulator's knowledge of the market, and ability to identify information which seems internally inconsistent, or out of line with other suppliers. Examples of regulated industries in UK are Airports, Communications, Education, Energy, Food standards, Pensions, Postal services, Railways, Health care, Social care and Water.

Germany

8.10 In Germany, many regulatory bodies are interested in accessing the Cost information of a business entity. The German Tax legislation requires current and fixed assets to be valued in financial reporting at their purchase price or production cost less depreciation. Under *Handelsgesetzbuch (German Commercial Code), Section 255, subsection 2 and paragraph 2 lay down the cost elements which are includible and not includible for arriving at the inventory value.*

8.11 The accounting of allowable costs in the case of contracts with public authorities is necessary for the calculation of the cost prices of the contracted output. In Germany, statutory instruments have been enacted to achieve uniformity and consistency in accounting for contracts with public authorities and to avoid calculation of cost price at excessive rates. These instruments determine the allowable resources and their prices plus the valuation of the used quantity of resources. On this determination, accounting for unallowable costs is excluded.

8.12 The following statutory instruments of accounting for Government contracts are in force at Germany:

- PR 30/53- Statutory instrument for prices of contracts with public authorities by the Department of Industry.
- LSP- Regulation of pricing based on cost prices.
- PR 1/72 – Statutory instrument for prices of public construction work or contracts financed by Government investment.
- LSP-BAU – Regulation for the calculation of prices of construction works based on the contract prices.

8.13 Article 14 of the European Commission regulations has mandated the adoption of uniform cost accounting practices across EUROPE by amending legal framework. The amendments in effect were to bring standard cost accounting practices to be consistently applied. Germany has also applied this provision in the operation of the German Postal law. Through this provision the required cost accounting principles have been standardised but a survey indicates that the German law is yet to introduce some of the substantive portions of the cost accounting framework mentioned in the Article 14.

8.14 Cost accounting and Cost management have played a major role in the German competitive edge in high technology manufacturing. The popular ERP SAP has a module on management accounting called Controlling Module which emanated only from the German company practices. Grenzplankostenrechnung (GPK): a German costing method focused on marginal costing that is helpful to support short-term decisions, for example a production decision (a decision to accept or reject an additional order based on contribution margin information) or a pricing decision. GPK varies in complexity depending on an organization’s history, culture, and requirements (which in turn are determined by the complexity of products and processes). In most instances, GPK combines both resource and activity analysis, and assigns resource costs to cost objects based on causality (as is the case in ABC systems).

8.15 In Germany, all companies have distinct Cost & Management Accounting departments. In a paper on “Management Accounting in Germany” presented in the Global Summit on Management Accounting in January 2008, it was said that cost accounting is traditionally the “heart” of German management accounting and German companies have on average 584 cost centres (spread from 12 to 40,000). Considering the application of cost information in public works contract management, taxation and pricing the following can be said to be the major interest groups on cost and management accounting:

- Regulators
- Taxation authorities
- Public works contract departments
- Postal authorities for implementing Article 14
- Corporate sector
- Management accounting departments of business entities
- SAP as a major stakeholder in building cost and management accounting modules in the software, and
- Academician from business schools

8.16 In Germany, most of the Public procurement contracts are awarded on Cost Plus basis and the costs are monitored continuously. There are many local prescriptive guidelines followed by public authorities while issuing such contracts but ultimately the principle of “Market Appropriate Cost” applies.

Canada

8.17 In Canada too, the Tax authorities as a regulatory body are interested in accessing Cost and Management Accounting information. No Costing Standards are established by the concerned Regulatory Body. Canada is a market based economy and so costs are dictated by the market place rather than by formula or edict except in cases where in a regulator steps in. The tax authorities would look for an objective evidence of whether the cost information provided by the company is correct and computed by way of an arm’s length transaction.

8.18 Interestingly, the Tribunal constituted under Canada’s Competition Commission has extensively dealt with cost accounting terminologies and their relevance for judging on predatory pricing in the *case of Air Canada.* In Phase I of the Air Canada case, the Tribunal declared that it would consider the following four questions relating to avoidable cost:

- What is the appropriate unit of capacity to examine?
- What categories of cost are avoidable and when do they become avoidable?
- What is the appropriate time period to examine? And
- What if any, recognition should be given to the concept of beyond contribution?

8.19 At the heart of the Air Canada matter is a quintessential cost accounting issue - the notion of avoidable cost and specifically, whether Air Canada operated or increased its capacity at prices below its avoidable cost. The Tribunal’s decision provides important practical interpretations of some common cost accounting terms.

8.20 Besides the above Regulator, in Ontario the CMAs are allowed to sign balance sheets and profit and loss accounts like chartered accountants and hence are subject to the jurisdiction of the Securities Commission. There is no requirement to have such information certified by an independent professional. The taxation authorities generally deal directly with the companies than through independent professionals. The Accountability Act also requires assurance of certain management accounting information submitted to the Parliament. Following entities can be considered to be the interested groups in the CMA profession:

- Certain regulators like the Competition Commission.
- Securities Commission of certain provinces like Ontario.
- Governmental institutions such as Auditor General Offices.
- Corporate and non corporate sector of the business

- All chapters of CMA in the provinces of Canada.

8.21 Canada basically being a developed economy the corporate culture supports best practices. Hence in the absence of cost accounting standards, management accounting guidelines issued by a CMA Canada play a major role in injecting quality in the cost and management accounting practices. CMA Canada also issues Management Accounting Practices Statements (MAP). MAP specifically gives the tools to enhance the internal operations of the *organisation as well as to provide information to enable shareholders to evaluate performance of organisations*.

8.22 In Canada, usually the Public supply contract specifies the components and the methodology of cost accumulation. Cost plus contract is generally used in awarding contracts. It is the responsibility of the purchasing entity to certify whether the costs reflect the content of the contractual agreement. Each contract or series of similar contracts would contain guidelines as to the nature and quantum of allowable costs. The Supply Manual of the Public Works and Government Services of Canada lays down the Guidelines relating to Cost and Profit.

United States of America

8.23 USA has been at the centre of seminal developments in the field of management accounting from 1980 onwards. Lack of advancements in management accounting has been cited to be a major reason for the loss of competitive edge of United States. The following words of Robert Kaplan of Harvard Business School are worth quoting in this context:

> *"Many companies however are not gaining these competitive advantages from enhanced cost systems. Their managers rely on information from a cost system designed for a simpler technological age, when competition was local and not global, that featured standard and not customised products and services, and when, speed, quality and performance were less critical for success. These managers do not have timely and relevant information to guide their operational improvement activities. Nor are they receiving accurate, valid information to shape their strategic decisions about processes, products, services and customers."*

8.24 The above background led to a spate of research in applied cost & management accounting resulting in new tools and techniques such as Activity Based Costing, Activity Based Management, Lean Accounting, Theory of Constraints, Cost of Quality reporting and so on and so forth. This converged with the growth in the field of software industry and many of these concepts were offered by US based companies as a part of the Enterprise Resource Systems solutions.

8.25 In USA, various public utility regulation entities, the Federal Trade Commission, and the U.S. Department of Justice are interested in accessing the Cost Information of any business entity. No Costing Standards are separately established by Regulatory bodies. But a very elaborate cost accounting board and its framework is available for regulating the procurement function of the Federal Government.

8.26 The *National Performance Review (NPR)* has set the stage for reforms to create a government that works better and costs less. On the importance of management information systems, such as managerial cost accounting, NPR states: "Management isn't about guessing, it's about knowing. Those in positions of responsibility must have the information they need to make good decisions. Good managers have the right information at their fingertips. Poor managers don't...Good information comes from good information systems...If federal decision-makers are supplied the same type of financial and performance information that private managers use, it too will show up on the bottom line...and cut the cost of government."

8.27 In addition to the long history of US Reforms commission, including the National Performance Review of 1993, a number of federal regulations have affected financial reporting requirements with cost linkages. Below is such a list of federal regulations, mostly since 1990, advocating financial measures that could benefit from the application of cost linkages: In fact, 1990s have proven to be the decade of “right-sizing” and eliminating inefficiencies. This trend is not exclusive to the private sector, but is actively underway in the public sector as well.

- The Chief Financial Officers (CFO) Act of 1990 contains several provisions related to managerial cost accounting, one of which states that an agency's CFO should develop and maintain an integrated accounting and financial management system that provides for the development and reporting of cost information.
- The Government Performance and Results (GPRA) Act of 1993 requires federal agencies to develop five-year strategic plans and annual performance plans beginning with fiscal year 1999; and report annually on actual performance compared to goals. Cost accounting information will aid entities in evaluating and reporting planned performance measures with actual results.
- The Government Management Results Act (GMRA) of 1994 authorizes the establishment of franchise fund pilot programs in six executive agencies. Participation in these franchise funds requires proper costing procedures.

- The Clinger-Cohen Act, formerly known as the Information Technology Management Reform Act (ITMRA) of 1996
- The Federal Financial Management Improvement Act (FFMIA) of 1996
- OMB (Office of Management and Budget) Circulars, routinely updated: In July 1995, OMB published the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as recommended by the Federal Accounting Standards Advisory Board (FASAB). Effective October 1, 1997, federal entities are required to implement these managerial cost accounting standards. In addition, full cost reporting is recommended in the Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, *Entity and Display*, and required in the SFFAS No. 7, *Accounting for Revenue and Other Financial Sources*, for the annual general purpose financial statements of federal entities.
- Joint Financial Management Improvement Program (JFMIP)
- Quadrennial Defence Review, 1997
- National Defence Panel, 1997
- Federal Activities Inventory Reform (FAIR) Act of 1998

8.28 The SEC of USA has also prescribed various formats for disclosures by the corporate America which will need the adoption of standard cost accounting practices. In the annual/quarterly returns sent to the US-SEC, the companies are required to include information relating to risk factors, quantitative & qualitative disclosures about market risks, controls & procedures, related party transactions, selected financial data and management's discussion and analysis of financial condition and results of operations explaining the reasons for material changes in the amount of revenue and expense items between the most recent fiscal year presented and the fiscal year immediately preceding it. Explanations of material changes should include, but not be limited to, changes in the various elements which determine revenue and expense levels such as unit sales volume, prices charged and paid, production levels, production cost variances, labour costs and discretionary spending programs. In addition, the analysis should include an explanation of the effect of any changes in accounting principles and practices or method of application that have a material effect on net income as reported.

8.29 The Group noted that in USA, the Federal Activities Inventory Reform Act of 1998 provides "Realistic and Fair Cost Comparisons – For the purpose of determining whether to contract with a source in the private sector for the performance of an executive agency activity on the list on the basis of a comparison of the costs of procuring services from such a source with the costs of performing that activity by the executive agency. The head of the executive agency shall ensure that all costs (including the costs of quality assurance, technical monitoring of the performance of such function, liability insurance, employee retirement and disability benefits, and all other overhead costs) are considered and that the costs considered are realistic and fair."

8.30 The US Federal Government has constituted a Cost Accounting Standards Board under the Office of Federal Procurement Policy, which is an independent legislatively-established board. The Board has the exclusive authority to make, promulgate, and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts with the United States. The standards are mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating and reporting costs in connection with pricing and administration of and settlement of disputes concerning all negotiated prime contract and subcontract procurement with the United States in excess of US $5 million. The Board has so far issued 19 Cost Accounting Standards.

8.31 The Federal Anti Trust bodies rely on cost and management accounting information on deciding cases relating to predatory pricing and have even driven the thinking on applying concepts such as activity based costing to predatory pricing cases. The four US Anti Trust statutes that are the source of the predatory pricing prohibition are:

- The Sherman Act of 1990
- The Clayton Act of 1914
- The Robinson - Patman Act of 1936 and
- The Federal Trade Commission Act of 1914.

8.32 Although the term predatory pricing does not appear in any of the statutes, these statutes are the primary authoritative reference for all reasoning by the courts in the development of predatory pricing rules. As a part of the evolution, the courts have found the price-cost relationship to be useful in determining whether pricing behaviour is predatory and therefore monopolising in nature. From future debate in and among the circuits, the US Supreme Court hopes to find new ideas for use in developing well reasoned predatory pricing guidelines and perhaps an appropriate measure of cost for the price-cost test.

8.33 In USA, one of the Treasury Department's order said that the state auditor shall annually make a cost-audit examination of the books and records of the county road engineer and make a written report thereon to the county legislative authority. The expense of the examination shall be paid from the county road fund. Similarly, in another order of 20th December 2000, it said that any company in the aerospace, telecommunications, electronics or engineering fields (Or any other field where provided for in the contract), which is classed as a mandatory supplier under a government contract, can be liable to a post factum cost price review.

8.34 In USA, interest groups do exist to the extent that cost & management accounting affects external reporting. These would include:

- Various regulatory bodies
- Cost Accounting Standards Board constituted in the President's office is a major stake holder in the domain of cost and management accounting.
- Major business analytics/software solution companies such as SAS, Oracle, etc.
- Academicians and business schools show considerable interest
- Governmental departments (such as the Securities and Exchange Commission)
- Financial analysts,
- Professional associations (including the Institute of Management Accountants and the Association of Governmental Accountants).

Japan

8.35 Cost competitiveness has been at the heart of the Japanese success in 1980s. The tripod of Cost–Quality-Delivery has been inextricably embedded into the manufacturing strategy of the Japanese lean enterprises as they are called. Target Costing and Kaizen Costing are two mantras contributed by the Japanese to the lexicon of management accounting. Robin Cooper who was an expert on Japanese Cost Management reveals the innovative cost management practices in several Japanese companies that implemented a concept of Pseudo Profit Centres. These Centres had motivated work teams which took responsibility for revenues, as well as costs. The companies motivated the groups to improve the yields and quality of the outputs they managed. The impact of any improvement – in cost reduction, yield improvement and quality enhancement – would show up immediately in their bottom line performance measure. *Thus the Japanese brought the application* *of cost accounting and its interface with operational cost management to such micro levels that they reached the zenith of manufacturing competitiveness beating the other economies hollow.* Conclusively, the Japanese business raised the cost management process to a strategic level and practiced tools such as target costing which delivered products of high functionality and quality at an acceptable price level in the market segments targeted.

8.36 Contrary to the belief that Cost Accounting Standards do not exist in the developed part of the world, an economy like Japan has experienced the evolution of cost accounting standards as a part of the pre and post world war build up of economic revival. The Japanese cost accounting systems have evolved through in various stages.

8.37 The Japanese cost accounting system for financial statements is based on the Cost Accounting Standard, with the current standard having gone through three steps (Ota *et al*., 1983). *As part of the policy to promote rationalization of Japanese industries, the Product Cost Accounting Rule (Seizou genkakeisan junsoku) was established in November 1937 in order to diffuse and enlighten knowledge of cost accounting.* This is the .first standard to focus on cost accounting in Japan and was considered to be voluntary, enlightening and recommendable to Japanese companies.

8.38 Unfortunately the China Incident (Sino-Japanese War) occurred in 1937 and so the Army and Navy set up their own cost accounting rules in 1939 and 1940 respectively. The purpose of these rules was primarily to control the price of munitions. Plurality of rules caused problems not only for the munitions industry but also for the purpose of national product price controls. *Therefore, the government really needed an integrated or united cost accounting rule. The Manufacturing Industry Cost Accounting Guideline was introduced in April 1942 to replace the cost accounting rules of the Army and Navy.* The purpose of this guideline was to control commodity prices and to increase the efficiency of management because of the Second World War.

8.39 After the Second World War, Japan was in a state of economic disorder, so the government used the cost accounting rule to control prices with effect from March 2, 1948. The economy was stabilized little by little and the government made efforts to improve productivity, and one result of this policy was the introduction of a modern cost accounting standards. The Business Accounting Deliberation Committee of the Ministry of Finance, formerly the Business Accounting Standard Committee of the Economic Stabilization Board, started to develop the Cost

Accounting Standards on 16 November 1950 but did not succeed until 8 November 1962. Japan has so far issued 10 Cost Accounting Standards. The three key aspects were:

a) **Nature and basic structure of the cost accounting standard:** The new standard codified best practices based on contemporary generally accepted cost accounting practices. This normative approach merely made the basic cost convention clear. Members of the council studied not only cost accounting systems in the US, UK, Germany and elsewhere but also visited Japanese manufacturing companies and studied practical cost accounting systems by obtaining co-operation from Yahata Steel, Mitsubishi Electric, Sumitomo Chemical, Fuji Textile, and others. The conception of this standard had more in common with 'Die allgemeinen Grundsatze der Kostenrechnung' (1939) than with 'Report of the Committee on Cost Concepts and Standards by AAA' (1951). In other words, the cost accounting standard was not only intended to make cost accounting principles clear but also to make the standard a foundation of cost accounting as part of an accounting system.

b) **The application of the cost accounting standard:** *The cost accounting standard was not just a standard to enlighten and diffuse knowledge of cost accounting, but to have a social binding power for Japanese companies*. The cost accounting standard made the basic framework of cost accounting practice clear in Japan although companies could not be punished by law even if they violated the standard. Therefore, companies could implement their own cost accounting practices under the standard. *This standard applied to all companies in Japan, but application depended on industry-type, business condition and size of company (Cost Accounting Committee for Small Companies, 1958).* Also, some industry groups had their own cost accounting manual or handbook of cost accounting procedures. For example, the military industry had their procurement manual (Defence Equipment Society, 1989), while the preventive maintenance industry had a cost accounting handbook (Government Buildings Department of Minister's Secretariat in the Ministry of Construction, 1991). These manuals and handbooks were, however, based on the Cost Accounting Standard.

c) **The framework of the Cost Accounting Standard:** This standard indicated that cost accounting has the following purposes:

   - Price setting;
   - Preparing financial statements;

- Cost management;
- Budgeting and budgetary control; and
- Setting basic plans and making decisions.

8.40 In a research paper on *Cost Accounting in Small and Medium Sized Japanese Companies* by *Trevor Hopper* from University of Manchester and *Tsutomu Koga* from Fukuoka University (1997), it has been said that the Japanese cost accounting, e.g. target costing, continuous cost reduction etc. was necessarily used in simpler smaller companies (SME's). In addition, given cost pressures stemming from Japan's changing socio-economic circumstances, it was surmised that SME's and their costing systems were undergoing significant pressures for change. In general, the research found that the costing systems of the SME's were similar to those of larger Japanese firms. Costing systems and cost management practices, though not uniform, emphasise simple routine accounting and they were not used much in decision-making or for performance evaluation. However, sophisticated detailed processes of cost management, often centred on engineering and quality control were the norm.

8.41 Academicians, Policy makers in the Government and Industry associations can be considered as external groups interested in costing information. For example the preventive maintenance business entities in civil segment were subject to the cost accounting standards prescribed in the manual of the Building Department of the Ministry of Construction ever since 1991. Ever since the world wars the following external entities have played a major role in shaping the cost accounting culture of the Japanese economy. These interest groups under various context of the socio economic context of Japan have been interested in the cost accounting information for financial statements.

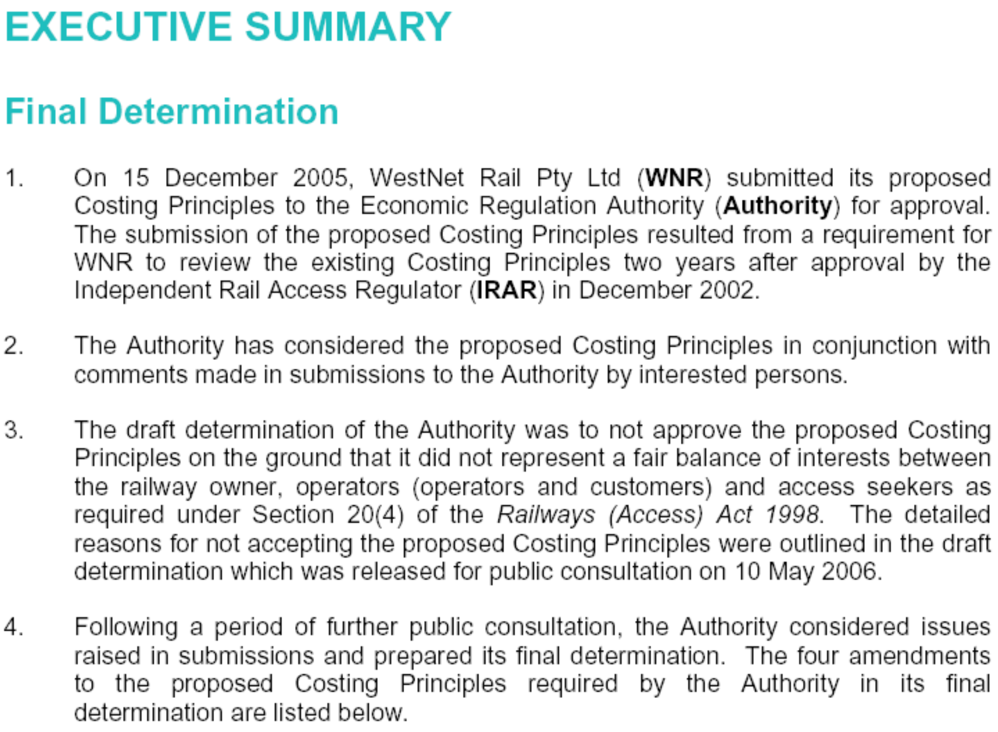
- Product Cost accounting Rule of the Government established in November 1937 also called as Seizou genkakeisan junsoku
- Cost Accounting Rules of the Army
- Cost Accounting Rules of the Navy
- Economic Stabilization Board
- Business Accounting Deliberations Committee
- Cost Accounting Committee for small companies
- Defence Equipment Society
- Board of Audit

Australia:

8.42 In Australia, the Cost and Management Accounting interest groups exist both internal as well as external to a business entity. The Institute of Certified Management Accountants (ICMA) of Australia is of recent origin as a body. Prior to the formation of this body, the universities of Australia, the business community and the chartered accountants body have been showing considerable interest in this body of knowledge. Cost Accounting mechanism also exists as per the insistence of some regulatory authorities.

8.43 In Australia, other than Tax Office who is interested in accessing the cost information of any business entity, some regulators also access the cost information. In fact cost accounting principles have also been publicly debated by some regulators such as railways before adoption. The Regulatory Board, who call for Cost and Management Accounting information, obtain them internally assured by the company managements.

8.44 The following extract from the executive summary of the Economic Regulation of Western Australia with head quarters at Perth show the adoption of costing principles by the Regulator after a period of public exposure.



EXECUTIVE SUMMARY

Final Determination

1. On 15 December 2005, WestNet Rail Pty Ltd (**WNR**) submitted its proposed Costing Principles to the Economic Regulation Authority (**Authority**) for approval. The submission of the proposed Costing Principles resulted from a requirement for WNR to review the existing Costing Principles two years after approval by the Independent Rail Access Regulator (**IRAR**) in December 2002.

2. The Authority has considered the proposed Costing Principles in conjunction with comments made in submissions to the Authority by interested persons.

3. The draft determination of the Authority was to not approve the proposed Costing Principles on the ground that it did not represent a fair balance of interests between the railway owner, operators (operators and customers) and access seekers as required under Section 20(4) of the *Railways (Access) Act 1998*. The detailed reasons for not accepting the proposed Costing Principles were outlined in the draft determination which was released for public consultation on 10 May 2006.

4. Following a period of further public consultation, the Authority considered issues raised in submissions and prepared its final determination. The four amendments to the proposed Costing Principles required by the Authority in its final determination are listed below.

8.45 The ICMA is proposing ‘Strategic Audits’ in Australia for the business to adhere to the Cost accounting principles. The Australian Competition and Consumer Commission is the antitrust body which depends on costing data for regulation of monopolistic trade practices. The Government gathers information on cost while formulating policies on Free Trade agreements/Restricted Trade Agreements through Australian Bureau of Statistics and other information gathering bodies. There are no major firms of Cost and Management Accounting, which render professional advice as an independent expert but there are some small independent consultants in ABC and Balanced Scorecard, software services etc.

China

8.46 Ministry of Commerce and Ministry of Finance are the only two Regulatory Bodies in China interested in accessing the Cost Information of any business entity. The State Asset Administration is interested in the cost information of state owned enterprises. The State Asset administration is represented by the owners of such enterprises. In private enterprises, the owners themselves or the tax agents are interested in the cost information. There are Accounting Standards for Business Enterprises which, though primarily oriented for external financial reporting, also influence internal reporting. In China, Publicly held companies issue only financial statements audited by certified independent professionals. The essential qualifications of such professionals are passing of a professional licensing exam and being a practicing CPA with a registered CPA firm. The adoption of the 2006 Accounting System for Business Enterprises (ASBE) by the Chinese companies has made external reporting closer to international standards. There are a number of cost items that have been inappropriately treated in the past as per Chinese accounting regulations: the 2006 accounting regulations have addressed some of these. For example, a major difference in the treatment of the cost of the production relates to the treatment of the cost of fringe benefits related to direct labour; this has been addressed.

8.47 The changes in the Chinese cost accounting brought about by changes to accounting regulations have been extensively dealt with in the Survey report by the Institute of Management Accountants of USA on the Chinese Costing practices. This paper presented the results of a study of costing methodologies and cost management practices utilized by companies in the Peoples' Republic of China (PRC). The Study found that costing practices employed by companies, while occasionally reflecting prior practices, are now largely in conformance with the 2006 ASBE. Cost management practices are in a state of transition in the PRC-reflecting the techniques used under the prior planned economic system, but also showing the beginning of the adoption (and adaptation) of Western techniques. As PRC companies grow and face the complexities associated with more diverse products and customers and increasing organizational size, they will increasingly face the need for more complex cost management systems.

8.48 Article 103 of ASBE states that an enterprise should determine the cost centres, cost items and cost calculation methods according to the characteristics of the production and operating process and the needs of the management. Once determined, they should not be changed arbitrarily. Changes should be approved in a shareholders' meeting or directors' meeting, or managers'/factory managers' meeting or a meeting of a similar body according to the management authority set -up in the enterprise, and should be disclosed in the notes to the accounting statements. Article 105 says that an enterprise must clearly identify the costs and expenses for the current period and those for subsequent periods. It must not accrue or defer expenses arbitrarily. An industrial enterprise must clearly identify the costs of each product. It must clearly identity the costs of work-in-progress and the costs of finished goods, and must not overstate or understate such costs.

8.49 The Rules on Cost Accounting of Power Transmission and Distribution have been published by China's State Power Regulatory Commission. They will take effect as of January 1, 2006. The rules include 19 articles in five chapters, specifying the cost target and cost items.

France

8.50 France does not have any management accounting institute and the French Government had always played a major role in the evolution of the cost and management accounting domain. Added to this was the contribution from industrial associations and engineers. The business schools of management have also played a major role in France on Cost and Management accounting.

8.51 Unlike the situation in the United States or the United Kingdom, where only industries dealing with the Government need to follow certain rules for product cost calculation, the French approach, *in a spirit of facilitating fair competition, applies to all industries,* whether or not they have dealings with state agency. French management accounting practice is different from what is found in most national traditions in the field. France's originality lies in having an almost universally *accepted single version of cost analysis and product costing, applicable to all industrial and trade sectors, both for profit and not for profit.* The current version of this system is described in a decree of the Ministry of Finance and Economy published as Title III of the 1982 *Plan Comptable General.*

8.52 The following Regulators/Government agencies routinely refer to the costs in line with the above standards as a sort of cost audit in respect of dealing with private parties on Government contracts:

- Telecommunication
- Aerospace
- Aviation
- Electronics
- Defence

Korean Malaysian Model of Cost and Management Accounting Standards

8.53 Korea and Malaysia have adopted a different model in issuing cost accounting or management accounting standards. In these two countries there is no separate professional accounting body focused on cost and management accounting. Hence the cost accounting standards/management accounting guidelines have been issued by the Accounting bodies of these countries.

Korea

8.54 The Korean Institute of Chartered Accountants have issued the cost accounting standards applicable to Korean companies by amending the Accounting regulations in 1990. These regulations came during the financial debacle in these countries during 1990s. The regulations clearly state that these are meant for measuring product costs in preparing financial statements.

8.55 More than thirty standards have been issued for adoption and the manufacturing companies were covered initially. Subsequently, these standards were also made applicable to non-manufacturing companies and later to the banks and financial institutions in 1999. However no survey or study is available as to the level of compliance with these cost accounting standards.

8.56 Korea’s Financial Accounting Standards require publication of a separate schedule of manufacturing cost (form no. 23) and schedule of cost of sales (form no. 25). The auditors have access to the cost accounting information generated by applying these regulations.

8.57 Korea’s Cost Accounting Standards have covered all the key aspects in three major sections, viz.

a) General Provisions;
b) Actual Cost Accounting System; and
c) Standard Cost Accounting System.

Malaysia

8.58 The Malaysian Institute of Accountants (MIA) is the only accounting institute in Malaysia recognized by IFAC. MIA has not issued cost accounting standards. Instead it has adopted verbatim all the

International Management Accounting Practice Statements issued by FMAC of IFAC. All the seven IMAPs have been reissued under the banner of MIA to be referred to by Malaysian companies as best practice. This is a unique position which no country has done.

Other Countries

8.59 Apart from the practices adopted in various countries, the United Nations also propagated the concept of cost accounting and cost audit. For example, the Audit Committee of the Program & Budget Committee of the United Nations, in its report in 2006, on the World Intellectual Property Organisation's new construction project recommended *Cost Audit* of the estimated budget of the project that had been agreed by the Member States in 2005 and suggested that such task could be assigned to an independent party, possibly FIPOI *(Fondation des immeubles pour les organisations internationales)* or the External Management Firm itself.

8.60 The end of the system of protection that had shielded Spanish industry from international competition until the mid 1970s, acted as a major force for the development of cost & management accounting systems in Spain thereafter. In Argentina the removal of tariff barriers with the country's 'Mercosur' partners (Brazil, Paraguay and Uruguay) has been seen as stimulating competition and consequently increasing the demand for strong cost management. In Brazil, it has been noted that the industries that have led the way in developing innovative approaches to costing have been those which do not enjoy protection, starting with the textile industry in the 1950s. The competitive pressures of a global economy are cited to explain the growing interest in advanced CMA techniques in Italy.

8.61 An extensive survey was conducted recently in some of the companies numbering to roughly 181 in the Estonian manufacturing sector which is basically the Eastern European economic region. This survey was conducted by scholars from the University of Tartu. The responding companies in Estonia represented 15 different branches of manufacturing such as energy, wood, food, tobacco, chemicals, metal, textile, etc. The categories of information that have been included into the survey cover various aspects of CMA such as cost measurement and appraisal in financial accounting, cost element accounting, cost centres accounting, costing methods, pricing principles, budgeting, and internal performance measurement systems. The respondents to the above survey in Estonian companies on CMA practices have admitted that mainly two driving forces had made them develop their companies' CMA systems namely, the need for more detailed divisional performance (segmental) information and changes in the organizational structure. Thus the growing market pressure has raised the companies' awareness about the need for more detailed cost information.

8.62 The Internal Audit group in Hong Kong has developed diagnostic tool kits to assist in enhancing operational efficiency and reducing costs to improve an organisation's competitiveness. The reviews focus on 9 key business areas:

- General Management Control
- Billings and Receivables
- Procurement and Payment
- Expenditure and Expenses
- Inventory Management
- Cash Management
- Human Resources
- Financial Accounting and Management Reporting
- Information Technology

8.63 This review will produce a list of opportunities for cost reduction/efficiency improvement, and estimated potential cost savings/improvements if implemented. Typical reasons for this service are (1) management wishes to reduce costs to maintain profits in view of reducing revenues, and (2) to increase competitiveness under the current economic climate.

8.64 In Pakistan, Institute of Cost & Management Accountants of Pakistan (ICMAP) has been able to generate considerable interest in the domain from the business and the students' community. The presence of ICMAP and its participation is felt across the international bodies such as CAPA and SAFA. It has also been able to successfully bring on the concept of cost audit in the company legislation of Pakistan. The following entities can said to be the interest groups of the cost and management accounting information in Pakistan:

- ➢ Central Board of Revenue of Pakistan
- ➢ Chambers of Commerce
- ➢ Securities and Exchange Commission of Pakistan
- ➢ Ministry of Finance
- ➢ Regulatory bodies such as Oil and Natural gas and Power sector
- ➢ State Bank of Pakistan

8.65 Despite being the youngest of the statutorily started CMA professional institute in the SAARC region, similar role has been played by the Institute of Cost & Management Accountants of Bangladesh (ICMAB). The following entities can said to be the interest groups of the cost and management accounting information in Bangladesh:

- Ministry of Commerce
- Chambers of Commerce
- Regulatory bodies such as power sector regulator
- Global organizations such as UNDP which are keen on capacity building of the CMA profession in Bangladesh.

Expert Group Observations

8.66 In India, various apex level industry associations have been playing key role in infusing a sense of cost consciousness among the member companies so as to enhance their competitiveness in the global market. For example, the Confederation of the Indian Industry (CII), which is a pioneer in several aspects as an association of business, initiated a movement of Total Cost Management (TCM). This movement has been in vogue for almost 6 to 7 years and has been attempting consistently drive home the message of a structured approach to the needs of cost management in a competitive environment. Since we as a nation are building our manufacturing and service competitiveness in the global arena, it is important that the CMA skills are honed to perfection and we do not mistakenly focus on measuring the end financial short term results through accounting standards as the only way of performing cost and management accounting.

8.67 While the business started recognizing the need for a structured movement on quality management, customer relations, etc., on the cost front, it has confined the efforts to waste elimination and lean manufacturing strategies without considering cost management as a holistic process. Industry federations such as Confederation of Indian Industry commenced movements such as Total Cost Management which is yet to gain critical mass such as TQM or TPM. Just like in Japan adherence to a minimum cost accounting plan is considered as a part of the social discipline and corporates adhere to the same without demur a base line plan for good cost accounting practices is yet to be accepted in India. When it comes to cost accounting the business is yet to come to terms with a base line adherence legally which one finds in countries like France, Japan, and Korea. For that matter in countries which are self disciplined in this aspect like Canada or UK consider the pronouncements of the CMA bodies in those countries (which do not have a legal status like ICWAI) as best practice. Besides this context, till a matured behaviour of the stakeholder emerges as India continues with the reforms process cost accounting discipline needs to be considered as an enabler of healthy competition and insurance against predatory behaviour. To top all the developments, there needs to be a check on the presence of a good cost accounting mechanism as a part of the risk management environment for ensuring good governance. The underlying spirit being, a business enterprise without a sound decision making including proper cost information is prone to more business risk.

8.68 From the aforesaid cross-country cost & management accounting practices, the Expert Group observed that these largely depend upon the maturity level of each economy in terms of its competitiveness, liberalisation & globalization, business pattern/models, average size/scale of an enterprise, risk-management models, market & information network, level of corporate/enterprise governance, strategic strengths & weaknesses, cost-leadership movement, sustainable cost reduction practices, extent of applied research, benchmarking, etc. Three maturity levels are recognized regarding the Regulation System in an economy:

8.69 **LEVEL-I**: This is lowest level in the maturity scale of regulation. It is characterized by lack of self motivation to discipline themselves; lack of appreciation for regulation and no perceived benefits of regulation by the players in the economy. This is a level where the Government has to perform role of regulation completely by itself. It makes detailed rules, procedures etc.; it monitors them whether they are properly followed; and punish those who are not abiding by these rules. This provides practically no flexibility to the players for necessary growth with the change in time and conditions; enforcement of the rules is usually through by force; and it leads to sometime unnecessary interference from the side of the Government.

8.70 **LEVEL-II**: This is a higher level of maturity where the players in the economy have become more matured; they start appreciating role of discipline in the economy; started coming out voluntarily with models of self discipline; Government role reduced to provide necessary direction and guidance so as to achieve the desired objectives of the economy. At this level, usually Government directly do not monitor the functioning of the companies to ensure whether the players are following necessary guidelines or not; rather some independent institution or regulator or some agency has been given the responsibility of monitoring and ensuring the necessary discipline among the players of the economy.

8.71 **LEVEL-III**: This is the highest level of maturity among the players of the economy. At this level, every player is well conscious about his/her responsibilities; develops systems to ensure that necessary self-disciple mechanism exists so as to achieve the objectives of the whole economy and as well as those of stakeholders. At this stage, the Government role is practically non-existent in the regulation mechanism; market forces more dominant in disciplining the market.

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

8.73 The transitory phase through which economies like India are passing, having moved from being under-developed to developing and now to a fast developing and finally gradually heading towards the developed stage still require suitable regulatory mechanism. Thus, besides routine financial information and other disclosures, companies should be subjected to a cost-effective cost & management information system, enabling the Government and regulatory authorities to play their intended role in enhancing the competitiveness of Indian industry and ensuring a fair-play for all stakeholders.

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CHAPTER-9: INTERNATIONAL FEDERATION OF ACCOUNTANTS (IFAC)

About IFAC

9.1 The International Federation of Accountants (IFAC) is the global organization for the accountancy profession. Founded in 1977, the organisation works with its 157 members and associates in 123 countries and jurisdictions to protect the public interest by encouraging high quality practices by the world's accountants. IFAC members and associates, which are primarily national professional accountancy bodies, represent 2.5 million accountants employed in public practice, industry and commerce, government, and academia. The 2.5 million accountants can be broadly divided into two groups. The first one can be termed as Professional Accountants in Public Practice (PAPP) and the second category can be called as Professional Accountants in Business (PAIB).

9.2 Following accounting bodies from India are members of IFAC:

- Institute of Chartered Accountants of India
- Institute of Cost & Works Accountants of India

Role of IFAC

9.3 IFAC's mission is to serve the public interest, strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant. To carry out this mission, IFAC works closely with the member bodies and regional accountancy organizations and obtain input of regulators, standard setters, governments and others who share our commitment to creating a sound global financial architecture.

9.4 Thus the IFAC's role is threefold:

- To establish and promote adherence to high quality international standards;
- To facilitate collaboration and cooperation with member bodies; and
- To serve as spokesperson for the international profession on relevant public policy issues.

9.5 IFAC have long recognised that a fundamental way to protect the public interest is to develop, promote, and enforce internationally recognized standards as a means of ensuring the credibility of information upon which investors and other stakeholders depend. IFAC strives to serve the public interest through the development of standards in the areas of auditing, education, ethics, and public sector financial reporting; by advocating transparency and convergence in financial reporting; by providing best practice guidance for professional accountants employed in business; and by implementing a membership compliance program.

9.6 IFAC's boards set the following standards:

- International Standards on Auditing, Assurance Engagements and Related Services
- International Standards on Quality Control
- International Code of Ethics
- International Education Standards
- International Public Sector Accounting Standards

9.7 Besides issuing Standards on various issues, IFAC also develops statements, information papers, benchmark guidance, and special reports and promotes the sharing of resources to serve professional accountants in business. It has also established groups to address issues pertaining to small and medium practices and enterprises and developing nations, all of which play a critical role in the global economy.

BALANCING PUBLIC ACCOUNTING AND BUSINESS ACCOUNTING

9.8 IFAC performs this role in three ways:

- By establishing and promoting adherence to high quality international standards, facilitating collaboration and cooperation with member bodies and serving as a spokesman for the international profession on relevant public policy issues.
- Developing, promoting and enforcing internationally recognized standards as a means of ensuring the credibility of information upon which investors and other shareholders depend. Several standards relating to auditing, assurance engagements, quality control, code of ethics, education standards, public sector accounting standards, etc have come out of this role.
- Developing benchmark guidance and promoting sharing of resources to serve professional accountants in business.

9.9 Over a period of time since there has been a major focus on improving the transparency and quality of information supplied to the investor community, the accounting standards of the IASB and the auditing standards of IFAC are more in lime light and are discussed intensively and exhaustively. As a result much of the work done by IFAC for promoting what can be called as Governance including performance and controls internally besides the compliance oriented corporate governance have not received much of public attention.

FINANCIAL AND MANAGEMENT ACCOUNTING COMMITTEE

9.10 Financial and Management Accounting Committee (FMAC) of IFAC concentrated on producing documents such as Articles of Merit, Information papers, and International Management Accounting Practice Statements (IMAP). The following seven statements called as IMAP were issued by FMAC:

- IMAP 1 on Management Accounting Concepts
- IMAP 2 on Capital Expenditure
- IMAP 3 on Currency Exposure
- IMAP 4 on Management Control of Projects
- IMAP 5 on Managing Quality Improvements
- IMAP 6 on Post Completion Review
- IMAP 7 on Strategic Planning for Information Management

9.11 Financial and Management Accounting Committee (FMAC) was later reconstituted by the IFAC as the Professional Accountants in Business (PAIB) Committee. Upon its reconstitution, the PAIB Committee withdrew all the aforesaid IMAPs as it found difficult to maintain the same. Instead the new Committee started considering the issuance of International Good Practice Guidance statements (IGPG).

PROFESSIONAL ACCOUNTANTS IN BUSINESS COMMITTEE

9.12 One of the most important Committee of IFAC is the Professional Accountants in Business (PAIB) Committee (earlier known as the Financial and Management Accounting Committee) is the vehicle for focusing on the benchmarks setting for best practices in the business. PAIB committee serves IFAC's 157 member bodies and more than one million professional accountants worldwide who work in commerce, industry, the public sector, education, and the not-for-profit sector. Its aim is to enhance the role of professional accountants in business by encouraging and facilitating the global development and exchange of knowledge and best practices.

9.13 This Committee has issued International Good Practice Guidance (IGPG) on a large number of contemporary issues encompassing the best practices followed internationally. IGPG are generally accepted internationally and applies to organizations of all sizes in commerce, industry, the public sector, education, and the not-for-profit sector.

9.14 IGPG covers management accounting and financial management, as well as broader topics in which professional accountants in business, sometimes in conjunction with professionals from other disciplines, are likely to engage. IFAC's prime purpose in issuing guidance in these areas is to foster a common and consistent approach to those aspects of the work of professional accountants in business that are not already covered by international standards. A secondary purpose is to help professional accountants in business to explain their work to non-accountants. By setting out principles for each topic, the documents create a contextual background for the more detailed methods and techniques used by professional accountants in business.

9.15 In a document titled *"Preface to IFAC's International Good Practice Guidance",* the PAIB said that a significant feature of IGPG is its explicit grounding in principles**.** The Committee reviews available guidance in a topic area, applying the extensive expertise and experience of its members and IFAC member bodies to draw out a set of globally applicable statements of principles. These principles should (a) guide the thought processes of professional accountants in business when they tackle the relevant topic, and (b) underpin the exercise of the professional judgment that is important in their roles. They provide the professional accountant in business (and those served by them) with a common frame of reference when deciding how to address issues encountered within a range of individual organizational situations. General guidance supports the consistent implementation of the principles and, where appropriate, provides signposts to sources of greater detail.

9.16 With regards due process, the Committee said that although IGPG does not impose an obligation on professional accountants in business, it does represent IFAC's recommended practice in the areas it covers. Therefore, each proposed guidance document is subject to a formal due process, whose key component is wide consultation including public exposure. This is intended to ensure both the quality and global applicability of the final document, attributes that lend the document its authority. This would mean that all IGPGs have been issued in a wide consultative and public exposure process.

9.17 For getting most out of the IGPG, the Committee said that the professional accountants in business should consider the relevance of IGPG documents to their organizational roles. The extensive and vital range of roles they perform is featured in the Committee's 2005 publication *The Roles and Domain of the Professional Accountant in Business.* Their roles include understanding and driving the creation of value; provision of information for decision-making, accountability and control; performance measurement and communication to stakeholders; financial control; improving efficiency; and managing risk. IGPG documents help professional accountants in business to select and apply the appropriate tools for analyzing and managing organizations in performing these critical tasks. This will encourage professional accountants in business, irrespective of geographical location or size or type of employer, to adopt broadly consistent approaches to their work. Some organizations might find it useful to distribute the content to subsidiaries, or to stakeholders in their value chain.

9.18 The Committee recommends that professional accountants in business (a) use the principles in IGPG to guide their decision-making, and (b) use the application guidance and signposting to other resources to consider how to implement guidance in practice. Good practice is always evolving. Therefore, over time newer and better techniques and approaches to the work of the accountant will inevitably emerge. Although the Committee periodically reviews its IGPG, it is the personal responsibility of the professional accountant to keep abreast of developments that may affect their work. IGPG also builds on the fundamental principles of integrity; objectivity; professional competence and due care; confidentiality; and professional behaviour already required of professional accountants in business by IFAC's *Code of Ethics for Professional Accountants*.

9.19 An IGPG document will typically include the following content:

- **General overview of why the topic is important,** including topic introduction and objective of the guidance and typical roles of the professional accountant in business in relation to the topic;
- **Principles that are widely accepted features of good practice,** including definitions of key terms and key concepts and frameworks (where they exist); and
- **Practical application guidance to support implementation of the principles,** including recognition of challenges and issues and sector-specific issues and practical examples of practice in the topic area.

9.20 Under the caption signposting to other key sources of information (resources), the document said:

- *Principles* represent fundamental generalizations that professional accountants in business should use as the basis of their reasoning and conduct. Principles typically provide a broad frame of reference, and stress starting points and boundaries rather than prescriptive rules. Principles, therefore, encourage the appropriate exercise of sound professional judgment by professional accountants in business.

- *Guidance* (application) supports the consistent implementation of principles, and recognizes issues and challenges in implementing good practice. Guidance also helps to clarify special issues in particular contexts, for example highlighting special considerations for public sector or small- and medium-sized entities.
- *Signposting* will ensure access to other key sources of information, including additional guidance, books, articles, websites, surveys, interviews, case studies, or critical analysis. Some of this information will be accessible via the IFAC Knowledge Net, accessible at www.ifacnet.com.

DOCUMENTS ISSUED BY THE PAIB SO FAR

9.21 PAIB has so far issued International Good Practice Guidance Statements (IGPG), Information Papers and other Publications on varied topics listed below. These publications led by IGPG play a stellar role of setting standards for improving the performance as well the quality of the internal governance inside organizations.

International Good Practice Guidance statements (IGPG)

- Project Appraisal using Discounted Cash Flow
- Defining and Developing an Effective Code of Conduct for organizations
- Evaluating and improving governance in organizations. (Exposure Draft)
- Costing to drive organizational performance (Exposure Draft)

Information Papers

- Developments in Performance Measurement in Public Sector entities.
- Crucial Role of the Professional Accountants in Business in mid sized enterprises.
- Business planning Guide - Practical Application for SMEs.
- Internal Control from a Risk Based Perspective.
- Internal Control - A review of recent developments.
- Professional Accountants in Business at the heart of sustainability.
- Role and Domain of the Professional Accountants in Business
- Why sustainability counts for the professional accountants in business.

Other Publications

- Role of Chief Financial Officers in 2010
- Enterprise Governance-Getting the balance right
- Managing Risk to enhance shareholder value
- Quality of Earnings- A case study collection
- The diverse roles of the Professional Accountants in Business

ENTERPRISE GOVERNANCE AND PAIB GUIDANCE NOTE

9.22 To understand the importance of the above publications it will be very useful to quote certain paragraphs from the exposure draft issued by IFAC on ***Evaluating and Improving Governance in Organisations*** (A copy of this exposure draft is placed at Annexure-XIV). This quote is useful in the context that all the documents of PAIB including IGPG are meant o improve the business governance of organizations.

> *"Concern that company attention is dominated by compliance at the expense of strategy and performance was confirmed by an independent survey commissioned by IFAC. The report issued in 2008, reveals that many respondents believed that organizations focus too much on compliance, and do not focus enough on matters such as strategy and building a business. The respondents also observed a check list mentality, leading to governance in name and not in spirit. Respondents recommended a move from compliance governance to business governance."*

9.23 The IGPG issued are all principle based and can be the corner stone of performance in business enterprises. For example the IGPG (exposure draft) on evaluating and improving governance in enterprise is based on the following principles:

- Creation and optimization of stakeholder value should be the objective of governance.
- Good governance should appropriately balance the interests of stakeholders to optimize value.
- The conformance and performance dimensions of governance are both important to optimize shareholder value.
- Good governance should be fully integrated into organizations.
- The governing body should be properly constituted and structured to achieve an appropriate balance between performance and governance.
- The governing body should establish a set of fundamental values by which the organization operates. All those

participating in governance should embrace those fundamental values.

- The governing body should understand the organisation's business model, its operating environment, and how stakeholder value is created and optimized.
- The governing body should provide strategic direction and oversight in both the conformance and performance dimensions.
- Effective and efficient enterprise risk management should form an integral part of an organisation's governance system.
- Resource utilization should align with strategic direction.
- The governing body should periodically measure and evaluate the organisation's strategic direction and business operations.
- The governing body should ensure that reasonable demands from stakeholders for information are met on timely basis.

IGPG ON COSTING TO DRIVE ORGANISATION PERFORMANCE

9.24 The PAIB of IFAC has issued an IGPG (exposure draft) on ***Costing to drive organizational performance*** that has been closed for comments recently. A copy of this exposure draft is placed at Annexure-XV. This IGPG is very important from the context of this report of the expert group in improving governance of organizations. In this IGPG, it has been said:

- The creation, operation, alteration, and cessation of every action and function in an organization, whether within the private, public, or voluntary sector – all incur costs. Costing – the accumulating and assigning of costs to the organization's various activities – enables the organization's cost structure to be understood, explained and improved. Costing is therefore an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It informs how profits and value are created, and how efficiently and effectively operational processes transform input into output. It includes product, process, and resource-related information covering the organization and its value chain. Costing information can be used to provide feedback on past performance, and to motivate future performance. It is most useful if it communicates not only what the costs are, but also how and why they are incurred.
- This view of costing supplants the traditional view that led many organizations to use costing exclusively as a tool to value inventories and determine profit. Many organizations now use

cost information to support a wide variety of decisions, which has led to the development and evolution of costing methods such as activity-based costing. The many costing methods and approaches to measuring costs often lead to confusion over (a) which costing methods might be useful in supporting an organization, (b) in which contexts they are best implemented, and (c) how they are implemented. Too often, such costing methods and approaches are perceived as solutions to business problems, whereas their principal value is diagnostic. However, alternative costing approaches should not be seen as competing with each other, and elements of each can be effectively combined. For example, both activity-based costing and standard costing can be applied to job-order or process costing systems. This International Good Practice Guidance (IGPG) establishes eight fundamental costing principles that will help professional accountants in business and their organizations evaluate and improve their approach to costing, and to *benchmark* good practice in applying costing systems and methods and using costing information.

- Good practice in costing involves improving costing systems and costing information to provide relevant cost and performance information with an objective of enabling organizations to deliver increased value to customers. Costing should therefore support a range of both regular and non-routine decisions when designing products and services to (a) meet customer expectations and profitability targets, (b) assist in continuous improvement, and (c) guide product mix and investment decisions.
- To better support decision-making, costing establishes and interprets relationships between financial, operational, and other data. Therefore, selecting the most appropriate approach for costing information and analysis, and using their output, requires the exercise of careful professional judgment and sound logic. Costing is not an exact science, but the selected costing approach should be rigorously applied. The eight principles have been developed in a way that allows professional accountants in business to be flexible developing costing systems and methods best suited to their organizations. Professional accountants in business should find this IGPG useful in explaining the role and purpose of costing to non-accounting colleagues.

9.25 Underlying the importance of cost accounting system, IFAC document further said that costing and the many costing methodologies applied in organizations, measures the consumption of economic resources and support the accountability of business performance. This is best achieved within a financial management system that

(a) delivers both cost information and operational feedback for planning, budgeting, cost, and financial accounting purposes, and for operational improvement;

(b) helps to ensure the fulfilment of external reporting and other compliance requirements; and

(c) helps to manage an organization.

9.26 Larger and more complex organizations (in terms of employee numbers, product and service lines, geographical spread, and complexity of processes) usually aim for a single costing system to develop reliable costing information to support both performance and conformance (against legal and regulatory requirements) decisions at both operational and strategic levels. Organizations with a single costing system typically derive cost data from a common data source to support the needs of both external users (investors, regulators, and tax authorities) and internal managers and employees. In manufacturing businesses, such an integrated system will allow (a) relevant costing and operational performance information to be provided to internal users, as well as (b) the valuation of inventory and measurement of cost of goods sold for financial reporting purposes. 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.

9.27 An integrated information system is not necessarily a single, closed information system for cost measurement, and performance improvement. Operational feedback systems could source data from outside the costing system, but the information presented needs to be integrated where appropriate to support operational performance, because it promotes employee learning and improvement in activities and processes. Integrating databases and information systems can help to provide useful costing information more efficiently as well as reducing source data manipulation. A comprehensive enterprise information system typically (a) tracks daily expenses by account code, activity, and business process, and (b) measures performance information that supports feedback to operations, such as the cost of resource consumption, defects, throughput, and quality, in addition to cost information associated with products, customers, and activities.

9.28 Small and/or less complex organizations will need cost information to manage their business operations. However, their requirements may involve costing systems with less formal procedures and methods, and these are likely to develop as a natural consequence of needing costing information. Such organizations should periodically consider the need for processes to report relevant and routine cost and operational information for management purposes. This will typically require a costing system and appropriate procedures to ensure that the necessary cost information is collected, measured, analyzed, and effectively communicated.

9.29 IFAC in their document has listed following ten costing methodologies and approaches that are more typically used worldwide:

- Activity Based Costing (ABC)
- Grenzplankostenrechnung (GPK)
- Lean Accounting
- Lifecycle Costing
- Job Order Costing
- Kaizen (continuous improvement) Costing
- Process Costing Systems
- Resource Consumption Accounting (RCA)
- Standard Costing
- Target Costing

9.30 The following definitions given by IFAC were found relevant by the Expert Group:

- **Accounting System**: It refers to the ledgers and the collection of financial information for financial reporting, supplemented by information needed for budgetary control. Costing systems draw on the same data, but require the additional ability to break particular ledger code outputs into smaller sums, usually by applying a factor derived from other ledger codes (for example, product revenues), payroll data (for example, timesheets), work study outputs, and sampling schemes, etc.

- **Cost Accounting**: It is the process (enabled by costing systems) of accumulating, measuring, analyzing, interpreting, and reporting cost information to both internal and external users. Cost accounting provides information for management accounting and financial accounting, although organizations typically use these terms interchangeably.

- **Cost Method**: Costing methods such as job and process costing, standard costing, ABC, Grenzplankostenrechnung, are (period costing) methods of assigning costs (cost assignment). Life cycle costing and target costing are non-period costing methods. Defining the appropriate measurement, assignment, and allocation of cost for a given purpose and decision involves selecting the appropriate costing method(s).

- **Cost Model**: The description of sources, drivers, classification, and organization of costs and the relationships between them, and the relationship between costs and income. The cost model therefore (a) explains an organization in dynamic financial terms, and (b) aggregates cost and contribution reports for an organization and its subdivisions (geographical, product, process, etc). A cost model can be used to design a technological solution that supports a costing system.

OBSERVATIONS OF THE EXPERT GROUP

9.31 Important features of the aforesaid exposure draft that are found relevant to the present exercise of the Expert Group are:

- Cost accounting that includes the accumulating and assigning of costs to the organization's various activities enables the organization's cost structure to be understood, explained and improved.
- Costing is an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It informs how profits and value are created, and how efficiently and effectively operational processes transform input into output.
- Costing includes product, process, and resource-related information covering the organization and its value chain. Costing information can be used to provide feedback on past performance, and to motivate future performance.
- Cost accounting serves as a most useful tool in communicating not only what the costs are, but also how and why they are incurred.
- 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 improvement; and
    - guide product mix and investment decisions.
- Costing is not an exact science, but the selected costing approach should be rigorously applied.
- Costing methodologies applied in organizations, measures the consumption of economic resources and support the accountability of business performance. This is best achieved within a financial management system that
    - delivers both cost information and operational feedback for planning, budgeting, cost and financial accounting purposes, and for operational improvement;

  - helps to ensure the fulfilment of external reporting and other compliance requirements; and
  - helps to manage an organization.

- Larger and more complex organizations (in terms of employee numbers, product and service lines, geographical spread, and complexity of processes) usually aim for a single costing system to develop reliable costing information to support both performance and conformance (against legal and regulatory requirements) decisions at both operational and strategic levels.
- Organizations with a single costing system typically derive cost data from a common data source to support the needs of both external users (investors, regulators, and tax authorities) and internal managers and employees.
- 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.
- An integrated information system is not necessarily a single, closed information system for cost measurement, and performance improvement.
- Integrating databases and information systems can help to provide useful costing information more efficiently as well as reducing source data manipulation.
- A comprehensive enterprise information system typically (a) tracks daily expenses by account code, activity, and business process, and (b) measures performance information that supports feedback to operations, such as the cost of resource consumption, defects, throughput, and quality, in addition to cost information associated with products, customers, and activities.
- Small and/or less complex organizations necessarily need cost information to manage their business operations. Therefore, these organizations must maintain proper cost accounting records. However, since their requirements may involve costing systems with less formal procedures and methods, these are likely to develop as a natural consequence of needing costing information.
- An accounting system refers to the ledgers and the collection of financial information for financial reporting, supplemented by information needed for budgetary control. Costing systems draw on the same data, but require the additional ability to break particular ledger code outputs into smaller sums.

- While cost accounting is the process of accumulating, measuring, analyzing, interpreting, and reporting cost information to both internal and external users; costing methods are methods of assigning costs; and a costing model is the description of sources, drivers, classification, and organization of costs and the relationships between them and the relationship between costs and income.

9.32 Further, as per the IFAC document, the key principles underlying widely accepted good practice in costing that drive the organizational performance are:

- The ability to account for, analyze, interpret, and present costs is necessary for an informed understanding of the drivers of profit and value, and is therefore an essential part of good financial management and decision-making.
- Cost information should be collected and analyzed systematically and consistently, whether in a routine information system, or for a specific application and/or purpose.
- Costing systems and methods should be designed and maintained to reflect an organization's chosen strategy and business model, taking account of its structure, culture and competitive environment.
- Cost information used to support strategic and operational decisions, performance management, or reporting should be appropriate for the specific purpose, context, and legal requirements.
- The professional judgment used to (a) determine costing methods, and (b) specifically select cost information to support decision-making, including any limitations on its applicability, should be transparent, rational, and understandable by the user.
- Definitions and sources of cost data, and the methods of calculation of costs, should be recorded and capable of review, risk analysis, and assurance.
- Cost information and costing assumptions should be periodically reviewed for their relevance, robustness, and susceptibility to change.
- The design, implementation, and continuous improvement of costing methods, data collection, and systems should reflect a balance between the required level of accuracy and cost.

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

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

9.35 Further, in a public sector context, using full cost information along with non-financial information on program outputs and outcomes can aid governments, managers, and other stakeholders to make decisions on service delivery. The full costing of public service programs (or the output of a responsibility centre) generally involves compiling the sum of direct and indirect costs that contribute to the program or output. This compilation also includes the full costs of intermediate activities, processes, projects, or programs that need to be measured to calculate the full costs of their outputs. This can enable better evaluation of the merits of a public service policy or program (although program outcomes may require separate measurement).

9.36 As per IFAC, activities that are referred to as Management Accounting can be:

- Generation or creation of value through the effective use of resources (financial and otherwise) through the understanding of the drivers of stakeholder value (which may include shareholders, customers, employees, suppliers, communities and government) and organizational innovation.
- The provision, analysis and interpretation to management for formulation of strategy, planning, decision making and control.
- Performance measurement and communication to stakeholders, including the financial recording of transactions and subsequent reporting to stakeholders typically under national or internationally Generally Accepted Accounting Principles (GAAP).

- Cost determination and financial control, through the use of cost accounting techniques, budgeting and forecasting.
- The reduction of waste in resources used in business processes through the use of process analysis and cost management.
- Risk management and business assurance.

9.37 The extent to which cost accounting is used within governments varies from country to country. In September 2000, the Public Sector Committee (PSC) of IFAC published a Study Paper on "*Perspectives on Cost Accounting for Governments, an International Public Sector Study*". This provided useful governmental perspectives on cost accounting and is aimed at improving public sector financial management and accountability. On the uses of Cost Accounting in Government, it said that in addition to its historical function of determining values in the financial accounting process for inventories or other types of property, cost accounting has a number of primarily management functions, including budgeting; cost control and reduction; setting prices and fees; performance measurement; program evaluations; and a variety of economic choice decisions. When cost accounting is used in the commercial activities of governments, its applications in financial accounting and management functions need not be materially different than those in the private sector. A copy of the aforesaid study paper is enclosed as Annexure –XVI.

9.38 Based on the above observations, the Expert Group concluded that in the approach of IFAC there is a major focus shift from the corporate governance to the enterprise governance. Hence, to achieve the objectives of enterprise governance, the content and relevance of purely financial accounting data and information, as a means to evaluate performance, is poised for a sea change. This is clearly reflected in many documents published by IFAC. In this context, IFAC has started recognizing the need for adequate cost information and reporting framework to the governing body of enterprises for risk-management and decision making needed to enhance the stakeholders' value. IFAC has also very clearly highlighted the usage of such framework in the functioning of government and other public agencies.

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CHAPTER-10: ROLE OF REGULATORY BODIES

Need for Regulatory Mechanism

10.1 A market is a social arrangement that allows buyers and sellers to discover information and carry out a voluntary exchange of goods or services. The neo-classical approach generated the view that a market could be defined as competitive when there was a significantly large number of sellers of homogenous products so that no sellers had enough of a market share to enable them to influence the product price by changing the quantity that they put into the market.

10.2 Economic regulation, a form of government intervention, is designed to influence the behaviour of firms and individuals in the private sector. Other forms include public expenditures, taxes, government ownership, loans and loan guarantees, tax expenditures, equity interests in private companies and moral suasion. Defined as the *"imposition of rules by a government, backed by the use of penalties, that are intended specifically to modify the economic behaviour of individuals and firms in the private sector"*, regulation in general is aimed at narrowing choices in certain areas.

10.3 In the past most developing countries were characterized by significant government involvement in their economies marked by dominance of large state owned enterprises. Economic reforms were undertaken such as trade liberalization, opening up of economy, promoting FDI, and facilitating private sector participation. The thrust of economic reforms has been to allow for more competition. The underlying rationale is that competitive markets ensure efficiency resulting in best choice of quality, lowest prices and adequate supplies to consumers. The possibility of market failure underpins the economic rationale for state regulation of market economies.

10.4 Firms can be regulated in terms of their profits or prices, as well as their quality of service. The three general forms of regulatory instruments are:

- Cost of Service Regulations
- Price Cap Regulations
- Sliding Scale Regulations

10.5 Regulations can take different forms with different roles, viz.

- Health, safety regulations and environmental regulations can be rationalized on the basis of imperfect information and externalities.

- Economic regulation of public utilities can be explained by economies of scale and scope and need to protect the consumers from monopoly exploitation.
- Aspects of fiscal policy can be rationalized on the basis in terms of wealth and income redistribution.
- Regulatory intervention for universal service obligations, etc.
- Regulatory intervention to ensure proper allocation of economy's resources towards economic activities that ensures growth in the desired direction and ensures competitiveness.
- As an effort by the state to address social risk, market failure or equity concerns through rule based direction of individual and society.

10.6 Regulation is a complex balancing act between advancing the interests of consumers, competitors and investors, while promoting a wider 'public interest' agenda, minimum prices to benefit the consumer (maximize consumer surplus); ensure adequate profits are earned to finance the proper investment needs of the industry (earn at least a normal rate of return on capital employed); provide an environment conducive for new firms to enter the industry and expand competition (police anti-competitive behaviour by the dominant supplier); preserve or improve the quality of service (ensure higher profitability is not achieved by cutting services to reduce costs); identify those parts of the business which are naturally monopolistic (statutory monopolies that are not necessarily justified in terms of either economies of scale or scope); take into consideration social and environmental issues (e.g. when removing cross subsidization of services). These are five principles to determine the relevance and effectiveness of regulations.

10.7 While regulation has significant relevance in the current economic scenario, cost data fed regulational issues are also many and worth considering while examining the relevance and usefulness of cost data of companies. For tariff fixation/approvals in public utilities like electricity, for ensuring objective subsidy policy, to ensure operational regulation within competitive practices are some of the areas that would require adequate cost audit systems. Admittedly, these factors are not addressed in financial reporting mechanisms. In fact, the nuances of competitive regulation would require elaborate cost data for ensuring that anti-competitive policies are not followed. For example, in anti-trust practices or predatory pricing practices, the cost data of concerned business units need to be examined for proper examination and adjudication. The regulatory mechanisms would greatly require a cost audit system in position as a pre-condition to positioning such regulatory mechanisms. In fact, the WTO agreement provides for different kinds of anti-competitive practices to be regulated by member countries through appropriate laws. Anti-dumping is one of such important areas where authenticated cost data would be extensively required for investigation into anti-dumping complaints and taking legal action against dumping practices. Non-existence of required cost data would be a handicap to the concerned companies as well as to the Government in its investigation. In a way such cost data has become imperatively mandatory under the WTO regime. The existing costing practices are poor in providing structured mechanisms for a good analysis of the cost information. Hence there is an urgent need to evolve mechanisms to ensure structured cost data in companies in all the sectors and a structured system to provide assurance service through cost audit mechanisms.

Regulatory Developments in India

10.8 Early 1990s were the turning points for the Indian Economy. A number of initiatives were taken by the Government and other authorities (like RBI) in liberalizing the Indian economy, abolishing the license system in areas which were not of strategic importance (like public utilities), and allowing the industry to produce and sell as per the free market forces like in other developed economies of the world. All these initiatives forced industry to compete with domestic players as well as foreign players and to find their own place in the market without any support from the State. FDI norms were also liberalized allowing international companies to have an access to Indian markets and to start manufacturing activities in India. Similarly from 1st January 1995, the imports and exports were opened up under the WTO Agreements, tariffs & custom duties were lowered and trade barriers were removed. As a result, Indian industry had to face further competition with imported goods also. All these changes and developments in the Indian economy, on one side, opened up immense opportunities before the Indian industry; on the other side, put a tremendous pressure on it to become *cost competitive* if to survive, to find the ways to become cost efficient, to improve systems' efficiency and to become more *professional* in their approach to do business.

10.9 Though it is strongly believed world-wide that free market forces bring efficiency into industry, reduction in cost, innovations, and wide product range for the customers, yet it is also strongly believed world-wide that 'unregulated markets' may sometimes cause more harm than good to the customers. Unregulated markets may lead to cartelization, unfair trade practices, predatory prices, etc. and therefore, some regulation of the markets is very much essential, especially in case of public goods/service industry like telecom, power, etc. Realizing this hard reality of the free markets, countries including highly developed are creating necessary regulators for the industry as per their requirements.

10.10 The transition of the Indian economy from being a controlled one to a deregulated one was a momentous step. But if a deregulated economy leads to, for instance, unhealthy competition or to predatory exploitation of the consumer, the whole objective of making Indian economy liberalized will be defeated. Therefore, some regulatory mechanism is very much desired. Following the international experiences, the concept of Regulatory Bodies was also introduced in India, to supervise and regulate the important sectors of the economy like Electricity, Telecom, Petroleum, Financial Sector, etc. In addition, it was also considered that there should be controls on the abuse of power like restrictive trade practices, cartelization, etc, through Regulatory Authority. For instance, the Competition Commission of India is created to prohibit things like anti-competitive agreement, abuse of dominant position by an enterprise and to regulate certain combinations which may include acquisition of shares, acquiring of control and mergers/amalgamation between and amongst enterprises.

10.11 In India, the importance of competition policy and related regulatory regimes has increased greatly since 1991 when a massive wave of liberalization eliminated many controls on investment, capital market, foreign trade and prices. Prior to 1991, the public interest was sought to be served more through direct regulations that required the prior approval of government for many commercial decisions. Post-1991, in most sectors of the economy, the protection of public interest objectives rests with the laws governing competition and the regulatory regimes that have been set up for “natural” monopolies and network industries (where the production patterns of one producer are linked to that of others). This approach may, however, become ineffective when competition in natural monopolies cannot be ensured as such. Situations can also arise where there may be a number of players in the market but the market itself is so segmented that individual players become monopolists. The only way to get ‘competitive outcomes’ in such markets is to put effective regulation in place. Thus, regulation in different sectors becomes an integral component of competition policy. Cartels, in India as well as elsewhere, are found to be the most common practice in markets particularly in the intermediate products, i.e. cement, tyres, steel, etc., that are processed and that form input costs all along several stages of the supply chain with fairly sophisticated customers. Thus, a cement cartel may result in a distributor being overcharged, which is then passed on in higher prices from the distributor to a builder, and finally the householder.

10.12 In the social sectors too, the need for regulation is strongly felt. Healthcare and education are critical soft infrastructural issues for economic growth. The healthcare sector is plagued with anticompetitive practices, which are mostly found at local level and need local solutions by way of local regulatory agencies supported by vigilant consumer activism. Strict regulation of all healthcare services is the need of the hour. Fee structures at private healthcare centres need to be formalized and monitored to prevent exploitation of patients. The education sector requires a paradigm shift in regulation and the debate has only just begun. The National Knowledge Commission has highlighted the extreme barriers to entry that exist in the field of higher education. This has resulted in an increase in the size and deterioration in the quality of existing universities, as there is no competition. Besides, it does not promote autonomy and accountability. The education sector requires two types of transformation: state must invest heavily to increase access to higher education and it should respect the autonomy of the institutions, so that a diversity of methods finds expression; and institutions should be allowed to have the flexibility so that talent can be retained in the country.

10.13 During the last two decades, large numbers of regulatory bodies have been set-up in India; and more are in the process of being constituted to regulate different sectors of economy. These can be classified into three categories:

- Central/State Government Ministries/Departments;
- Councils/Committees/Commissions/Boards; and
- Sector-specific Regulators.

10.14 Important regulatory bodies are:

- All India Council for Technical Education
- Central Board of Direct Taxes
- Central Board of Excise & Customs
- Central Pollution Control Board
- Central Silk Board
- Central/State Electricity Regulatory Commission
- Coastal Aquaculture Authority
- Coffee Board
- Coir Board
- Directorate of Anti-dumping
- Directorate of Sugar

- Directorate of Vanaspati
- Fertilizer Industry Coordination Committee
- Food Authority (being set up)
- Forward Markets Commission
- Insurance Regulatory and Development Authority
- Jute Commission
- Ministry of Corporate Affairs
- National Highways Authority
- National Pharmaceuticals Pricing Authority
- National Rainfed Area Authority
- Petroleum and Natural Gas Regulatory Board
- Reserve Bank of India
- Rubber Board
- Securities & Exchange Board of India
- Tariff Authority for Major Ports
- Tea Board
- Telecom Regulatory Authority of India
- The Competition Commission of India
- University Grants Commission

Role of Regulatory Bodies

10.15 In order to ensure proper and effective regulation of the markets, the regulatory bodies have been equipped with necessary powers and are authorized to regulate the market and the corporate sector. Under their respective Acts, the regulatory bodies set minimum standards of operational efficiency which are to be adhered to in production and services provided by the companies. They also monitor that the prices charged are consistent with efficiency, equity and sustained healthy development of the sector. For this purpose, the regulatory bodies need to collect data related to a utility's costs, revenues, performance, and other to use in tariff determinations and monitoring related sector outcomes. Accordingly, the companies and the utilities are required to furnish the required information concerning their facilities and operations which the concerned regulatory body might require to determine utility rates, assess their practices or to ensure '*fairness*' to the players and the consumers in a particular sector.

10.16 Among others, one of the most important tasks of many regulatory bodies is to fix prices/charges for different products/services especially where there is a single supplier of goods/services or the good in public good/service or they may fix maximum price that can be charged by the companies or service providers. For example, National Highways Authority of India (NHAI) which is the regulatory authority responsible for the development, maintenance and management of National Highways entrusted to it and for matters connected or incidental thereto, is also responsible for fixing up the toll charges to be taken by the companies or utilities from the users of the highway toll road. While fixing the toll charges, the NHAI considers not only the relevant policy issues e.g. exemption of toll charges to two wheelers, tractors, etc. but also ascertain the costs incurred for constructing the road and operating costs, and then it fixes the toll charges. Hence, to take sound decisions with necessary 'fair gains' to all concerned parties related to the development of national highways, the NHAI needs necessary cost data. And, the companies can provide NHAI the required data related to various cost elements only when they have a reliable and principle based cost accounting system.

10.17 Many times, due to social and economic reasons, a particular section of society needs concessions in charges for goods/services. For example, in Telecom Sector, the telephone services have to be provided to rural India at concessional rates. Also, villagers may need concessions on toll charges on whose land the roads are built. Similarly, senior citizens have also been offered special concession. In all such cases, unless and until the regulatory bodies have reliable cost data from the companies/utilities, it will be very difficult for them to decide the quantum of concession and cross-subsidy among the customers which is *fair* to all concerned players in that sector. Therefore, the regulatory bodies need reliable cost estimates for this purpose and the companies cannot provide them unless their own costing systems are in place.

10.18 Further, in some sectors, players are sharing each other's infrastructure or some common infrastructure. Then, the regulatory bodies are required to fix usage charges for the use of such infrastructure facilities to be paid by the service providers. To ensure that each player pays *fair* charges for using such infrastructure facilities, the regulatory bodies need proper cost estimate of the same and fix charges that are *just* for everyone in the given sector. For that, each player in that sector must maintain necessary cost accounting records so as to provide the regulatory bodies necessary cost data on the basis of which *just* decisions could be taken by them.

10.19 Government also provides subsidies to the manufacturers of certain products e.g. fertilizer, so as to achieve certain objectives stated in its various economic and social policies. In that case the amount of subsidy is decided by the concerned regulatory body. How much subsidies should be extended to concerned manufacturers depends upon their cost structure. Besides, the direct intervention by some regulatory bodies requires conducting various studies to know the various trends in industry for taking necessary steps in advance to achieve policy determined objectives. All these require that the regulatory bodies should have necessary cost data about related to the concerned companies/utilities. Unless the companies/utilities are maintaining the necessary cost data in this regard, they cannot supply reliable cost data in the required form as needed by the regulatory bodies. Therefore, it is must for the companies to maintain necessary cost data in the form meeting the requirements of the concerned regulatory bodies.

10.20 Regulatory bodies, like the Competition Commission of India and SEBI, are required to seek fair play for all players in the market so that each manufacturer should have a right to enter and exit a sector, customers have a right to be protected from the unfair practices, and investors need to be protected from unscrupulous enterprises and other such issues. To play an effective role, these regulatory bodies need many times cost information from the companies especially when it is doubted that the enterprises are exploiting customers and others or they are resorting to predatory pricing to create artificial entry barriers for others or are unduly cross-subsidizing one class of customers at the cost of the other class of customers. Reliable and certified cost will provide necessary basis on which these regulatory bodies can base their decisions to ensure justice for everyone in the market.

10.21 Further, many times the regulatory bodies require cost data to determine the profitability levels in a particular sector so that they can fix a *fair* license fee or any mechanism of revenue-sharing.

10.22 From the above, it can be inferred that the regulatory bodies require cost data for a number of purposes like fixing the tariff, amount of subsidy, usage charges, etc. For all these purposes, the regulatory bodies need accurate and reliable cost data from companies/utilities/service providers. Therefore, the relevance of cost accounting systems in companies/utilities has increased immensely with the creation of regulatory bodies.

Observations of the Expert Group

10.23 At present, the regulatory bodies have prescribed their own formats in which the companies are required to submit the necessary cost information. In the absence of accurate and reliable cost data at the end of the companies/utilities, the regulatory bodies cannot discharge their statutory responsibilities in, say, fixing the correct tariff and other charges. They take the certified cost data in the prescribed formats from the companies/service providers. Such data is generated from the companies costing systems and if they are not well designed and implemented, even the certified copies may not provide relevant and reliable data to the regulatory bodies on which they base their decisions. Hence, it is highly mandated and imperative to ensure that the companies are maintaining proper records of costing through well designed costing accounting system and get these records duly audited/certified from an independent cost expert.

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CHAPTER-11: INDUSTRY ASSOCIATIONS' REPRESENTATIONS

11.1 On the issues relating to maintenance of cost accounting records and cost audit, Ministry of Corporate Affairs has been receiving representations from various industry associations and sectoral organizations. Since the Expert Group was constituted on 21.01.2008, all these representations were referred to this Group for examination. These are:

- Confederation of Indian Industry (CII), New Delhi
- Crop Care Federation of India (CCFI), New Delhi
- Federation of Industries and Associations (Gujarat), Ahmedabad
- The Gujarat Dyestuffs Manufacturers' Association, Ahmedabad
- Gujarat Chamber of Commerce & Industry, Ahmedabad
- Pesticides Manufacturers & Formulators Association of India, Mumbai
- Basic Chemicals, Pharmaceuticals & Cosmetics Export Promotion Council (CHEMEXCIL), Mumbai
- Indian Chemical Council (ICC), Kolkata
- Manufacturers' Association for Information Technology (MAIT), New Delhi
- Indian Paper Manufacturers Association (IPMA), New Delhi
- Association of Synthetic Fibre Industry (ASFI), New Delhi
- Society of Indian Automobile Manufacturers, New Delhi
- Alkali Manufacturers' Association of India, Delhi

11.2 Generally, identical issues have been raised in most of these representations. These are summarized as under:

- Cost audit reports are not being demanded from all companies engaged in production of a product.

- Data requirement under CARR & cost audit is extremely detailed and cumbersome and requires a lot of time, work leading to high cost of compliance.

- Costing for each product has to be submitted separately. In many instances, even the data available within the ERP systems are not adequate, and needs to be manually extracted and prepared.

- Companies are required to include in the cost audit reports very sensitive information which they are otherwise not required to make public. There is, therefore, the danger of sensitive information being used for unauthorized, illegal, and competitive purposes.

- Some of the prescriptions under CARRs are contrary to the requirements prescribed under GAAP and the financial records that companies are required to maintain. Thus the information in the cost statements can contradict the financial records maintained by companies.

11.3 These associations have also made the following suggestions:

- CARRs and cost audit should be applicable to the industries under licensing, engaged in essential services, infrastructure industries, receipt of grant/subsidy, etc.
- Cost Accounting Standards be evolved on the lines of financial Accounting Standards and made mandatory for companies to follow the same in preparing the cost statements.
- Under CAS, companies would compile the cost through their own ERP system and arrive at the cost more precisely than before which will be more meaningful and cost effective.
- CARRs be scrapped and in its place, companies may be asked to adopt their own system conforming to the Cost Accounting Standards.
- The appointment of cost auditors may be done by the Board without reference to the Government.
- The cost auditors may be asked to submit their report to the Management instead of to the Government.
- The requirement to submit Proforma and the annexure to the cost audit report may be dispensed with. The cost audit report shall only contain the product cost details duly certified by the cost auditor along with the cost auditor's suggestions for improvement.
- It is highly unjust to get cost data from small Indian manufacturers. Therefore, all SSI units should be exempted from the applicability of sections 209(1)(d) and 233B of the Companies Act, 1956.

11.4 Earlier, on many occasions, various industry associations have been tendering their views on the existing mechanism/framework of cost accounting records and cost audit. These are:

- ➢ The Cost Audit methodology as structured originally under section 233B had two perspectives viz., the attestation of cost structure and the efficiency review perspective.
- ➢ In a period of price control and administered interventions, attested cost structure had a major role to play and hence the attestation perspective got the emphasis. The profession was

required to verify and validate the cost figures in selected industries before they were submitted to the Government.

- The efficiency review was relatively less emphasized and therefore, did not receive much impetus in the form of new auditing techniques and methodology.
- The period starting from early 90's onwards witnessed the dawn of an era of liberalization and global competition. This brought in the necessity to move towards Market Driven Prices, where the end price was determined by the customer in the domestic and international markets.
- In the present competitive economic environment, opening up of markets at national and international levels has made the manufacturing sector more conscious about the need to bring efficiency and economy in their operations.
- “Cost Leadership” and “Total Cost Management” is the present day mantra.
- Cost control and cost reduction is an on-going exercise for the management to have competitive edge over others.
- In the face of open market competition, companies by default are required to be competitive, and cost conscious for their survival. Therefore, companies and manufacturers keep necessary cost data irrespective of rules and regulations.
- The maintenance of cost records is essentially an internal affair of a company. Mandatory maintenance of records under prescribed CARRs adds to compliance cost. The rules, therefore, needs a re-look in the light of the opening up of the Indian economy and market rule pricing. These need to be simplified.
- What needs to be done is to redefine the cost audit objectives without losing the legal backup and the mandatory force it gives for compliance.
- Instead of the attestation perspective, which was emphasized earlier for price control, the efficiency review aspect should be blown in full force to enable better corporate governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness.
- There is need to revisit the current methodologies of cost auditing and reporting frameworks. Ultimately, cost audit should catalyze and facilitate the cost competitiveness of India Inc. Present formats of Cost Audit Report need to be restructured.
- Feedback on Cost Audit Report is essential. Therefore, while maintaining full confidentiality of cost data and without

disclosing the company identity, the industry-wide cost data may be disseminated and shared with the industry associations to help them to improve their competitiveness.

- Industry-wide Cost Standards/Benchmarks should be made available to the industry to enable them to maintain uniformity and enhance value for money.

11.5 The representations received from various associations referred to in para 11.1 above were examined by the Expert Group. It was noted that broadly these relate to issues like scope of sections 209(1)(d) and 233B, applicability of CARR, structure of cost audit report, cost of compliance, confidentiality of cost data, etc. The Expert Group noted that barring CII, all other sectoral associations are part and parcel of the apex level industry associations, viz., CII, FICCI, and ASSOCHAM. Since all these apex level industry associations are members of the Expert Group and their views are being duly addressed, the Group decided that no further action is required on the representations made by such sector based associations.

11.6 Apart from the aforesaid representations, the following associations have sent their detailed replies to the Expert Group Questionnaire. Except Indian Banks Association, all others have voluntarily participated in this exercise.

- Confederation of Indian Industry (CII), New Delhi
- Crop Care Federation of India (CCFI), New Delhi
- Indian Paper Manufacturers Association (IPMA), New Delhi
- Indian Banks Association (IBA), Mumbai

11.7 Their views on various issues have been duly incorporated at suitable places in this Report. In general, they have agreed to the modified framework initially proposed by the Expert Group through the questionnaire. This is, at many places, in line with their earlier views. The revised scheme, duly consented to by all the participants, is expected to benefit different stakeholders and address genuine concerns of the industry associations/companies.

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CHAPTER-12: MAINTENANCE OF COST ACCOUNTING RECORDS

Constitution of Working Group

12.1 One of the principle terms of reference assigned to the Expert Group was

> *"to review the Cost Accounting Record Rules and their continued relevance in the contemporary competitive environment as per the presently prescribed structure/format, and make recommendations for requisite modifications and/or alternative structures."*

12.2 For this purpose, a separate Working Group (WG-II) was constituted by the Expert Group, under the chairmanship of Shri Lalit Bhasin, leading Advocate at Supreme Court of India & Chairman, Corporate Affairs Committee, representing the PHD Chamber of Commerce and Industry and Federation of Indian Chambers of Commerce & Industry in the Expert Group. Other members of this Working Group were:

5. Shri Kunal Banerjee, the then Vice-President and currently President, ICWAI
6. Shri D.K. Sarraf, Director (Finance), ONGC
7. Shri A.R. Ramanathan Iyer (since deceased), Former Member, Company Law Board & CERC and a leading Cost Consultant
8. Shri I.P. Singh, Director (Cost), Ministry of Defence

12.3 The aforesaid Working Group held several meetings and detailed deliberations on the subject. They submitted their report that was considered and taken on record by the Expert Group in its meeting held in New Delhi on 18th November, 2008. Relevant issues highlighted by the Working Group and its' recommendations have been discussed in the ensuing paragraphs.

12.4 This issue, being interrelated with the other terms of reference, has also figured in the reports of other Working Groups as well. Therefore, any views and/or recommendations made by other Working Groups have also been suitably incorporated in this chapter.

Existing Provisions in the Companies Act, 1956

12.5 Section 209 of the Companies Act 1956 deals with the books of accounts to be maintained by a body corporate. The section provides as follows (full text is appended as Annexure-V):

> ***Section 209(1):*** *Every company shall keep at its registered office proper books of account with respect to -*

> *(a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place;*
>
> *(b) all sales and purchases of goods by the company;*
>
> *(c) the assets and liabilities of the company; and*
>
> *(d) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particular in the books of account.*

12.6 Clause (d) of sub-section (1) of section 209 was inserted by section 20 of the Companies (Amendment) Act, 1965 (31 of 1965). The Objects and Reasons in the Bill stated:

> *"The object of the amendment of sub-section (1) of section 209 is to ensure that in respect of companies engaged in production, processing, manufacturing or mining activities which may be specified by notification issued by the Central Government, proper records relating to utilisation of material and labour are available, which would make the efficiency audit possible."*

12.7 Ramaiya's Guide to the Companies Act elaborates that "*Efficiency audit*" is possible only when a system of cost accounting is adopted and costing records maintained for purposes such as the following:

- To furnish accurate cost of jobs, materials, finished products, comparing present cost with previous cost experience;
- To make accurate periodical cost statements for information and guidance of the management;
- To help determining price of finished products by furnishing all relevant data;
- To evaluate production processes with cost data;
- To analyse each production activity whether it is value-added or non-value added and to link-up with cost data;
- To help planning operations and control stock;
- To determine efficiency of operations by furnishing data as to cost volume of production etc.;
- To distribute overhead costs in a rational manner; and
- To help, continuous study and reporting as to material cost prices, quality of material, transportation costs, plant idleness, production capacity overhead costs etc., quality of labour,

> labour costs, waste, depreciation in all its aspects such as machine deterioration, accelerated depreciation, etc.

12.8 The Joint Select Committee in their Report said:

> *"The Committee feel that a company may be required under the proposed clause (d) of sub-section (1) of section 209 to include the prescribed particulars in its books of account only if it pertains to a class of companies engaged in production, processing, manufacturing or mining activities and all other companies belonging to that class are required to include such particulars in their books of account."*

12.9 In his reply to the Debate in Rajya Sabha, the then Hon'ble Finance Minister of India, Shri T.T. Krishnamachari stated that:

> *"while we have made it obligatory or rather semi-obligatory to employ Cost Accountant, it is our intention to ask certain industries to have a cost accountant's report."* (*Proceedings of Rajya Sabha, 14th September, 1965* column 3974)

12.10 Highlighting the absolute necessity of cost accounting and cost audit in all companies in due course, he added:

> "w*hen we can have sufficient number of Cost Accountants so as to make it obligatory for every company, every producing concern and every manufacturing concern, to have a cost accountant's* report." (*ibid column 3974*)

12.11 Reiterating the future vision of the Government, he further said:

> "*we are really making it possible for the institution of Cost Accountants to grow so as to enable the Government some time later to make every manufacturing company employ a Cost Accountant, and have a cost accountant's report in regard to the cost of product that it produces.*" (*ibid columns 3974*)

Observations on Section 209(1)

12.12 Whereas clauses (a), (b) and (c) of sub-section (1) of section 209 deals with maintenance of financial books of account, clause (d) deals with the maintenance of cost accounting records.

12.13 A company may, if it so chooses, keep particulars relating to utilisation of material, labour or other items of cost in one set of books along with the financial accounts. This section does not insist on having separate books for maintaining particulars relating to costs referred to in clause (d) of sub-section (1) thereof. ICAI in their Guidance Note on the Statement on the Companies (Auditor's Report) Order, 2003 has also said that "*section 209(1)(d) of the Act requires a company pertaining to a class of companies ……… to maintain proper books of account showing particulars relating to utilization of material or labour or to other items of cost …….. These* *books of account and records form part of the books of account of the company within the meaning of section 209……."* Therefore, it is amply clear from above that the law does not distinguish between the books of account maintained by a company either for the purposes of financial statements or for preparation & presentation of cost statements.

12.14 Cost accounting is a continuous process and cost records should be such as to enable a comparative analysis of expenses, variations and changes, both with reference to actual costs and standard costs. In this regard, ICAI in their Guidance Note on the Statement on the Companies (Auditor's Report) Order, 2003 has said that the Cost Accounting Records Rules issued for various industries contain requirements relating to two matters (a) maintenance of proper books of account relating to materials, labour, and other items of cost; and (b) preparation of cost statements at the end of the financial year in accordance with the rules specific to the industry concerned. While the records relating to materials, labour, etc. are required to be maintained on a day-to-day basis, the cost statements have to be prepared periodically. The Order requires the auditor to report whether cost accounts and records have been made and maintained. The word "made" applies in respect of cost accounts (or cost statements) and the word "maintained" applies in respect of cost records relating to materials, labour, overheads, etc.

12.15 The cost accounting records should be kept in such a manner that it should be possible to compute properly the cost of production and the cost of sale. The books should also contain the prescribed particulars of various elements of cost, e.g. material, labour, etc. Where a company is a multi-product company and is engaged in manufacturing products other than, or in addition to, the product covered by the Cost Accounting Records Rules, the record should be kept in such a manner that the cost of other products is not included in the cost of production of the product covered by the Rules.

12.16 A plain reading of section 209(1)(d) brings out the following distinct features of the provision:

a) It applies to a "class of companies";

b) Class of companies to be engaged in production, processing, manufacturing or mining activities; and

c) Central Government to prescribe rules/particulars relating to utilization of material or labour or to other items of cost.

12.17 As per the vision of law makers at that time, every manufacturing company would be required to engage a cost accountant and have his report on the cost of products produced.

Implementation of section 209(1)(d)

12.18 Except the term "production company", other terms have been defined under the Companies (Auditor's Report) Order, 2003 as under:

- *"Processing company"* means a company engaged in the business of processing materials with a view to their use, sale, delivery or disposal.
- *"Manufacturing company"* means a company engaged in any manufacturing process as defined in the Factories Act, 1948 (63 of 1948).
- *"Mining Company"* means a company owning a mine, and includes a company which carries on the business of a mine either as a lessee or occupier thereof.

12.19 The term "class of companies" was construed to mean as companies engaged in the production/manufacture of a particular product. For each product/industry, Government of India prescribed separate Cost Accounting Records Rules (CARRs).

12.20 Small scale industrial undertakings, as defined in the Industries (Development and Regulation) Act, 1951 were granted exemption from the requirement of maintaining cost accounting records even if they belong to a class of companies for which CARRs are prescribed subject to the following conditions (*Notification Nos. GSR 425(E) to 467(E), F. No. 52/19/97-CAB dated 03.08.1998*):

(c) the aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year, does *not exceed limit as specified for a small scale industrial undertaking* under *the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and*

(d) the aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crore of rupees.

12.21 Since 1965, under section 209(1)(d) of the Companies Act, 1956, Government of India has framed and notified separate CARR for 44 industries/products. This list contains items used as agriculture inputs, mass consumption products, industrial products, etc. Most of these industries are engaged in the production, processing, manufacturing or mining activities. Later, Government prescribed Cost Accounting Record Rules for companies engaged in various other activities such as, exploration & processing of crude oil, growth & processing of plantation products, generation, transmission & distribution of electricity, all range of telecommunication services, etc.

12.22 All the 44 Cost Accounting Record Rules (CARR) carry almost identical information (except for some industry specific minor variations). Each CARR has three parts, viz.

- Part-I is the main rule itself showing applicability clause, directions to maintain cost records and the penalty clause.
- Part-II is the main schedule carrying 26 paragraphs giving narrative explanation of various elements of cost and their treatment in cost records. Since the cost accounting principles remain same for all industries, these paragraphs are almost identical in all the rules. However, a few para under some CARR also contain industry specific terms/variations.
- Part-III contains various proformae. Though these proformae are also largely common for utilities, process materials, intermediates, cost of production, cost of sales and reconciliation with financial records across industries/products, however, they show variations with respect to specific industries taking into consideration their peculiar process.

12.23 Important industries/products so far covered by CARRs can be broadly classified as under:

- **Agriculture Inputs:** Insecticides, Fertilizers, Electricity and Diesel.
- **Consumer Products:** Milk Food, Sugar, Vanaspati, Tea, Coffee, Textiles, Paper, Jute Goods, Bulk Drugs & Formulations, Soaps & Detergents, Footwear, Cycles, Tyres & Tubes, Air-Conditioners & Refrigerators, Motor Vehicles, Cement, Electronic Products, Electric Lamps, Fans, etc.
- **Industrial Products:** Steel Plants, Steel Tubes & Pipes, Electric Motors, Power driven Pumps, IC Engines, Transformers, Generators & Machine Tools and Bearings, Electric Cables & Conductors, Motor Vehicles, Industrial Alcohol, Aluminium, Rayon, Nylon, Polyester & Dyes, Chemicals (only 44), Mining and Metallurgy, Petroleum Products & Industrial Gases, and Generation of Electricity.
- **Services Sector:** Transmission & Distribution of Electricity and Telecommunication services.

12.24 Important industries/products that are not so far covered by CARRs can be broadly classified as under:

- **Agriculture Inputs:** Agriculture Tools & Implements and Agriculture Machinery, Bio-diesel, etc.

- **Consumer Products:** Salt, Chocolates, Food Processing Industry, Agro-based products, Matches, Articles of various Metals, Leather, Wood, Glass, Rubber, etc., Ceramic Products, Home Appliances, Telephone Instruments, Sports Goods, Photographic & Optical Goods, Tobacco, Cigars & Cigarettes, etc.

- **Industrial Products:** Coal & Lignite and Ores, Slag & Ash, Fire Extinguishers, Explosives, Banking Machines, Railway Locomotives, Coaches, Wagons, etc. Plastics and articles thereof, Turbines, Textile Machinery, Printing Machinery, Binding Machinery, Typewriters, etc., Optical Fibres, large number of Organic & Inorganic Chemicals, Steel Re-rolling Mills and other articles of iron & Steel - Railway track material, tanks, structures, wire, grill, drums, etc., Manufacture/sub-assembly of aircrafts, Ships, Sub-Marines, Missiles, etc., Arms, Ammunition and Weapon system, and Pipeline Transport of Petroleum & other Industrial Products, etc.

- **Services Sector:** Banking & Insurance Services; Health & Education Services; Civic amenities like Water; Toll Taxes for Roads; Infrastructure Sector; Media/Broadcasting Services; Airlines Services, Road Transport & Shipping Services; Port & Dredging Services; Hospitality & Tourism Services; Packaging & Container Services; and Real Estate & Construction Services.

Need for Structured Cost Accounting

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

> *"Cost accounting is a function entirely different from general or financial accounting. Cost accountancy covers a wide range of subjects, with special emphasis on cost accounting, factory organization and management, engineering techniques, and knowledge of the working of the factories. The cost accountant performs services involving pricing of goods, preparation, verification, certification of cost accounts and related statements, or recording presentation or certification of cost facts or data. In a manufacturing concern, he works out the economical cost of production and evaluates its progress at each stage of production. In mass production enterprises, he points out wastage of manpower due to overstaffing or inefficient organization and indicates the output, the capacity of*

the machines and labour, the stock position, the movement of stores and weakness in the production process. The systematic determination of cost in every single and distinct process of manufacturing provides a continuous check on the margin of waste in the processing of raw and semi-finished materials, on the utilisation of machinery installed, on manpower expended and the percentage of rejection of finished products. This pinpoints also the particular process in which defects and deficiencies exist, thereby enabling immediate remedial measure being taken. Costing, in short, aims at making the organization efficient and economical, by providing the minimum of labour and material and getting the full capacity of the machine output. The cost accountant, therefore, is concerned solely and mainly with the internal economy of the industry, and renders services essential to the day-to-day management of the undertaking."

12.26 This issue has been well debated in the Expert Group as well as in the Working Group-II meetings. Relevant extracts from the Working Group Report are as under.

12.27 The need for cost accountancy and its impact on cost reduction, optimum utilisation of resources and thereby lowering of price levels cannot be under estimated in the complex economic conditions through which the industries are passing. The use of cost data, in formulating the policy of an undertaking and for the purpose of controlling its activities, has been widely acknowledged. The determination of cost by a continuous process in pursuance of a cost accounting plan helps in recording the operation of various activities within an organisation and is expressed in the form of a cost structure. It portrays distinctly the actual operational levels achieved and the resources utilised in a particular period. The process of imparting knowledge of the incidence of cost elements and its application to various purposes of an organisation is an essential service to the management for regulating its affairs with more confidence.

12.28 The contemporary developments in the economic environment have brought about wide range of changes. Market forces and competition are perceived to improve production and delivery of goods and services. This is the consensus emerging from a re-evaluation of the experiences of different economies and a new insight is being evolved into a regulatory design. Regulatory innovation has made possible the unbundling of activities, promoting competition and opening them to various forms of competitive provisions. To put it plainly, globalisation, by definition, implies global competition with world-class companies even in our own domestic market within the country. In such a situation one cannot survive unless its costs and quality are competitive and there is comprehensive cost management for maximising value, keeping an eye to the market strategy. It is a customer-driven, market oriented, and competitive world that compels us to tailor our costs and quality to sustain in the business.

12.29 With globalisation the entire world economy is integrating into one single, huge system where geographic boundaries are fading out and protecting umbrellas held by governments over the industry and national economy are gradually closing down. In this 'borderless' world, one has to venture out not only for survival but also for life-supporting growth and prosperity. In essence, growth has become a necessary condition for survival in this global village. Here again, in the game of invading foreign market and retaining one's own, strategic cost management plays the most vital role. In the WTO regime, in India, we particularly need to build up appropriate cost database to fight anti-dumping measures imposed against us in foreign markets as also to detect the cases of dumping in our market by foreign competitors. Similarly, cases relating to transfer pricing or arm's length price cannot be decided judiciously in the absence of reliable cost data. Further, proper allocation/apportionment of common costs to the enterprises operating in SEZ areas would also require adoption of well laid down costing principles. Such a reliable, standardized and industry-wide database is possible only by way of statutory cost accounting and cost reporting.

12.30 In the present economic scenario where Indian economy is characterized by increasingly open markets, presence of national and international competition and the gradual withdrawal of administrative prices, corporate decisions are guided by the competitive situation determined by economic liberalization, globalization and privatization. The present competitive economic environment has made all the organizations more cost conscious. From cost consciousness to a competitive cost structure, the country needs to travel through a road of structured cost practices. The cost of learning through this road, if unstructured, can be time consuming and arduous. Maintenance of cost records in a systematic manner enables this transition to achieve the objective of sustainability and competitiveness. Therefore, it is considered necessary to review the existing provisions of cost accounting and cost audit under the Companies Act, 1956 and to make it more beneficial to various regulators, Government departments/bodies to protect the interest of consumers and investors and to protect the industry from unfair trade practices (like anti-dumping, subsidies & counter-veiling measure, cartels, etc.) under WTO agreements.

12.31 The existing provisions under section 209(1)(d) of the Companies Act, 1956 were gone into by the "Expert Committee on New Company Law" (chaired by Dr. J.J. Irani) set up by the Ministry of Company Affairs, which made its recommendations to the Ministry in May, 2005. The observation made by the Committee on this issue is reproduced below:

> *"At present, the Companies Act contains provision relating to maintenance of Cost Records u/s 209(1)(d) and Cost Audit u/s 233B of the Companies Act in respect of specified industries. The Committee felt that Cost Records and Cost Audit were important instruments that would enable companies make their operations efficient and exist in a competitive environment."*

12.32 Provisions of section 209(1)(d) of the Companies Act, 1956 and the existing coverage of industries under CARRs were reviewed by the Committee on Subordinate Legislation (Fourteenth Lok Sabha) in its First Report (Chapter-III) submitted on 2nd December, 2004. The Committee said as follows (relevant extracts only):

> *"3.12 The Committee regret to note that even 38 years after enactment of the relevant provisions empowering the Government to prescribe Cost Accounting Records Rules (CARRs), these have not been framed to cover all major industries/projects…… The slow pace of framing rules negates the very purpose of the important provisions of the legislation passed by the Parliament……..*
>
> *3.13 Service sectors such as Banking, Insurance, Health Services, Education, Hotel, etc. have admittedly "attained strategic importance to the economy and the public at large, particularly after opening up of the economy for private/foreign companies". It has been stated that an authentic cost data base is of paramount importance to various existing and new regulatory bodies, Competition Commission and Government Departments for fixation of user charges in respect of services provided by them and would go a long way in fulfilling their respective objectives. The existing provisions of the Companies Act, however, do not require formulation of CARRs for service industries. The Committee feel that absence of 'enabling' provision in the Companies Act should not be a reason for not prescribing CARRs for service industries. If the need for cost audit is otherwise found to be vital for service industries, the Committee emphasise that expeditious action should be taken to remove the lacuna in the Companies Act by suitably amending it.*
>
> *3.14 In a note submitted to the Committee, the Department opined that the main objective of cost audit when introduced*

was mainly to meet Government requirements for regulating the price mechanism in certain industries and that in the present scenario authentic cost data base is not only essential for the industries to improve upon their performance and face competitive environment but is useful to various Government agencies, revenue authorities, regulatory bodies, banks and financial institutions for meeting their respective objectives………. The Committee note that one of the objects of the Companies (Second Amendment) Bill, 1964, [which on enactment became Companies (Amendment) Act, 1965] as stated in the Statement of Objects and Reasons appended to the Bill, was "to strengthen the provisions relating to investigation into the affairs of Companies and to provide for more effective audit in dealing with cases of dishonesty and fraud in the corporate sector"……… The Committee urge that the Department of Company Affairs in consultation with Ministries and regulators concerned should examine thoroughly from all angles the need and importance of the Cost Accounting Records Rules in the present day scenario and lay down clear, coherent and unambiguous policy guidelines in regard to CARRs."

12.33 With reference to the aforesaid recommendations made by the Committee on Subordinate Legislation, Ministry of Corporate Affairs, in August 2006, framed internal Policy Guidelines on Cost Accounting Record Rules and Cost Audit which would guide the Ministry in its approach to the subject within the existing provisions of the Companies Act, 1956. Highlights of these guidelines are:

- There should be total freedom to the companies to maintain their own cost records.
- All the existing CARRs should be reviewed and those not found relevant should be repealed.
- Future application of CARRs should be in selective industries to be guided by factors such as price control, subsidy payment, products produced by PSUs, infrastructure sector, defence sector, recommended by sector regulator, administrative Ministry or industry association, etc.
- Exemption limit to be raised from Rs.10 crore to Rs.20 crore.
- Formats/Proformae prescribed under various CARRs may be reviewed and simplified.
- Existing system of compliance by Statutory Auditors under CARO to be reviewed periodically.
- Cost Audit Report Rules, 2001 to be reviewed.
- Confidentiality of cost data to be maintained.

- ICWAI to play pro-active role in
    - o Creating awareness about importance of “Cost control measures” in efficient running of corporates/enterprises;
    - o Framing cost accounting standards for different products, processes and services; and
    - o Suggesting “standard costs”.

12.34 In continuum of these internal policy guidelines framed by the Ministry, Government of India, Ministry of Corporate Affairs vide their Order dated 21st January 2008 constituted this Expert Group to review the existing mechanism/framework of Cost Accounting Records Rules, Cost Audit Report Rules, Cost Accounting Standards, Confidentiality of company cost data and cost of compliance.

12.35 These guidelines were examined by the Expert Group. The Group is of the opinion that these guidelines need to be evolved as a complete policy with regard to cost accounting records and cost audit in the corporate sector. Broad issues that require examination are:

- Whether to continue the scheme in terms of products/industries or adopt the class of companies as contained in the Companies Act?
- Whether there is need to continue prescribing CARRs for every product/industry or leave it free to the companies to maintain their cost records in the manner they deem necessary depending upon the size, scale, type, purpose, etc.
- What approach to be followed with respect to essential services? What should be the criteria for exempting a company from cost audit?
- How to maintain the confidentiality of cost data?
- Should all stakeholders be given access to the cost audit report, in full or in part?
- The new policy should help in improving the existing system of Investor Protection, Enterprise Governance, Segmental Reporting, Transfer Pricing, etc; all requirements under WTO agreements on Anti-dumping, subsidies, safeguards, valuation, etc; providing necessary cost data to all the regulators, tariff or price fixation bodies, subsidy administration, fixation of cost-based user charges, CCI, SFIO, revenue authorities, banks & financial institutions, etc.
- The rationale of revising the exemption limits to Rs.20 crore and not Rs.50 or Rs.100 crore.

- How to treat companies within the exempted limit but having high level of public participation?
- Will the limited cost data be of any help in carrying out economic analysis, assessing competitiveness, free trade agreements, predatory pricing, working out standard costs, etc.?
- Will the nation not suffer due to the inefficient running of any company and its' eventual closure by loss of funds by small investors; loss of production in the country; loss of potential revenue inflow to the Government; and loss of employment.
- What should be the time frame for ICWAI to frame Cost Accounting Standards and suggest Standard Costs?
- Whether these Cost Accounting Standards to be made mandatory?
- What is the guarantee that selective coverage of products/industries for cost accounting and cost audit will not result in increasing the existing sense of discrimination resulting in these units or industry associations pressurizing the government to withdraw the provisions selectively made applicable on them.

Global Cost Accounting Practices

12.36 Governments of various countries have traditionally played a major role in the evolution of cost accounting practices. Policy intervention, administered pricing, social pricing, funding plans etc. could be the reasons for such a role. As a result they have put forward detailed requirements on cost accounting in judicial or even a quasi judicial form. Taxation laws in various countries exerted a major influence on the adoption of cost accounting standards. Price control environment in various countries have also made a major influence on cost accounting practices. Details of evolution of the cost accounting standards and practices in a legal environment in different parts of the world have been given in a separate chapter of this report. A summary of same, together with the observations of Working Group-II are given in the ensuing paragraphs.

12.37 In United Kingdom, cost accounting became integrated into the main body of accounting knowledge after the outbreak of the First World War. For all significant project proposals, the UK Government expects the use of Full Economic Costing as a more accurate way of helping to determine whether an activity or a project is worthwhile and sustainable. The UK Treasury's *Green Book, Appraisal and Evaluation in Central Government*, states that for substantial proposals, relevant costs are likely to equate to the full economic cost of providing the associated goods and services. In some regulated industries of UK, regulators require accounts, statistics, business plans, capital expenditure projections, or operating costs calculations from participants. The focus of the Regulatory bodies is on the efficient and fair working of the markets they oversee, and hence their scope is wider than accounting information.

12.38 In Germany, many regulatory bodies are interested in accessing the Cost information of a business entity. The accounting of allowable costs in the case of contracts with public authorities is necessary for the calculation of the cost prices of the contracted output. In Germany, statutory instruments have been enacted to achieve uniformity and consistency in accounting for contracts with public authorities and to avoid calculation of cost price at excessive rates. Article 14 of the European Commission regulations has mandated the adoption of uniform cost accounting practices across EUROPE by amending legal framework. The amendments in effect were to bring standard cost accounting practices to be consistently applied. Cost accounting and Cost management have played a major role in the German competitive edge in high technology manufacturing. Grenzplankostenrechnung (GPK): a German costing method focused on marginal costing that is helpful to support short-term decisions or a pricing decision. In Germany, all companies have distinct Cost & Management Accounting departments. In a paper on “Management Accounting in Germany” presented in the Global Summit on Management Accounting in January 2008, it was said that cost accounting is traditionally the “heart” of German management accounting and German companies have on average 584 cost centres (spread from 12 to 40,000).

12.39 In Canada, the Tax authorities as a regulatory body are interested in accessing Cost and Management Accounting information. The Tribunal constituted under Canada’s Competition Commission has extensively dealt with cost accounting terminologies and their relevance for judging on predatory pricing in the *case of Air Canada.* Besides above, in Ontario, the CMAs are allowed to sign balance sheets and profit and loss accounts like chartered accountants and hence are subject to the jurisdiction of the Securities Commission. The Supply Manual of the Public Works and Government Services of Canada lays down the Guidelines relating to Cost and Profit. Canada basically being a developed economy, the corporate culture supports best practices. Hence in the absence of cost accounting standards, management accounting guidelines issued by a CMA Canada play a major role in injecting quality in the cost and management accounting practices.

12.40 USA has been at the centre of seminal developments in the field of management accounting from 1980 onwards. Lack of advancements in management accounting has been cited to be a major reason for the loss of competitive edge of United States. This led to a spate of research in applied cost & management accounting resulting in new tools and techniques such as Activity Based Costing, Activity Based Management, Lean Accounting, Theory of Constraints, Cost of Quality reporting and so on and so forth. In USA, various public utility regulation entities, the Federal Trade Commission, and the U.S. Department of Justice are interested in accessing the Cost Information of any business entity. Besides US Reforms commission, including the National Performance Review of 1993, a number of federal regulations have affected financial reporting requirements with cost linkages. This is not exclusive to the private sector, but is actively underway in the public sector as well.

12.41 The Securities & Exchange Commission (SEC) of USA has also prescribed various formats for disclosures by the corporate America which will need the adoption of standard cost accounting practices. In the annual/quarterly returns sent to the US-SEC, the companies are required to include information relating to risk factors, quantitative & qualitative disclosures about market risks, controls & procedures, related party transactions, selected financial data and management’s discussion and analysis of financial condition and results of operations explaining the reasons for material changes that include changes in the various elements which determine revenue and expense levels such as unit sales volume, prices charged and paid, production levels, production cost variances, labour costs and discretionary spending programs.

12.42 The US Federal Government has constituted a Cost Accounting Standards Board under the Office of Federal Procurement Policy, which is an independent legislatively-established board. The Board has the exclusive authority to make, promulgate, and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts with the United States. The standards are mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating and reporting costs in connection with pricing and administration of and settlement of disputes concerning all negotiated prime contract and subcontract procurement with the United States in excess of US $5 million. The Board has so far issued 19 Cost Accounting Standards.

12.43 Cost competitiveness has been at the heart of the Japanese success in 1980s. The tripod of Cost–Quality-Delivery has been inextricably embedded into the manufacturing strategy of the Japanese lean enterprises as they are called. Target Costing and Kaizen Costing are two mantras contributed by the Japanese to the lexicon of management accounting. Contrary to the belief that Cost Accounting Standards do not exist in the developed part of the world, an economy like Japan has experienced the evolution of cost accounting standards as a part of the pre and post world war build up of economic revival. The Japanese cost accounting systems have evolved through in various stages. The Business Accounting Deliberation Committee of the Ministry of Finance, formerly the Business Accounting Standard Committee of the Economic Stabilization Board, started to develop the Cost Accounting Standards on 16 November 1950 but did not succeed until 8 November 1962. Japan has so far issued 10 Cost Accounting Standards.

12.44 In a research paper on *Cost Accounting in Small and Medium Sized Japanese Companies* by *Trevor Hopper* from University of Manchester and *Tsutomu Koga* from Fukuoka University (1997), it has been said that the Japanese cost accounting, e.g. target costing, continuous cost reduction etc. was necessarily used in simpler smaller companies (SME's). In addition, given cost pressures stemming from Japan's changing socio-economic circumstances, it was surmised that SME's and their costing systems were undergoing significant pressures for change. In general, the research found that the costing systems of the SME's were similar to those of larger Japanese firms.

12.45 In Australia, the Cost and Management Accounting interest groups exist both internal as well as external to a business entity. The Institute of Certified Management Accountants (ICMA) of Australia is of recent origin as a body. Cost Accounting mechanism also exists as per the insistence of some regulatory authorities. In Australia, other than Tax Office who is interested in accessing the cost information of any business entity, some regulators also access the cost information. In fact, cost accounting principles have also been publicly debated by some regulators such as railways before adoption.

12.46 The ICMA is proposing ‘Strategic Audits’ in Australia for the business to adhere to the Cost accounting principles. The Australian Competition and Consumer Commission is the antitrust body which depend on costing data for regulation of monopolistic trade practices. The Government gathers information on cost while formulating policies on Free Trade agreements/Restricted Trade Agreements through Australian Bureau of Statistics and other information gathering bodies.

12.47 In China, Ministry of Commerce and Ministry of Finance are the only two Regulatory Bodies interested in accessing the cost information of any business entity. The State Asset Administration is interested in the cost information of state owned enterprises. The adoption of the 2006 Accounting System for Business Enterprises (ASBE) by the Chinese companies has made external reporting closer to international standards that has addressed a number of cost related issues. In a recent survey conducted by the Institute of Management Accountants of USA on the Chinese costing practices, it was found that costing practices employed by companies are now largely in conformance with the 2006 ASBE.

12.48 Article 103 of ASBE states that an enterprise should determine the cost centres, cost items and cost calculation methods according to the characteristics of the production and operating process and the needs of the management. Once determined, they should not be changed arbitrarily. Article 105 says that an enterprise must clearly identify the costs and expenses for the current period and those for subsequent periods. It must not accrue or defer expenses arbitrarily. An industrial enterprise must clearly identify the costs of each product. It must clearly identity the costs of work-in-progress and the costs of finished goods, and must not overstate or understate such costs.

12.49 The Rules on Cost Accounting of Power Transmission and Distribution have been published by China's State Power Regulatory Commission. They will take effect as of January 1, 2006. The rules include 19 articles in five chapters, specifying the cost target and cost items.

12.50 Unlike the situation in the United States or the United Kingdom, where only industries dealing with the Government need to follow certain rules for product cost calculation, the French approach, *in a spirit of facilitating fair competition, applies to all industries,* whether or not they have dealings with state agency. French management accounting practice is different from what is found in most national traditions in the field. France’s originality lies in having an almost universally *accepted single version of cost analysis and product costing, applicable to all industrial and trade sectors, both for profit and not for profit.* The current version of this system is described in a decree of the Ministry of Finance and Economy published as Title III of the 1982 *Plan Comptable General.*

12.51 After the financial debacle of 1990s, Korea issued cost accounting standards applicable to Korean companies by amending the Accounting regulations. The regulations clearly state that these are meant for measuring product costs in preparing financial statements. Initially, these standards were for adoption by the manufacturing companies. Subsequently, these were also made applicable to non-manufacturing companies and later to the banks and financial institutions in 1999. Korea's Cost Accounting Standards have covered all the key aspects in three major sections, viz. General Provisions; Actual Cost Accounting System; and Standard Cost Accounting System. Korea's Financial Accounting Standards require publication of a separate schedule of manufacturing cost (form no. 23) and schedule of cost of sales (form no. 25). The auditors have access to the cost accounting information generated by applying these regulations.

12.52 The Malaysian Institute of Accountants (MIA) is the only accounting institute in Malaysia recognized by IFAC. MIA has not issued cost accounting standards. Instead it has adopted verbatim all the International Management Accounting Practice Statements issued by FMAC of IFAC. All the seven IMAPs have been reissued under the banner of MIA to be referred to by Malaysian companies as best practice. This is a unique position which no country has done.

12.53 The end of the system of protection that had shielded Spanish industry from international competition until the mid 1970s, acted as a major force for the development of cost & management accounting systems in Spain thereafter. In Argentina the removal of tariff barriers with the country's 'Mercosur' partners (Brazil, Paraguay and Uruguay) has been seen as stimulating competition and consequently increasing the demand for strong cost management. In Brazil, it has been noted that the industries that have led the way in developing innovative approaches to costing have been those which do not enjoy protection, starting with the textile industry in the 1950s. The competitive pressures of a global economy are cited to explain the growing interest in advanced CMA techniques in Italy.

12.54 An extensive survey was conducted recently in some of the companies numbering to roughly 181 in the Estonian manufacturing sector which is basically the Eastern European economic region. This survey was conducted by scholars from the University of Tartu. The responding companies in Estonia represented 15 different branches of manufacturing such as energy, wood, food, tobacco, chemicals, metal, textile, etc. The categories of information that have been included into the survey cover various aspects of CMA such as cost measurement and appraisal in financial accounting, cost element accounting, cost centres accounting, costing methods, pricing principles, budgeting, and internal performance measurement systems. The respondents to the above survey in Estonian companies on CMA practices have admitted that mainly two driving forces had made them develop their companies' CMA systems namely, the need for more detailed divisional performance (segmental) information and changes in the organizational structure. Thus the growing market pressure has raised the companies' awareness about the need for more detailed cost information.

12.55 The Internal Audit group in Hong Kong has developed diagnostic tool kits to assist in enhancing operational efficiency and reducing costs to improve an organisation's competitiveness. The reviews focus on 9 key business areas viz. General Management Control; Billings and Receivables; Procurement and Payment; Expenditure and Expenses; Inventory Management; Cash Management; Human Resources; Financial Accounting and Management Reporting; and Information Technology. This review will produce a list of opportunities for cost reduction/efficiency improvement, and estimated potential cost savings/improvements if implemented. Typical reasons for this service are (1) management wishes to reduce costs to maintain profits in view of reducing revenues, and (2) to increase competitiveness under the current economic climate.

12.56 In Pakistan, Institute of Cost & Management Accountants of Pakistan (ICMAP) has been able to generate considerable interest in the domain from the business and the students' community. The presence of ICMAP and its participation is felt across the international bodies such as CAPA and SAFA. It has also been able to successfully bring on the concept of cost audit in the company legislation of Pakistan. The entities who can said to be the interest groups of the cost and management accounting information in Pakistan are Central Board of Revenue of Pakistan, Chambers of Commerce, Securities and Exchange Commission of Pakistan, Ministry of Finance, Regulatory bodies such as Oil and Natural gas and Power sector, and State Bank of Pakistan.

12.57 Despite being the youngest of the statutorily started CMA professional institute in the SAARC region, similar role has been played by the Institute of Cost & Management Accountants of Bangladesh (ICMAB). The following entities can said to be the interest groups of the cost and management accounting information in Bangladesh:

- Ministry of Commerce
- Chambers of Commerce
- Regulatory bodies such as power sector regulator
- Global organizations such as UNDP which are keen on capacity building of the CMA profession in Bangladesh.

12.58 In India, various apex level industry associations have been playing key role in infusing a sense of cost consciousness among the member companies so as to enhance their competitiveness in the global market. For example, the Confederation of the Indian Industry (CII), which is a pioneer in several aspects as an association of business, initiated a movement of Total Cost Management (TCM). This movement has been in vogue for almost 6 to 7 years and has been attempting consistently drive home the message of a structured approach to the needs of cost management in a competitive environment. Since we as a nation are building our manufacturing and service competitiveness in the global arena, it is important that the CMA skills are honed to perfection and we do not mistakenly focus on measuring the end financial short term results through accounting standards as the only way of performing cost and management accounting.

12.59 While the business started recognizing the need for a structured movement on quality management, customer relations, etc., on the cost front, it has confined the efforts to waste elimination and lean manufacturing strategies without considering cost management as a holistic process. Industry federations such as Confederation of Indian Industry commenced movements such as Total Cost Management which is yet to gain critical mass such as TQM or TPM. Just like in Japan adherence to a minimum cost accounting plan is considered as a part of the social discipline and corporates adhere to the same without demur a base line plan for good cost accounting practices is yet to be accepted in India. When it comes to cost accounting the business is yet to come to terms with a base line adherence legally which one finds in countries like France, Japan, and Korea. For that matter in countries which are self disciplined in this aspect like Canada or UK consider the pronouncements of the CMA bodies in those countries (which do not have a legal status like ICWAI) as best practice. Besides this context, till a matured behaviour of the stakeholder emerges as India continues with the reforms process cost accounting discipline needs to be considered as an enabler of healthy competition and insurance against predatory behaviour. To top all the developments, there needs to be a check on the presence of a good cost accounting mechanism as a part of the risk management environment for ensuring good governance. The underlying spirit being, a business enterprise without a sound decision making including proper cost information is prone to more business risk.

International Federation of Accountants (IFAC)

12.60 A separate chapter of this report focuses on the issues relating to cost & management accounting principles & practices that have figured in various documents of the International Federation of Accountants (IFAC). However, the Working Group-II in their report noted that the Professional Accountants in Business Committee of

IFAC in their exposure draft on ***Costing to drive organizational performance*** has said as under:

- The creation, operation, alteration, and cessation of every action and function in an organization, whether within the private, public, or voluntary sector – all incur costs. Costing – the accumulating and assigning of costs to the organization's various activities – enables the organization's cost structure to be understood, explained and improved. Costing is therefore an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It informs how profits and value are created, and how efficiently and effectively operational processes transform input into output. It includes product, process, and resource-related information covering the organization and its value chain. Costing information can be used to provide feedback on past performance, and to motivate future performance. It is most useful if it communicates not only what the costs are, but also how and why they are incurred.

- This view of costing supplants the traditional view that led many organizations to use costing exclusively as a tool to value inventories and determine profit. Many organizations now use cost information to support a wide variety of decisions, which has led to the development and evolution of costing methods such as activity-based costing. The many costing methods and approaches to measuring costs often lead to confusion over (a) which costing methods might be useful in supporting an organization, (b) in which contexts they are best implemented, and (c) how they are implemented. Too often, such costing methods and approaches are perceived as solutions to business problems, whereas their principal value is diagnostic. However, alternative costing approaches should not be seen as competing with each other, and elements of each can be effectively combined. For example, both activity-based costing and standard costing can be applied to job-order or process costing systems. This International Good Practice Guidance (IGPG) establishes eight fundamental costing principles that will help professional accountants in business and their organizations evaluate and improve their approach to costing, and to *benchmark* good practice in applying costing systems and methods and using costing information.

- Good practice in costing involves improving costing systems and costing information to provide relevant cost and performance information with an objective of enabling organizations to deliver increased value to customers. Costing should therefore support a range of both regular and non-routine decisions when designing products and services to (a) meet customer expectations and profitability targets, (b) assist in continuous improvement, and (c) guide product mix and investment decisions.

- To better support decision-making, costing establishes and interprets relationships between financial, operational, and other data. Therefore, selecting the most appropriate approach for costing information and analysis, and using their output, requires the exercise of careful professional judgment and sound logic. Costing is not an exact science, but the selected costing approach should be rigorously applied. The eight principles have been developed in a way that allows professional accountants in business to be flexible developing costing systems and methods best suited to their organizations. Professional accountants in business should find this IGPG useful in explaining the role and purpose of costing to non-accounting colleagues.

12.61 The Working Group further noted that as per the IFAC document, the key principles underlying widely accepted good practice in costing that drive the organizational performance are:

- The ability to account for, analyze, interpret, and present costs is necessary for an informed understanding of the drivers of profit and value, and is therefore an essential part of good financial management and decision-making.
- Cost information should be collected and analyzed systematically and consistently, whether in a routine information system, or for a specific application and/or purpose.
- Costing systems and methods should be designed and maintained to reflect an organization’s chosen strategy and business model, taking account of its structure, culture and competitive environment.
- Cost information used to support strategic and operational decisions, performance management, or reporting should be appropriate for the specific purpose, context, and legal requirements.
- The professional judgment used to (a) determine costing methods, and (b) specifically select cost information to support decision-making, including any limitations on its applicability, should be transparent, rational, and understandable by the user.
- Definitions and sources of cost data, and the methods of calculation of costs, should be recorded and capable of review, risk analysis, and assurance.

- Cost information and costing assumptions should be periodically reviewed for their relevance, robustness, and susceptibility to change.
- The design, implementation, and continuous improvement of costing methods, data collection, and systems should reflect a balance between the required level of accuracy and cost.

12.62 Underlying the importance of cost accounting system, IFAC document further said that costing and the many costing methodologies applied in organizations, measures the consumption of economic resources and support the accountability of business performance. This is best achieved within a financial management system that (a) delivers both cost information and operational feedback for planning, budgeting, cost, and financial accounting purposes, and for operational improvement, (b) helps to ensure the fulfilment of external reporting and other compliance requirements, and (c) helps to manage an organization.

12.63 Larger and more complex organizations (in terms of employee numbers, product and service lines, geographical spread, and complexity of processes) usually aim for a single costing system to develop reliable costing information to support both performance and conformance (against legal and regulatory requirements) decisions at both operational and strategic levels. Organizations with a single costing system typically derive cost data from a common data source to support the needs of both external users (investors, regulators, and tax authorities) and internal managers and employees. In manufacturing businesses, such an integrated system will allow (a) relevant costing and operational performance information to be provided to internal users, as well as (b) the valuation of inventory and measurement of cost of goods sold for financial reporting purposes. 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.

12.64 An integrated information system is not necessarily a single, closed information system for cost measurement, and performance improvement. Operational feedback systems could source data from outside the costing system, but the information presented needs to be integrated where appropriate to support operational performance, because it promotes employee learning and improvement in activities and processes. Integrating databases and information systems can help to provide useful costing information more efficiently as well as reducing source data manipulation. A comprehensive enterprise information system typically (a) tracks daily expenses by account code, activity, and business process, and (b) measures performance information that supports feedback to operations, such as the cost of resource consumption, defects, throughput, and quality, in addition to cost information associated with products, customers, and activities.

12.65 Small and/or less complex organizations will need cost information to manage their business operations. However, their requirements may involve costing systems with less formal procedures and methods, and these are likely to develop as a natural consequence of needing costing information. Such organizations should periodically consider the need for processes to report relevant and routine cost and operational information for management purposes. This will typically require a costing system and appropriate procedures to ensure that the necessary cost information is collected, measured, analyzed, and effectively communicated.

12.66 The following definitions given by IFAC were found relevant by the Working Group-II:

- **Accounting System**: It refers to the ledgers and the collection of financial information for financial reporting, supplemented by information needed for budgetary control. Costing systems draw on the same data, but require the additional ability to break particular ledger code outputs into smaller sums, usually by applying a factor derived from other ledger codes (for example, product revenues), payroll data (for example, timesheets), work study outputs, and sampling schemes, etc.
- **Cost Accounting**: It is the process (enabled by costing systems) of accumulating, measuring, analyzing, interpreting, and reporting cost information to both internal and external users. Cost accounting provides information for management accounting and financial accounting, although organizations typically use these terms interchangeably.
- **Cost Method**: Costing methods such as job and process costing, standard costing, ABC, Grenzplankostenrechnung, are (period costing) methods of assigning costs (cost assignment). Life cycle costing and target costing are non-period costing methods. Defining the appropriate measurement, assignment, and allocation of cost for a given purpose and decision involves selecting the appropriate costing method(s).
- **Cost Model**: The description of sources, drivers, classification, and organization of costs and the relationships between them, and the relationship between costs and income. The cost model therefore (a) explains an organization in dynamic financial terms, and (b) aggregates cost and contribution reports for an organization and its subdivisions (geographical, product, process, etc). A cost model can be used to design a technological solution that supports a costing system.

Observations & Suggestions of Working Group-II

12.67 The Working Group-II in their report have made the following observations and suggestions:

12.68 Historically, the "class of companies" as contained in Section 209(1)(d) has been construed to mean companies engaged in the manufacture of a particular product or those belonging to a specified industry. Consequently, from 1965, Central Government has been prescribing different "Cost Accounting Records Rules" for different industries/products despite the fact that cost accounting principles remain same across the industries/products. The Group is of the view that under section 209(1)(d), the term "class of companies" belongs to all such companies that are engaged in the production, or processing, or manufacturing or mining activities. However, "class of companies" has been interpreted to mean companies engaged in the manufacture of a particular product or those belonging to a specified industry. Accordingly, the Central Government has been prescribing separate CARR for each industry or product by assigning it the meaning as "class of companies". In fact, the Companies Act, 1956 has nowhere defined the concept "class of companies" as those producing cement or textiles or cycles or steel or petroleum products, etc. Therefore, class of companies should have been taken in totality as those engaged in the production, processing, manufacturing or mining activities and not merely those engaged in the production of a single product or belonging to a single industry.

12.69 Further, for the purpose of preparation & presentation of financial records, under section 211(2), there is a reference to the term "class of companies" that is primarily construed to mean companies for which a form of profit and loss account has been specified in or under the Act governing such class of company. For example, insurance companies are governed by the Insurance Act of 1938, banking companies by the Banking Regulation Act of 1949, electricity generation/distribution companies by the Electricity Act of 2003, etc. Therefore, the existing term "class of companies" under section 209(1)(d) also need to be understood in a similar manner as that given under section 211(2) but restricted to those engaged in the production, processing, manufacturing or mining activities.

12.70 Since CARR have so far been prescribed for 44 industries/products, does it mean that all other companies not covered by the said 44 CARR are not required to maintain any cost records. In other words, cost data/information relating to such (not so far covered) companies is neither needed by the company management nor by any government agency or regulators. It is not true. In fact, due to the product/industry based approach, a wrong perception has come about in the minds of the industry as if cost accounting records are only for selective industry and the prescription is considered to be penalization for 44 industries that have got covered under the provisions of section 209(1)(d) till date from 1965 i.e. in a span of 43 years. Though it is universally accepted that maintenance of cost records in a systematic manner is essential for all the companies, irrespective of the type of product, the provision in the act could not be extended to all industries due to this approach. In many multi-product industries, only one or a few products may have got covered under the rules whereas other products have been kept out of the ambit of the provision leading to ineffective use of the records since the company is unable to derive the benefit of a proper structured cost accounting system.

12.71 The Group noted that irrespective of any rules, number of companies, especially the large ones, have well established cost accounting system and thus, have been maintaining detailed cost records. Therefore, restricting maintenance of cost records to only a few specified companies in the country does not show any justification. Since maintenance of cost records and the cost data/information, through the determination and allocation of costs to various products/services, provides a valuable service to the managements of companies in cost analysis and control and in this way, it helps to improve efficiency in the use of materials, labour and plant, maximize production and realize greater profits, all companies, without any exception, should maintain cost records as an integral part of books of accounts. In a survey conducted by the Expert Group, there has been a general consensus among all the respondents that all companies should maintain cost records as an integral part of books of accounts, but to be left free to follow and apply relevant method of cost management.

12.72 Presently, the existing CARRs do not apply to a company wherein the aggregate value of plant & machinery does not exceed limit as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951; and the aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crore of rupees.

12.73 The Micro, Small and Medium Enterprises Development Act, 2006 has defined an enterprise as “an industrial undertaking or a business concern or any establishment by whichever name called, engaged in the manufacture or production of goods, in any manner, pertaining to any industry specified in the first schedule to the Industrial (Development & Regulation) Act, 1951 or engaged in providing or rendering of any service or services". Further, the micro, small and medium enterprises have been defined as under:

- In the case of enterprises engaged in the manufacture or production of goods:

Type of enterprise	Investment in Plant & Machinery
Micro Enterprises	Investment <= Rs.25 lakhs
Small Enterprises	Investment >Rs.25 lakhs but<=Rs.5 crore
Medium Enterprises	Investment> Rs.5 crore but<=Rs.10 crore

- In the case of Enterprises engaged in providing or rendering of services:

Type of enterprise	Investment in Plant & Machinery
Micro Enterprises	Investment <= Rs.10 lakhs
Small Enterprises	Investment >Rs.10 lakhs but<=Rs.2 crore
Medium Enterprises	Investment> Rs.2 crore but<=Rs.5 crore

NOTE: Investment in Plant & Machinery excludes the cost of pollution control, research & development, and industrial safety devices.

12.74 The Companies (Accounting Standards) Rules, 2006 has defined an enterprise as "a company as defined in section 3 of the Companies Act, 1956". Further, a "Small and Medium Sized Company" (SMC) means, a company –

- whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
- which is not a bank, financial institution or an insurance company;
- whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
- which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
- which is not a holding or subsidiary company of a company which is not a small and medium sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

12.75 The Group noted that the classification of micro, small and medium enterprises based on investment in Plant & Machinery, under the Micro, Small and Medium Enterprises Development Act, 2006, is primarily for the purposes of facilitating the promotion and development and enhancing the competitiveness of micro, small and medium enterprises, particularly of the micro and small enterprises, by way of development of skill in the employees, management and entrepreneurs; provisioning for technological up gradation; providing marketing assistance or infrastructure facilities; cluster development of such enterprises with a view to strengthening backward and forward linkages; regulating credit facilities to ensure timely and smooth flow of credit to such enterprises; minimize the incidence of sickness; extending preference in respect of procurement of goods and services produced and provided by micro and small enterprises; regulating payments by buyers for the supply of any goods or services, etc. Under this Act, a micro, small and medium enterprise need not necessarily be a company under the Companies Act, 1956; it can be any form of business entity.

12.76 Similarly, the Small and Medium Sized Company (SMC) as defined under the Companies (Accounting Standards) Rules, 2006 is for a limited purpose of extending certain exemptions or relaxations and disclosures from compliance with the requirements prescribed in various Accounting Standards.

12.77 The Group further noted that neither the Micro, Small and Medium Enterprises Development Act, 2006 nor the Companies (Accounting Standards) Rules, 2006 have any provision to extend any relief with respect to either maintenance of accounting records or audit thereof to the micro, small and medium enterprises or to the small and medium sized companies.

12.78 Notwithstanding above, IFAC in their exposure draft has said that the small and/or less complex organizations will need cost information to manage their business operations. However, their requirements may involve costing systems with less formal procedures and methods, and these are likely to develop as a natural consequence of needing costing information.

12.79 In view of this, the Group is of the view that all micro and small companies should remain exempted from the compulsory maintenance of requisite cost records. These companies may still voluntarily maintain such cost records as an integral part of their books of account as the cost data/information could provide valuable service to their managements. However, keeping in line with the revised provisions, the threshold limit for micro & small companies should be changed to Rs.5 crore for investment in plant & machinery but the limit for annual turnover may be enhanced from the existing level of Rs.10 crore to Rs.20 crore, in the immediately preceding accounting year. Such companies should also remain outside the ambit of cost audit.

12.80 As regards medium size companies, these are not presently exempted from the application of CARRs. Hence, the Group is of the view that there appears no justification in granting them exemption from merely maintenance of cost records as they would draw much greater benefits from such mechanism and it would also help them to comply with any type of legal/statutory requirements. Therefore, medium size companies should maintain cost records based on generally accepted cost accounting principles and cost accounting standards, as may be notified under section 209(1)(d) of the Companies Act, 1956. However, with a view to avoid incidence of any additional cost of compliance, such class of companies should also be exempted from the provisions of cost audit. But such companies should only file a compliance report with the Central Government, on a proforma to be notified, from a cost accountant certifying requisite maintenance of cost records.

12.81 The suggested threshold limits for exemption to medium size companies from the provisions of section 233B of the Companies Act, 1956 should be investment in plant & machinery exceeding Rs.5 crore but not exceeding Rs.10 crore (as defined in the statute) and annual turnover exceeding Rs.20 crore but not exceeding Rs.50 crore in the immediately preceding accounting year. While calculating annual turnover, any turnover from trading operations, consultancy services, other incomes, etc. in a manufacturing organisation will not be considered. But turnover from job work or loan license operations would stand included. Other conditions that would apply to a medium size company to avail exemption from cost audit shall be:

- ➢ The company’s equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
- ➢ It is not a bank, financial institution or an insurance company;
- ➢ It does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
- ➢ It is not a holding or subsidiary company of a company which is not a small and medium sized company.

12.82 The Group’s proposal to extend maintenance of cost records to all companies (excluding the micro and small size companies) cannot be done without amending the existing legal provisions in the Act. Hence, in the first phase, it should be extended to all companies engaged in the production, processing, manufacturing or mining activities. Later, after the Act is suitably amended, the same can be extended to the remaining class of companies.

12.83 Cost records to be kept as an integral part of the books of accounts should not be construed asking companies to necessarily maintain integrated books of accounts. This is only meant to explain that the basic record of any income or expense is same in any business environment. It is the final flow of summarized results for a period or as on date that are generated from these basic records for the purpose of preparing financial statements such as balance sheet, profit & loss account, cash/fund flow statement, etc. and as well as for preparing cost statements such as cost of production/service or cost of sales, margin, etc. For example, the materials cost is shown as lump sum expenditure in the profit & loss account, but the same is charged to different products/services on the basis of consumption. Similarly, while the salaries & wages cost for the entire company is shown in totality in the financial statements, but in preparing the cost statements, the same is first charged to various production and service cost centres and then gets finally absorbed to the final products/services. These basic records are also put to use by the internal & external stakeholders for analysis and decision making. Therefore, while the freedom to follow integrated accounting system or not should exist with the company itself, the records should adhere to the Cost Accounting Standards issued by ICWAI; provide necessary data required to be furnished under the Cost Audit Report Rules; and capable of satisfying the requirements of all regulatory bodies.

12.84 When the section 209(1)(d) was implemented after 1965, perhaps it was understood as if cost records are product or industry specific and therefore, separate CARR continued to be prescribed for each industry/product, including prescription of industry/product specific formats/proformae to maintain such cost records. As already said earlier, the cost accounting (or for that matter any accounting) has always been principle based and not rule/format based. The Rules are only meant to simply give a legal force to the principles. The existing CARRs have made an attempt to capture the generally accepted cost accounting principles but these are not complete in all respects. These Rules have the following deficiencies:

- In Part-II of each CARR, there are 26 paras that enumerate the need to maintain separate records for various elements of cost and host of other issues/subjects. However, these Rules nowhere specifies as to how various costs are to be collected, collated, allocated/assigned, apportioned and absorbed to various cost centres and through them, to the final products/activities. Though this has been attempted through the formats/proformae prescribed therein, but the same is not clear for anyone to correctly understand and implement.

- These Rules do not cover all elements of cost that may arise under different situations. For example, under the para overheads, there is no explanation as to what item of expense belongs to factory/works overheads, or to administrative overheads, or to selling overheads, or to distribution overheads; in para on royalty & technical know-how fee, there is no reference to the IP related costs; in para on captive consumption, there is no explanation as to how such items should be valued; there is no reference to capacity determination, identification & recognition of cost centres, direct expenses, stock valuation methodology, arm's length price, amortization, shared services costs including outsourcing, non-cost incomes & expenses, etc. Therefore, these Rules are incomplete documents.
- At various places, it has been mentioned that the costs are to be ascertained and absorbed as per normally accepted cost accounting principles and practices. At no place in these Rules, "normally accepted cost accounting principles and practices" have been clearly laid down. These are left to be understood by each company or by each cost accountant, as it may suit them or with reference to the explanations given in various text books on the subject. This often leads to adoption of non-integrated, disharmonized, and non-standard practices resulting in presentation of non-uniform and inconsistent results.
- Under para "related party transactions", there is an unwarranted attempt to lay down definitions of various legal terms that already find place in the Companies Act itself. Therefore, any such attempt under the CARR may lead to creating a conflict with the parent Statute.
- These Rules, being subordinate legislation under the Companies Act, 1956, have a binding force for the companies to comply. Since different rules and formats/proformae have been prescribed for different products, companies manufacturing multiple products find it difficult to follow one standard cost accounting system suited to its' size, scale & type of operations. Therefore, besides incurring huge cost in preparing cost records as per the notified rules/formats, it leaves no room for flexibility with the company management.
- Prescription of different rules has led to the companies maintaining cost records more from compliance point of view rather than maintaining the same as a part of management information tool and as an aid to the management. Since

formats are prescribed as part of the rules, maintenance of cost records have become more of a format-filling effort rather than natural outcome of desired data flowing from a structured maintenance of cost accounting system. The strait-jacketed formats are perceived to be an additional burden that are required to be "made and filled up" as an additional exercise on the part of the corporates.

12.85 There is a dichotomy in understanding of existing provisions by the Government as well as of the entire professional fraternity. While on the one hand, separate industry/product specific Cost Accounting Record Rules including the formats/proformae have been prescribed, on the other, there are only one combined Cost Audit Report Rules incorporating one single set of common formats/proformae for presentation of same cost data/information and these common formats/proformae are applicable to all companies (covered by cost audit) across industries. Therefore, it is not true that separate rules are needed for each industry/product. However, certain regulated industries such as electricity, telecommunications, petroleum & natural gas, etc. may require separate guidelines suiting to the requirements of their regulators. The Group is of the view that such guidelines should be issued by the apex-body i.e. ICWAI in consultation with the concerned regulatory body and industry association.

12.86 In order to promote uniformity and consistency, there is an urgent need to integrate, harmonize and standardize the cost accounting principles and practices. Similar such need has been felt to standardize the auditing and assurance practices. This not only helps in better (clear & in uniform manner) understanding of all the related issues by the companies and/or by the professional fraternity, but it also helps various user organisations, Government bodies, regulators, research agencies, academic institutions, etc. Therefore, there cannot be a second argument to the fact that the country requires "generally accepted cost accounting principles and practices" to be clearly defined and well documented. For various good reasons, this cannot be done solely by the Government through the Rules. This is a highly professional job that can only be done by the concerned professional bodies in the country. Precisely for these reasons, various national level apex institutes have issued or are in the process of issuing standards in areas falling under their domain. For example, the Institute of Chartered Accountants of India has been issuing financial accounting and auditing standards; Institute of Company Secretaries of India has been issuing secretarial standards; and the Institute of Cost & Works Accountants of India has been issuing cost accounting and audit standards. The Group is of the view that ICWAI should assign topmost priority for issue of all the required cost accounting standards. These should be prepared in consultation with all the stakeholders and fully aligned with the Financial Accounting Standards issued by ICAI with regard to the common aspects, which are applicable to both. Since, Cost Accounting Standards have been already issued by different countries; CAS issued by ICWAI should incorporate their best practices.

12.87 The existing mechanism can be considered as the prescriptive methodology rather than a principle based approach. The Working Group is of the view that there is need to shift from present practice of rule-based to principle-based accounting. Revised mechanism should address issues like deregulation, changing dynamics of economy, regulatory framework, WTO requirements, unfair trade practices, etc. and above all, cost competitiveness of India Inc. and global benchmarking. Thus, this mechanism should result in value addition to the industry. Hence, all the existing Cost Accounting Record Rules (CARRs) may be repealed and in place, Government may prescribe maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards. However, since the requisite cost accounting standards covering all the elements of cost, as presently included in the CARRs, are not in-place and it is likely to take considerable time, a state of vacuum should not be created for the interregnum period. The Group is of the view that all the existing CARRs should be immediately replaced with a single combined CARR, covering all companies engaged in the production, processing, manufacturing or mining activities, incorporating simplified format/proformae for preparation and presentation of requisite cost data/information. A sample of such single CARR is enclosed.

Recommendations of Working Group-II

12.88 The Working Group-II, in its report to the Expert Group, have made the following recommendations:

- Section 209 of the Companies Act, 1956 primarily relate to maintenance of books of account by the companies that includes cost records as well. While financial accounting/reporting is supported by the principle based accounting standards approved by NACAS, a differential treatment has been accorded to cost accounting by prescribing separate rules/formats causing an extra burden of additional records. Therefore, separate Rules (CARR) prescribing formats only for cost records or two sets of accounting formats are not required. As such, necessary cost data should emanate from the same set of primary accounting data/records.

- Under the existing section 209(1)(d) of the Companies Act, 1956, the term “class of companies” should be taken in totality as those engaged in the production, processing, manufacturing or mining activities and not merely those engaged in the production of a single product or belonging to a single industry. This would also remove the present anomaly of maintaining a separate set of cost records only for a particular “product” (as prescribed under the extant rules) of a multi-product company and not doing so for the rest of the products/activities.

- All companies should maintain cost records as an integral part of books of account, but in a highly competitive environment, it is the management’s prerogative to choose appropriate cost management methodology. However, for sake of uniformity, such records should adhere to the generally accepted cost accounting principles and cost accounting standards.

- Present exemption to SSI units from the provisions of section 209(1)(d) and 233B of the Companies Act 1956, relating to maintenance of cost records and cost audit should be continued. All micro and small enterprises should remain exempted from the compulsory maintenance of requisite cost records. Keeping in line with the revised provisions, the threshold limit for micro & small companies should be changed to Rs.5 crore for investment in plant & machinery but the limit for annual turnover may be enhanced from the existing level of Rs.10 crore to Rs.20 crore, in the immediately preceding accounting year. Such companies should also remain outside the ambit of cost audit.

- Medium size companies are not presently exempted from the application of CARRs. Hence, the Group is of the view that there appears no justification in granting them exemption from merely maintenance of cost records as they would draw much greater benefits from such mechanism and it would also help them to comply with any type of legal/statutory requirements. Therefore, medium size companies should maintain cost records based on generally accepted cost accounting principles and cost accounting standards, as may be notified under section 209 (1)(d) of the Companies Act, 1956. However, with a view to avoid incidence of any additional cost of compliance, such class of companies should also be exempted from the provisions of cost audit. But such companies should only file a compliance report with the Central Government, on a proforma to be notified, from a cost accountant certifying requisite maintenance of cost records.

- The suggested threshold limits for exemption to medium size companies from the provisions of section 233B of the Companies Act, 1956 should be investment in plant & machinery exceeding Rs.5 crore but not exceeding Rs.10 crore (as defined in the statute) and annual turnover exceeding Rs.20 crore but not exceeding Rs.50 crore in the immediately preceding accounting year. While calculating annual turnover, any turnover from trading operations, consultancy services, other incomes, etc. in a manufacturing organisation will not be considered. But turnover from job work or loan license operations would stand included. Other conditions that would apply to a medium size company to avail exemption from cost audit shall be:
    - The company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
    - It is not a bank, financial institution or an insurance company;
    - It does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
    - It is not a holding or subsidiary company of a company which is not a small and medium sized company.
- The existing mechanism can be considered as the prescriptive methodology rather than a principle based approach. The Working Group is of the view that there is need to shift from present practice of rule/format-based to principle-based accounting. Hence, all the existing Cost Accounting Record Rules (CARRs) may be replaced with the Government prescribing maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards. A draft of modified common Cost Accounting Record Rules (CARR) is enclosed as Annexure-XVII.
- Separate CARRs are not needed for each industry/product. However, certain regulated industries such as electricity, telecommunications, petroleum & natural gas, etc. may require separate guidelines suiting to the requirements of their regulators. Such guidelines should be issued by ICWAI in consultation with the concerned regulatory body and industry association.
- The cost records should adhere to the Cost Accounting Standards issued by ICWAI; provide necessary data required to

be furnished under the Cost Audit Report Rules; and capable of satisfying the requirements of all regulatory bodies.

- In order to promote uniformity and consistency, there is an urgent need to integrate, harmonize and standardize the cost accounting principles and practices. Similar such need has been felt to standardize the auditing and assurance practices. ICWAI should assign topmost priority for issue of all the required cost accounting standards. These should be prepared in consultation with all the stakeholders and fully aligned with the Financial Accounting Standards issued by ICAI with regard to the common aspects, which are applicable to both. Since, Cost Accounting Standards have been already issued by different countries; CAS issued by ICWAI should incorporate their best practices.

- Since the requisite cost accounting standards covering all the elements of cost, as presently included in the CARRs, are not in-place and it is likely to take considerable time, a state of vacuum should not be created for the interregnum period. Therefore, all the existing CARRs should be immediately replaced with a single combined CARR, covering all companies engaged in the production, processing, manufacturing or mining activities, incorporating simplified format/proformae for preparation and presentation of requisite cost data/information. A sample of such single CARR is enclosed.

- The Group's proposal to extend maintenance of cost records to all companies based on generally accepted cost accounting principles and cost accounting standards may be implemented in phases, as under:

  <u>Phase-I:</u>

  - No change in the existing provisions under section 209(1)(d) of the Companies Act, 1956 required.
  - In place of all the existing CARRs, single combined CARR should be notified.
  - Scope of CARR should cover all companies (except the micro & small companies) engaged in the production, processing, manufacturing or mining activities.

  <u>Phase-II:</u>

  - No change in the existing provisions under section 209(1)(d) of the Companies Act, 1956 required.
  - All the Cost Accounting Standards issued by ICWAI should be adopted under the Companies Act, 1956 based on the

recommendations of either the existing NACAS or a similar body to be set-up.

- Single combined CARR as notified in Phase-I should be replaced with modified CARR containing adherence to the Cost Accounting Standards issued by ICWAI.

Phase-III:

- The existing provisions under section 209(1)(d) of the Companies Act, 1956 should be amended as under:

  Section 209(1)(d): *Every company shall keep at its registered office proper books of account with respect to utilization of material or labour or to other items of cost as may be prescribed by the Central Government.*

  The Central Government may, by notification in the Official Gazette, exempt any company or class of companies from compliance with any of the requirements in section 209(1)(d), if in its opinion, it is necessary to grant the exemption in the public interest.

- Scope of CARR as notified in Phase-II above should cover all companies.

- The Group feels that the modified approach/mechanism, as proposed, would necessarily provide due flexibility to the companies and also reduce their compliance cost considerably.

Views of various Stakeholders

12.89 The Expert Group devised a detailed Questionnaire on the related issues of cost accounting and cost audit in the corporate sector, also including therein issues relating to confidentiality of company cost data and cost of compliance, cost accounting standards and the need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors and also to various Government projects/schemes, departmental undertakings, etc. A copy of the questionnaire is placed at Annexure-XI. This questionnaire was circulated to all the interest groups such as user ministries/departments, regulators, companies (public, private & cooperative), eminent academicians, experts, management consultants, practicing professionals, all the central council members and past presidents of ICWAI, etc. seeking their views on the questions set-out therein. Further open-house consultations were also held at select places in the country that were widely participated by representatives of all the interest groups/stakeholders. As regards cost accounting records, following questions were raised:

- Do you agree with the Expert Group to shift maintenance of cost records from existing rule/format-based to principle-based having universal application?
- If yes, do you propose repeal of all the existing Cost Accounting Record Rules and in place, Government may prescribe maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards?
- Do you agree that under the principle-based accounting system, all companies should maintain cost records as an integral part of books of accounts, but to be left free to follow relevant method of cost management?
- Maintenance of cost data/records, as an integral part of the books of accounts, does not normally entail any additional cost to the companies. However, do you agree that the above mechanism of moving away from rule/format based to principle based maintenance of cost data/records will provide due flexibility to the companies and reduce compliance cost, if any, further?

12.90 **These responses have been tabulated and analyzed by the Working Group-I**. According to WG-I report, majority of all the respondents, including various regulators & user departments/agencies; Navratna/Miniratna PSUs; major private sector industrial conglomerates/ companies; major industry associations; IIMs, and ISB, Hyderabad; ICWAI and leading management consultants have broadly agreed with the revised framework as proposed by the Expert Group. Gist of the responses received on cost accounting records, as per the report of the Working Group-I, is as under:

a. As regards maintenance of cost records by the corporate sector, there is an over-whelming agreement for shifting the same from existing rule/format-based to principle-based having universal application. It is said that in a rule-based system, lawmakers and regulators try to prescribe in great detail exactly what companies must do and must not do. This system relies on stating specific requirements or prohibiting certain actions by law. Principle-based approach provides more flexibility and opportunities to the companies to be more creative in finding solutions to the unpredictable and complex problems as this system merely states broad objectives and then puts the onus on the companies to meet with the stated objectives. Presently, more nations are moving towards principle-based system from rule-based system. Thus, the respondents have argued that in the present competitive scenario having rapid changes in all dimensions, different needs of the industry can be met only from principle based costing system that would result in its value addition, flexibility and innovations. They have suggested that ICWAI should issue standards with regard to various cost accounting principles. Such standards should be on similar lines as the accounting standards issued by the Institute of Chartered Accountants of India. This would facilitate uniform compliance by all entities. Once the cost accounting principles are well defined through the cost accounting standards, the companies should be allowed to use their own formats instead of those prescribed by the Government. At best, ICWAI may suggest formats for guidance. In addition, to cater to certain industry specific requirements, ICWAI should also issue guidance notes clearly explaining the specific terms/principles for their use/interpretation on uniform basis.

b. On this issue, the ICWAI Council said that the Central Government has been prescribing different “rules” for different products from 1965 onwards despite the fact that cost accounting principles remains same across the products/industries. Prescription of such rules under this methodology has led to prescription of multiple formats for different products/industries resulting in companies maintaining the multiple and non-integrated records. Moreover, all this is done more from the compliance point of view rather than maintaining the same as a part of management information tool and as an aid to management for improving efficiency into the system. With the changes in the business environment, the companies have shifted from a single product to multi product companies present in several business segments and each is usually designated as SBU (Strategic Business Unit). The consolidation of businesses and the need for global integration based on size have given rise to global corporations, which have made the Indian operations as SBUs. The IFRS (International Financial Reporting Standards) also talks about Cost of Sales and Gross Profit reporting, for reportable segment of business. Under this environment, the “made and filled up” approach for cost information by the companies cannot be perceived to be compliant with the objectives of maintenance of cost accounting records, as originally intended by the law makers. Such approach also leads to a dichotomy between the cost information maintained by the Company for internal purposes and that used for legal or statute purposes. Therefore, the existing mechanism can be considered as the rule/format based methodology which has to be consistent with a principle based approach. The existing Rules are based on a prescriptive approach for different types of industries. The principle of arriving at the cost of a product should be the same irrespective of the type of industry. Only the measurement, assignment and reporting mechanism may differ from industry to industry. The cost accounting principles have been in existence for a long time and similar to the financial accounting they have to be structured and codified into cost accounting standards. Therefore, the Council of the ICWAI feels that there should be maintenance of Cost Records on the basis of cost accounting principles having universal application across industries.

c. Those who do not agree to this change argued that the existing Cost Accounting Record Rules (CARRs) are well established and also principle based. Hence, there is no need to change. They suggested maintaining status quo with more number of companies covered for cost audit under the existing CARR or at best prescribing one common CARR for all the manufacturing and service sector industries/ companies.

d. The respondents in majority have agreed to the maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards in place of the existing CARRs. However, statutory rules have a legal & binding force that is necessary for the maintenance of cost records by the corporates. Therefore, it has been suggested that the Government should prescribe maintenance of cost records by all companies based on generally accepted cost accounting principles and cost accounting standards that should be fully synchronized, to the extent possible, with Indian GAAP and also a universal summarized reporting format for all classes of industries/companies. Law should make it mandatory for all companies to follow the cost accounting standards.

e. But a general view is that it should be done in a phased manner. Since the requisite cost accounting standards covering all the elements of cost, as presently included in the CARRs, are not in-place and it is likely to take considerable time, a state of vacuum should not be created for the interregnum period. Therefore, all the existing CARRs that carry almost identical provisions may be replaced with a single combined CARR, covering all companies engaged in the production, processing, manufacturing or mining activities, simply referring to maintenance of requisite cost records based on the generally accepted cost accounting principles and cost accounting standards. In addition, ICWAI should issue simplified format/proformae for preparation and presentation of requisite cost data/information for the benefit of industry & professional fraternity.

f. The ICWAI Council has also said that the existing cost accounting record rules should not be repealed till the appropriate and relevant principle based cost accounting standards and guidelines are in place. The ICWAI Council would take on the responsibility of providing standards and guidelines for treatment of different items of costs and a general guideline for cost determination in view of the above suggestion. The CARR can be suitably modified to be applicable to all companies engaged in production, processing, manufacturing or mining activities instead of prescribing industry wise cost records on an arbitrary basis. Considering the fact that "class of companies" should not restrict itself to a particular product/industry, there is an urgent need to introduce rules having a universal application. This can only be achieved if the maintenance of cost accounting records is prescribed to be maintained in accordance with generally accepted cost accounting principles and cost accounting standards.

g. Another school of thought argues that there being diversity and design of product, cost statements must be industry specific e.g. cost statements for Engineering, Chemicals, Electricity, Petroleum and service sector cannot have uniformity. There must be mandatory prescription for "Product/Industry specific" formats of cost statements, which may be issued by ICWAI with the statutory backing under the Companies Act like Accounting Standards Board under section 211. There is a dichotomy in understanding of the existing provisions by the Government as well as of the entire professional fraternity. While on the one hand, separate industry/product specific Cost Accounting Record Rules including the formats/proformae have been prescribed, on the other, there are only one combined Cost Audit Report Rules incorporating one single set of common formats/proformae for presentation of same cost data/information and these common formats/proformae are applicable to all companies (covered by cost audit) across industries. Therefore, it is not true that separate rules and/or formats are needed for each industry/product. However, certain regulated industries such as electricity, telecommunications, petroleum & natural gas, etc. may require separate guidelines suiting to the requirements of their regulators. The Group is of the view that such guidelines should be issued by the apex-body i.e. ICWAI in consultation with the concerned regulatory body and industry association.

h. It is also a general consensus among all the respondents that all companies should maintain cost records as an integral part of books of accounts. Further, the respondents reaffirmed the

Expert Group's view that in a highly competitive environment, it is the management's prerogative to choose appropriate cost management methodology. Since maintenance of cost records and the cost data/information, through the determination and allocation of costs to various products/services, provides a valuable service to the managements of companies in cost analysis, control and decision making and in this way, it helps to improve efficiency in the use of materials, labour and other resources, optimize production and realize greater profits. In addition, the cost records serve as an important tool in the hands of regulators and other Government departments/agencies to protect the interest of consumers and investors and the society as a whole and to protect the industry from unfair trade practices (like anti-dumping, subsidies & counter-veiling measure, cartels, etc.) under WTO environment. Therefore, all companies, without any exception, should maintain cost records as an integral part of books of account. However, companies should choose appropriate method of cost management depending upon their type of operations and the business model.

i. With regard to the maintenance of cost records, ICWAI Council has opined that in line with the existing provisions, all companies having investment in fixed assets up to Rs.5 crore or turnover up to Rs.10 crore should be exempted from the provisions of section 209(1)(d) of the Companies Act, 1956. However, the CII in their reply has said that small and medium sized companies should be exempted from maintaining the cost accounting records as an integral part of books of account and exemption should be based on a specified turnover, say companies whose turnover is less than Rs.50 crore.

j. Cost records to be kept as an *integral part* of the books of account should not be construed asking companies to necessarily maintain *integrated* books of account. This is only meant to explain that the basic record of incomes or expenses is same in any business environment. However, it is the final flow of summarized results for a period or as on a date that are generated from these basic records for the purpose of preparing financial statements such as balance sheet, profit & loss account, cash/fund flow statement, etc. and as well as for preparing cost statements such as cost of production/service or cost of sales, margin, etc. These basic records are also put to use by the internal & external stakeholders for monitoring, analysis, performance evaluation and decision making. Therefore, while the freedom to follow integrated accounting system should exist with the company itself; but for ensuring uniformity & consistency, the records should adhere to the generally accepted cost accounting principles and the cost accounting standards issued or to be issued by ICWAI; provide necessary data required to be furnished under the Cost Audit Report Rules; and should be capable of satisfying the requirements of regulatory bodies and other Government departments/agencies.

k. Section 209(1)(d) of the Companies Act, 1956 states that in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particular in the books of account. Since the proposal of the Expert Group to extend principle based maintenance of cost records as an integral part of books of account to all companies has been widely welcomed, it cannot be done without amending the existing legal provisions in the Act. Hence, a suggestion is made that in the first phase, it should be extended to all companies (excluding the exempted ones) engaged in the production, processing, manufacturing or mining activities. Later, after the Act is suitably amended, the same can be extended to the remaining class of companies.

l. Further, it has been generally agreed that the above mechanism of moving away from rule/format based to principle based maintenance of cost data/records will provide due flexibility to the companies and reduce compliance cost. Maintenance of cost data/records as part of books of account never entails any additional cost. Maintaining integrated accounting records under ERP system and compilation of cost statements in computerized accounting environment does not involve any major cost. In fact, it is their view that compliance is more important than the cost. In this regard, a view emerged that since cost data is very much needed for internal purposes also, cost of compliance per se is not relevant. Thus, most of the companies are of the view that more than the compliance cost, it is the flexibility which would benefit them the most. Prescription based methods involve more costs, and hence the majority of respondents have favoured principle based accounting mechanism as the resultant benefits in terms of due flexibility and reduced compliance cost are possible only under the proposed principle based accounting.

Observations/Recommendations of the Expert Group

12.91 The Expert Group noted that section 209(1) of the Companies Act, 1956 primarily relate to maintenance of books of account by the companies that includes cost records as well. This section does not insist on having separate books for maintaining particulars relating to costs referred to in clause (d) of sub-section (1) thereof. ICAI in their Guidance Note has also said that the cost records form part of the books of account of the company within the meaning of section 209. Therefore, the Group noted that the law does not distinguish between the books of account maintained by a company either for the purposes of financial statements or for the preparation and presentation of cost statements. While financial accounting/reporting is supported by the principle based accounting standards approved by NACAS and adopted as Companies (Accounting Standards) Rules, 2006, a differential treatment has been accorded to cost accounting by prescribing separate rules/formats causing an extra burden of additional records. **Therefore, the Expert Group recommends that individual Cost Accounting Records Rules (CARR) prescribing product wise formats for maintenance of cost records are not required. As such, necessary cost data should logically emanate from the same set of primary books of account and other accounting data/records.**

12.92 The Expert Group noted that in the Object & Reasons of the Bill seeking insertion of clause (d) under sub-section (1) of section 209 of the Companies Act, 1956, in the Report of the Joint Select Committee, and in the statements of the then Hon'ble Finance Minister made in reply to the debate in Rajya Sabha, it was stated that (a) maintenance of proper cost accounting records by the companies is essential which would make the efficiency audit possible; (b) all companies belonging to class of companies engaged in the production, processing, manufacturing or mining activities to include in their books of account particulars relating to the utilisation of materials, labour or other items of cost; and (c) every producing/manufacturing company to employ a cost accountant and to have a cost accountant's report in regard to the product(s) that it produces. The Group also noted that the term "class of companies" belongs to all such companies that are engaged in the production, or processing, or manufacturing or mining activities. However, "class of companies" has been interpreted to mean companies engaged in the manufacture of a particular product or those belonging to a specified industry. Accordingly Central Government has been prescribing separate CARR for each industry or product by assigning it the meaning as "class of companies". In fact, the Companies Act, 1956 has nowhere defined the concept “class of companies” as those producing cement or textiles or cycles or steel or petroleum products, etc. Therefore, class of companies should have been taken in totality as those engaged in the production, processing, manufacturing or mining activities and not merely those engaged in the production of a single product or belonging to a single industry. Further, for the purpose of preparation & presentation of financial records, under section 211(2), there is a reference to the term “class of companies” that is primarily construed to mean companies for which a form of profit and loss account has been specified in or under the Act governing such class of company. For example, insurance companies are governed by the Insurance Act of 1938, banking companies by the Banking Regulation Act of 1949, electricity generation/distribution companies by the Electricity Act of 2003, etc. Therefore, the existing term “class of companies” under section 209(1)(d) also need to be understood in a similar manner as that given under section 211(2) but restricted to those engaged in the production, processing, manufacturing or mining activities. **Therefore, the Group recommends that in order to enhance the competitiveness of the company, the term “class of companies” under the existing section 209(1)(d) of the Companies Act, 1956, should be considered at the company level rather than at the product level. This will facilitate focus shift to the enterprise governance.** This would also remove the present anomaly of maintaining a separate set of cost records only for a particular “product” (as prescribed under the extant rules) of a multi-product company and not doing so for the rest of the products/activities.

12.93 The Group noted that with globalisation the entire world economy is integrating into one single, huge system where geographic boundaries are fading out and protecting umbrellas held by governments over the industry and national economy are gradually closing down. In this ‘borderless’ world one has to venture out not only for survival but also for life-supporting growth and prosperity. In this context, strategic cost management plays the most vital role. In the WTO regime, we need to build up appropriate cost database to detect or fight all anti-dumping cases. Similarly, cases relating to transfer pricing or arm’s length price cannot be decided judiciously in the absence of reliable cost data. Further, proper allocation/apportionment of common costs to the enterprises operating in SEZ areas would also require adoption of well laid down costing principles. Such a reliable, standardized and industry-wide database is possible only by way of statutory cost accounting and cost reporting. Further, in the present economic scenario, maintenance of cost records in a systematic manner is essential for all the companies. It is also considered necessary to provide requisite cost inputs to various regulators and government departments/bodies to protect the interest of consumers and investors and to protect the industry from unfair trade practices under WTO agreements. The Group also noted that in a survey conducted by the Expert Group, there has been a general consensus among all the respondents that all companies should maintain cost records as an integral part of books of account, but to be left free to follow and apply relevant method of cost management. **In view of this, the Group recommends that all companies (excluding the exempted categories), should maintain cost accounting records in respect of utilisation of materials, labour or other items of cost, as an integral part of books of account. However, in order to promote uniformity and consistency in the preparation and presentation of cost statements under different statutes and under WTO, it is also recommended that such cost accounting records should adhere to the cost accounting standards issued by ICWAI that have integrated, harmonized and standardized the generally accepted cost accounting principles and practices. The above should be introduced in a phased manner as recommended in a later paragraph.**

12.94 The Group noted that cost management is distinct from the cost accounting. In a customer-driven, market oriented, and competitive world, one cannot survive unless its costs and quality are competitive and there is comprehensive cost management for maximising value, keeping an eye to the market strategy. In the context of a sustainable competitive environment which a nation builds through individual firm's competitiveness, the result is enduring competitiveness of the nation in the entire globe. This competitive environment determines the form and intensity of each firm's cost and management practices being followed. **Therefore, the Expert Group recommends that it should be the management's prerogative to choose appropriate cost management framework. The Group also recommends that the Government, professional bodies and industry associations should play a pro-active role in promoting such competitiveness of India Inc. by undertaking sector-based competitiveness and benchmarking studies. The Group further recommends that ICWAI should undertake an exercise to suggest sector specific standard costs on priority basis.**

12.95 The Group noted that all the existing 44 Cost Accounting Records Rules (CARRs) carry almost identical prescription and formats (except for some industry specific minor variations) for maintaining cost accounting records by the companies. The Group also noted that these rules are incomplete documents that lack clarity leading to presentation of non-uniform and inconsistent results; create conflict with the parent Statute; forces companies manufacturing multiple products to follow multiple rules; leaves no room for flexibility with the company management to follow one standard cost accounting system suited to its' size, scale & type of operations; results in companies incurring huge cost in preparing cost records as per the notified rules/formats; and the strait-jacketed formats are perceived to be an additional burden that are required to be "made and filled up" as an additional exercise on the part of the corporates. Moreover, all this is done more from the compliance point of view rather than maintaining the same as part of management information tool and as an aid to management for improving efficiency into the system. Further, there is a dichotomy in understanding of the existing provisions by the Government as well as of the entire professional fraternity. While on the one hand, separate industry/product specific Cost Accounting Record Rules including the formats/proformae have been prescribed, on the other, there are only one combined Cost Audit Report Rules incorporating one single set of common formats/proformae for presentation of same cost data/information and these common formats/proformae are applicable to all companies (covered by cost audit) across industries. The existing mechanism can be considered as the prescriptive methodology rather than a principle based approach. Therefore, the Working Group noted that separate rules and/or formats are not needed for each industry/product and viewed that there is need to shift from present practice of rule-based to principle-based accounting. Hence, the Working Group opined that all the existing Cost Accounting Record Rules (CARRs) may be repealed and in place, Government may prescribe maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards. However, since the requisite cost accounting standards covering all the elements of cost, as presently included in the CARRs, are not in-place and it is likely to take considerable time, a state of vacuum should not be created for the interregnum period. Therefore, the Working Group is of the view that all the existing CARRs should be immediately replaced with a single combined CARR, covering all companies engaged in the production, processing, manufacturing or mining activities, incorporating simplified format/proformae for preparation and presentation of requisite cost data/information. The Expert Group has deliberated upon this issue in greater detail and concluded that in the present competitive scenario having rapid changes in all dimensions, different needs of the industry can be met only from principle based costing system that would result in its value addition, flexibility and innovations. **Based on the wide-spread opinion expressed by all categories of stakeholders to provide due flexibility to the companies to have a sound cost accounting framework, as also to reduce their compliance cost, the Expert Group recommends as under:**

a. **Maintenance of cost accounting records by the corporate sector should be shifted from the existing rule/format-based mechanism to a principle-based mechanism having universal application.**

b. **Maintenance of cost accounting records by the corporate sector should be based on generally accepted cost accounting principles that have to be integrated, harmonized and standardized in the Cost Accounting Standards (CAS) to be issued by ICWAI in consultation with all stakeholders and in harmony with the Indian GAAP and Accounting Standards. The Group has already made detailed recommendations in the relevant chapter on CAS.**

c. **As recommended by the Working Group, this may be done in a phased manner as under:**

   <u>Phase-I:</u>

   - **No change in the existing provisions under section 209(1)(d) of the Companies Act, 1956 required.**
   - **In place of all the existing CARRs, single combined CARR should be notified.**
   - **Scope of CARR should cover all companies (except the micro & small companies) engaged in the production, processing, manufacturing or mining activities.**

   <u>Phase-II:</u>

   - **No change in the existing provisions under section 209(1)(d) of the Companies Act, 1956 required.**
   - **All the Cost Accounting Standards issued by ICWAI should be adopted under the Companies Act, 1956 based on the recommendations of either the existing NACAS or a similar body to be set-up.**
   - **Single combined CARR as notified in Phase-I should be replaced with modified CARR containing adherence to the Cost Accounting Standards issued by ICWAI.**

Phase-III:

- **The existing provisions under section 209(1)(d) of the Companies Act, 1956 should be amended as under:**

Section 209(1)(d): Every company shall keep at its registered office proper books of account with respect to utilization of material or labour or to other items of cost as may be prescribed by the Central Government.

The Central Government may, by notification in the Official Gazette, exempt any company or class of companies from compliance with any of the requirements of section 209(1)(d), if in its opinion, it is necessary to grant the exemption in the public interest.

- **Scope of CARR as notified in Phase-II above should cover all companies.**

d. **ICWAI should issue simplified format/proformae for preparation and presentation of requisite cost data/information for the benefit of industry & professional fraternity.**

e. **For certain regulated industries such as electricity, telecommunications, petroleum & natural gas, etc., ICWAI should issue industry-specific guidelines in consultation with the concerned regulatory body and industry association.**

f. **A sample of combined simplified CARR is enclosed.**

12.96 The Group noted that even though the law clearly envisaged the fact that all companies belonging to class of companies engaged in the production, processing, manufacturing or mining activities should include in their books of account particulars relating to the utilisation of materials, labour or other items of cost and every producing/manufacturing company to employ a cost accountant and to have a cost accountant's report in regard to the product(s) that it produces, still as per the present rules notified under section 209(1)(d) of the Act, small scale industrial undertakings, as defined in the Industries (Development and Regulation) Act, 1951 were granted exemption from the requirement of maintaining cost accounting records even if they belong to a class of companies for which CARRs are prescribed subject to the certain conditions i.e. *the aggregate value of the machinery and plant installed wherein, as on the last date of the preceding financial year,* does *not exceed limit as specified for a small scale industrial undertaking* under *the provisions of Industries (Development and Regulation) Act, 1951*

(65 of 1951); and the aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crore of rupees. The Group also noted that as per IFAC statement, even though small and/or less complex organizations will need cost information to manage their business operations, their requirements, however, may involve costing systems with less formal procedures and methods and these are likely to develop as a natural consequence of needing costing information. **In view of above, the Group recommends that the existing provision of exemption to small scale industrial undertakings, as defined in the Industries (Development and Regulation) Act, 1951 from the requirement of maintaining cost accounting records should be continued.**

12.97 As regards the threshold limit for identifying such small scale industrial undertakings, the Group already noted that the limit for the value of machinery & plant that was earlier fixed as Rs.3 crore has been revised to Rs.5 crore as per the Micro, Small and Medium Enterprises Development Act, 2006. Therefore, this has to be revised accordingly. In respect of the second condition of annual turnover, the Group noted that the ICWAI Council has recommended retaining the existing limit of Rs.10 crore; CII said that all small and medium sized companies whose turnover is less than Rs.50 crore should be exempted from maintaining the cost accounting records; internal Policy Guidelines of Ministry of Corporate Affairs desired to enhance the limit to Rs.20 crore; and the Working Group-II has also recommended to enhance the limit for annual turnover from the existing level of Rs.10 crore to Rs.20 crore in the immediately preceding accounting year. The Expert Group deliberated on this issue in greater detail and decided to go along the limits suggested by the MCA and Working Group-II. **Accordingly, the Expert Group recommends that all micro & small scale industrial undertakings, as defined in the Micro, Small and Medium Enterprises Development Act, 2006 should continue to remain exempted from the requirement of maintaining cost accounting records even if they belong to class of companies engaged in the production, processing, manufacturing or mining activities, subject to the following conditions. Such companies should also remain outside the ambit of cost audit.**

a. ***The aggregate value of the machinery and plant installed wherein, as on the last date of the immediate preceding accounting year,*** **does** ***not exceed limit as specified for a small scale industrial***

undertaking **under** ***the provisions of Micro, Small and Medium Enterprises Development Act, 2006;***

b. ***The aggregate value of the turnover made by the company from sale or supply of all its products during the immediate preceding accounting year does not exceed twenty crore of rupees;***

c. ***The company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;***

d. ***It is not a bank, financial institution or an insurance company;***

e. **It does not have borrowings (including public deposits) in excess of rupees five crore at any time during the immediately preceding accounting year; and**

f. **It is not a holding or subsidiary company of a company which is not a small sized company.**

12.98 The Group noted that medium size companies are not presently exempted from the application of CARRs. Such companies would necessarily require requisite cost data/information for internal purposes as well as for legal or statutory purposes. Hence, the Working Group is of the view that there appears no justification in granting them exemption from merely maintenance of cost records as they would draw much greater benefits from such mechanism and it would also help them to comply with any type of legal/statutory requirements. Therefore, medium size companies should maintain cost records based on generally accepted cost accounting principles and cost accounting standards, as may be notified under section 209(1)(d) of the Companies Act, 1956. However, with a view to avoid incidence of any additional cost of compliance, such class of companies should also be exempted from the provisions of cost audit. But such companies should only file a compliance report with the Central Government, on a proforma to be notified, from a cost accountant certifying requisite maintenance of cost records. The Working Group further recommended that the threshold limits for exemption to medium size companies from the provisions of section 233B of the Companies Act, 1956 should be investment in plant & machinery exceeding Rs.5 crore but not exceeding Rs.10 crore (as defined in the statute) and annual turnover exceeding Rs.20 crore but not exceeding Rs.50 crore in the immediately preceding accounting year. While calculating annual turnover, any turnover from trading operations, consultancy services, other incomes, etc. in a manufacturing organisation will not be considered. But turnover from job work or loan license operations would stand included. Other conditions that would apply to a medium size company to avail exemption from cost audit shall be (a) the company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; (b) it is not a bank, financial institution or an insurance company; (c) it does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and (d) it is not a holding or subsidiary company of a company which is not a small and medium sized company. **Taking into account the aforesaid, the Expert Group recommends as under:**

I. **All medium size companies should maintain cost accounting records based on generally accepted cost accounting principles and cost accounting standards, as may be notified under section 209 (1)(d) of the Companies Act, 1956.**

II. **With a view to avoid incidence of any additional cost of compliance, such class of companies should also be exempted from the provisions of cost audit under section 233B of the Act.**

III. **Such companies should only file a compliance report with the Central Government, on a proforma to be notified, from a cost accountant certifying requisite maintenance of cost accounting records, as notified under section 209 (1)(d) of the Act.**

IV. **Medium size companies should be classified based on investment in plant & machinery exceeding Rs.5 crore but not exceeding Rs.10 crore (as defined in the statute) and annual turnover exceeding Rs.20 crore but not exceeding Rs.50 crore in the immediately preceding accounting year. While calculating annual turnover, any turnover from trading operations, consultancy services, other incomes, etc. in a manufacturing organisation will not be considered. But turnover from job work or loan license operations would stand included.**

V. **Other conditions that would apply to a medium size company shall be as under:**

    a. ***The aggregate value of the machinery and plant installed wherein, as on the last date of the immediate preceding accounting year,* does *not exceed limit as specified for a medium size industrial undertaking* under *the provisions of Micro, Small and Medium Enterprises Development Act, 2006;***

b. ***The aggregate value of the turnover made by the company from sale or supply of all its products during the immediate preceding accounting year does not exceed fifty crore of rupees;***

c. ***The company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;***

d. ***It is not a bank, financial institution or an insurance company;***

e. ***It does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and***

f. ***It is not a holding or subsidiary company of a company which is not a small and/or medium sized company.***

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CHAPTER-13: AUDIT OF COST ACCOUNTING RECORDS

Constitution of Working Group

13.1 One of the principle terms of reference assigned to the Expert Group was

> *"to review the existing Cost Audit Report Rules and formats prescribed therein, and recommend appropriate modifications to make them more relevant to the needs of different stakeholders including company management, shareholders, regulators, etc."*

13.2 For this purpose, a separate Working Group (WG-III) was constituted by the Expert Group, under the chairmanship of Shri B.B. Goyal, Adviser (Cost), MCA & Chairman, Expert Group. Other members of this Working Group were:

1. Shri Chandra Wadhwa, the then President, ICWAI
2. Shri A.N. Raman, Member, CII-TCM Working Group
3. Shri K. Sridharan, Chief Finance Officer, Ashok Leyland Limited
4. Shri Pawan Kumar Ruia, Chairman, Ruia Group of Companies
5. Shri K. Narasimha Murthy, Director, IDBI & IFCI
6. Shri S.A. Murali Prasad, Director, SAM Consultancy Services

13.3 The aforesaid Working Group held several meetings and detailed deliberations on the subject. They submitted their report that was considered and taken on record by the Expert Group in its meeting held in New Delhi on 18th November, 2008. Relevant issues highlighted by the Working Group and its' recommendations have been discussed in the ensuing paragraphs.

13.4 This issue, being interrelated with the other terms of reference, has also figured in the reports of other Working Groups as well. Therefore, any views and/or recommendations made by other Working Groups have also been suitably incorporated in this chapter.

Background

13.5 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. Government then started verifying and investigating into the cost structure of such firms. The Institute of Cost and Works Accountants of India (ICWAI), which was initially set up as a society in 1944 with the objectives of promoting, regulating, and developing the profession of cost accountancy in the country, later incorporated as a statutory body by an Act of Parliament in 1959.

13.6 In 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.

13.7 Cost audit and authentic cost data was considered an important instrument 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.

13.8 These developments resulted in inserting sections 209(1)(d) and 233B in the Companies Act, 1956, by the Companies (Amendment) Act, 1965 (31 of 1965). These provisions relate to maintenance of cost accounting records and audit of cost records.

13.9 The justification for mandatory cost accounting records and cost audit has been well explained and documented in the Notes on clauses, Report of the Joint Select Committee and Parliamentary Debate that led to adoption of Companies Amendment Bill, 1965 incorporating above-mentioned Section 209(1)(d) and 233B. The primary aim was not to detect frauds and dishonesty in the corporate sector but to prevent it and also to make the corporate sector more efficient through the scheme of detailed cost accounting and efficiency audit. The scheme was intended to serve best interest of the company itself and also of all other stakeholders as well as of various Government agencies. One of the major objectives was to provide authentic data to the Government on which various elements of costs and profits that could be allowed to the manufacturers of controlled goods.

13.10 Clause (d) of sub-section (1) of section 209 was inserted by section 20 of the Companies (Amendment) Act, 1965. The Objects and Reasons in the Bill stated:

> *"The object of the amendment of sub-section (1) of section 209 is to ensure that in respect of companies engaged in production, processing, manufacturing or mining activities which may be specified by notification issued by the Central Government, proper records relating to utilisation of material and labour are available, which would make the efficiency audit possible."*

13.11 Ramaiya's Guide to the Companies Act elaborates that "*Efficiency audit*" is possible only when a system of cost accounting is adopted and costing records maintained for purposes such as the following:

- To furnish accurate cost of jobs, materials, finished products, comparing present cost with previous cost experience;
- To make accurate periodical cost statements for information and guidance of the management;
- To help determining price of finished products by furnishing all relevant data;
- To evaluate production processes with cost data;
- To analyse each production activity whether it is value-added or non-value added and to link-up with cost data;
- To help planning operations and control stock;
- To determine efficiency of operations by furnishing data as to cost volume of production etc.;
- To distribute overhead costs in a rational manner; and
- To help, continuous study and reporting as to material cost prices, quality of material, transportation costs, plant idleness, production capacity overhead costs etc., quality of labour, labour costs, waste, depreciation in all its aspects such as machine deterioration, accelerated depreciation, etc.

13.12 The Joint Select Committee in their Report said:

> *"The Committee feel that a company may be required under the proposed clause (d) of sub-section (1) of section 209 to include the prescribed particulars in its books of account only if it pertains to a class of companies engaged in production, processing, manufacturing or mining activities and all other companies belonging to that class are required to include such particulars in their books of account."*

13.13 Explaining the provision, notes below the section, as they appear in the Ramaiya's Guide, said that the concept and scope of cost audit in India is much wider as the definition lays emphasis on the evaluation of efficiency of operations and the propriety of management actions and decisions, executive programs and policies. In this sense, cost audit appears to be synonymous with the efficiency audit.

13.14 Section 233B was inserted by section 23 of the Companies (Amendment) Act, 1965, in order to enable Government to issue necessary directions for conducting cost audit of companies engaged in production, processing, manufacturing or mining activities. The Notes on clauses stated that the purpose of the section was to "*enable Government to issue necessary directions for conducting cost audit of companies engaged in production, processing, manufacturing or mining activities*" (*clause* 24).

13.15 During the Rajya Sabha Debate, Smt Tara Ramchandra Sathe (Hon'ble MP for Maharashtra) stated as under:

> *"What is Cost Audit? The Cost Audit is quite different from the Financial Audit. It is to see whether the labour is sufficient or not whether the industry has provided efficient labour or the labour which is required by that industry is less than what is required, whether every material and every part of the machinery is used to the optimum, whether any material is wasted, etc.*
>
> *As we all know, we are short of material, there is so much material is imported, when we are short of foreign exchange. In these circumstances, it is very essential that there should be cost audit. In fact, it should be introduced in almost all the industries, but the Government is trying this in certain cases only. So by this we will know whether there is a proper utilization of the material or not. It is very essential, no doubt, and in factories and industries, everywhere, this cost audit should be emphasized." (Proceedings of Rajya Sabha, 14th September, 1965 Columns 3944 and 3945)*

13.16 In his reply, the then Hon'ble Finance Minister of India, Shri T.T. Krishnamachari stated that:

> *"while we have made it obligatory or rather semi-obligatory to employ Cost Accountant, it is our intention to ask certain industries to have a cost accountant's report."* (ibid column 3974)

13.17 Highlighting the absolute necessity of cost accounting and cost audit in all companies in due course, he added:

> "w*hen we can have sufficient number of Cost Accountants so as to make it obligatory for every company, every producing concern and every manufacturing concern, to have a cost accountant's* report." (*ibid column 3974*).

13.18 Reiterating the future vision of the Government, he further said:

> "*we are really making it possible for the institution of Cost Accountants to grow so as to enable the Government some time later to make every manufacturing company employ a Cost Accountant, and have a cost accountant's report in regard to the cost of product that it produces.*" (*ibid columns 3974*)

Existing Provisions/Framework of Cost Audit

13.19 Section 233B of the Companies Act 1956 deals with the audit of cost accounting records maintained by a body corporate as part of its books of account as prescribed under section 209(1)(d) ibid. The section provides as follows (full text is appended as Annexure-VI):

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

13.20 Government of India, Ministry of Corporate Affairs, under section 233B read with section 642(1) of Companies Act, 1956, has notified Cost Audit Report Rules. These Rules were originally notified in 1968, which were later amended in 1996 and again in 2001. A summarized Form-I was also introduced in 2006 after introduction of online filing of Cost Audit Reports through MCA-21. A Copy of these Report Rules and Form-I is available at Annexure-IX & X.

13.21 The existing Cost Audit Report Rules contain following four segments:

1. Form-I which contains summarized information for 2 years with regard to physical, financial and cost parameters. It also contains few key cost/financial ratios and details of margin per unit of output – separately for trading sales, loan license sales and own manufactured sales.
2. Part-I: It includes basically a format of the Cost Auditor’s Report, together with his views with regard to various issues concerning the working of the company/unit covered. It also includes cost auditor’s certification/suggestions on varied issues like inventory valuation, budgetary control system, related party transactions, adverse trends in profitability, default in servicing of loans, competitive environment, export commitments, domestics & export pricing policy, scope & performance of internal audit of cost records, measures for further improvements, etc.
3. Part-II: This is an Annexure to the Cost Audit Report. It comprises of various paras seeking information for 3 years on the following:

   a. Party-wise details of loan license/job work arrangement by the company

- Details of all foreign collaborations
- Details of all other manufacturing activities of the company not covered by the said cost audit report
- Cost accounting system followed by the company
- Process of manufacture
- Quantitative details
- Standard & actual materials consumed
- Break-up of imported materials
- Standard & actual consumption of power, fuel & utilities
- Details of salaries & wages
- Repairs & maintenance
- Fixed assets & depreciation
- Factory, administrative, selling & distribution overheads
- Research & development expenses
- Royalty & technical know-how charges
- Quality control expenses
- Pollution control expenses
- Abnormal non-recurring costs
- Non-moving stock
- Written off stock
- Inventory valuation
- Physical verification of inventory
- Sales of the product under reference
- Margin per unit of output
- Competitive margin against imports
- Value addition & distribution of earnings
- Financial position & ratio analysis
- Capitalization of revenue expenditure
- Related party transactions
- Central excise reconciliation for the product under reference
- Profit reconciliation
- Large number of cost related issues

4. Part-III: This is a format for the proforma cost sheet which is to be given for each product separately.

13.22 All the aforesaid details are required to be given for each factory/unit, within a factory/unit for each product, and within a product for each type/variety/description separately. Separate proforma are required to be prepared for the quantity used for captive consumption, quantity sold within the country and the quantity exported. Similarly, separate proforma are also required to be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference. In few formats, the information/data is required to be given for the product under reference, for all other products, for the factory as a whole and also for the company as whole.

13.23 As per existing provisions, cost audit orders are issued on individual companies. Within the 44 industries/products covered by Cost Accounting Records Rules, Cost Audit orders have been issued in about 2500 cases, covering about 2000 companies. It has been observed that for a particular industry/product covered under the scheme, cost audit orders have not been issued for all the companies. It is also observed that in case of multi-product companies, more than one Cost Accounting Record Rules become applicable to the company. Consequently in few companies, more than one Cost Audit Orders have been issued for different products. Similarly, all products of a multi-product company may not be covered by the existing set of Cost Accounting Record Rules. Hence, no cost audit orders can be issued for such non-covered products.

13.24 On the issue of appointment of cost auditors, sub-section (2) of section 233B says that *"The Auditor under this section shall be appointed by the Board of Directors of the company in accordance with the provisions of sub0section (1B) of section 224 and with the previous approval of the Central Government."* Further, as per sub-section (3), audit under section 233B shall be in addition to an audit under section 224; and as per sub-section (4), cost auditor shall have same powers and duties as granted to an auditor under section 227(1). Therefore, in accordance with these provisions, appointment of Cost Auditor is done by the Board of Directors of the company after obtaining prior approval from the Central Government; and in-short, all other provisions in relation to the qualification, disqualification, powers, duties, ceiling on number of audits, etc., as applicable to an auditor appointed under section 224 of the Act, are also, *mutatis mutandis,* applicable to the cost auditor appointed under section 233B.

13.25 On filing of cost auditor's report, Joint Select Committee, in Para 23 of their report said, *"The Committee have also noted that since cost audit was likely to reveal certain information which are regarded as confidential by the companies, the cost audit report should be filed with the Company Law Board and not with the Registrar and a copy of the report should be sent to the company."* Therefore, sub-section (4) of section 233B of the Act provided that the cost auditor shall make his report to the Central Government *[substituted in 1975 for Company Law Board]* in such form and within such time as may be prescribed and shall also at the same time forward a copy of the report to the company. As already indicated above, Central Government has already prescribed Cost Audit Report Rules, prescribing the manner & the formats for filing of cost audit report. As per these Rules, the report is now e-filed with the Government, with a copy to the company.

13.26 As regards the time of submission of cost audit report, the Cost Audit Report Rules, 2001 provides as under:

> *"Clause 5 - Time limit for submission of Report: The Cost Auditor shall forward his report referred to in sub-rule (1) of rule 4 to the Central Government and to the concerned company within one hundred and eighty days from the close of the company's financial year to which the report relates."*

13.27 Section 233B of the Companies Act, 1956 states that Central Government may issue orders for conduct of audit of cost accounting records of a company only if that company is required to maintain such records under section 209(1)(d) of the Act. As per provisions contained in various Cost Accounting Records Rules (CARRs) notified under section 209(1)(d), all small scale industrial undertakings, as defined in the Industries (Development and Regulation) Act, 1951 were granted exemption from the requirement of maintaining cost accounting records even if they belong to a class of companies for which CARRs are prescribed, subject to the certain conditions. Therefore, all these SSI units were also exempted from the purview of cost audit.

13.28 Further, as per para 4(viii) of the Statement on the Companies (Auditor's Report) Order (CARO), 2003, the auditor's report shall include a statement on the following:

> *"where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained."*

13.29 As a result, in case of all companies presently covered under section 209(1)(d), the auditor(s) of a company are required to include a statement in their Audit Report whether requisite cost accounts and records, as prescribed by the Central Government, have been made and maintained. In this regard, the Institute of Chartered Accountants of India *[Handbook of Auditing Pronouncements, Compendium of Standards & Statements, Volume-I, as on April 1, 2008, Pages VII-76 to 78]*, has issued following guidelines to their members (relevant extracts only):

- Section 209(1)(d) of the Act requires a company pertaining to a class of companies ……… to maintain proper books of account showing particulars relating to utilization of material or labour or to other items of cost …….. These books of account and records form part of the books of account of the company within the meaning of section 209…….
- The Cost Accounting Records Rules issued for various industries contain requirements relating to two matters (a) maintenance

of proper books of account relating to materials, labour, and other items of cost; and (b) preparation of cost statements at the end of the financial year in accordance with the rules specific to the industry concerned. While the records relating to materials, labour, etc. are required to be maintained on a day-to-day basis, the cost statements have to be prepared periodically. The Order requires the auditor to report whether cost accounts and records have been made and maintained. The word "made" applies in respect of cost accounts (or cost statements) and the word "maintained" applies in respect of cost records relating to materials, labour, overheads, etc.

- The auditor has to report under the clause irrespective of whether a cost audit has been ordered by the Central Government.
- The auditor should obtain a written representation from the management stating (a) whether cost records are required to be maintained for any product(s) of the company under section 209(1)(d) and (b) whether cost accounts and records are being made and maintained regularly.
- The auditor should also obtain a list of books/records made and maintained in this regard. The Order does not require a detailed examination of such records. The auditor should, therefore, conduct a general review of the cost records to ensure that the records as prescribed are made and maintained. He should, of course, make such reference to the records as is necessary for the purposes of his audit.
- It is necessary that the extent of the examination made by the auditor is clearly brought out in his report. The following wording is, therefore, suggested:

  > *"We have broadly reviewed the books of account maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under section 209(1)(d) of the Companies Act, 1956 and are of the opinion that prima facie the prescribed accounts and records have been made and maintained."*

- Where the auditor finds that records have not been written up or not prima facie complete, it will be necessary for the auditor to make suitable comment in his report.

13.30 Further, as per the existing framework, there is no mechanism in the Central Government to know as to which company is presently covered under the relevant CARR notified under section 209(1)(d) of the Act.

13.31 The existing provisions under section 209(1)(d) and 233B of the Companies Act, 1956 were gone into by the "Expert Committee on New Company Law" (chaired by Dr. J.J. Irani) set up by the Ministry of Company Affairs, which made its recommendations to the Ministry in May, 2005. The recommendations made by the Committee on these issues are reproduced below:

> *"At present, the Companies Act contains provision relating to maintenance of Cost Records u/s 209(1)(d) and Cost Audit u/s 233B of the Companies Act in respect of specified industries. The Committee felt that Cost Records and Cost Audit were important instruments that would enable companies make their operations efficient and exist in a competitive environment.*
>
> *The Committee noted that the present corporate scenario also included a sizeable component of Government owned enterprises or companies operating under administrative price mechanism or a regime of subsidies. It would be relevant for the Government or the regulators concerned with non-competitive situations to seek costing data. The Committee, therefore, took the view that while the enabling provision may be retained in the law providing powers to the Government to cause Cost Audit, legislative guidance has to be taken into account the role of management and addressing cost management issues in context of the liberalized business and economic environment. Further, Government approval for appointment of Cost Auditor for carrying out such Cost Audit was also not considered necessary."*

13.32 Provisions of section 209(1)(d) of the Companies Act, 1956 and the existing coverage of industries under CARRs were reviewed by the Committee on Subordinate Legislation (Fourteenth Lok Sabha) in its First Report (Chapter-III) submitted on 2nd December, 2004. The Committee recommended for further strengthening of the existing mechanism of CARR and extending the same to service sectors as well. Full text of their recommendations has been given in another chapter of this report.

13.33 With reference to the aforesaid recommendations made by the Committee on Subordinate Legislation, Ministry of Corporate Affairs, in August 2006, framed internal Policy Guidelines on Cost Accounting Record Rules and Cost Audit which would guide the Ministry in its approach to the subject within the existing provisions of the Companies Act, 1956. Highlights of these guidelines, as these relate to the cost audit, are:

- Existing system of compliance by Statutory Auditors under CARO to be reviewed periodically.
- Cost Audit Report Rules, 2001 to be reviewed.

- Confidentiality of cost data to be maintained.

13.34 In continuum of these internal policy guidelines framed by the Ministry, Government of India, Ministry of Corporate Affairs vide their Order dated 21st January 2008 constituted this Expert Group to review the existing mechanism/framework of Cost Accounting Records Rules, Cost Audit Report Rules, Cost Accounting Standards, Confidentiality of company cost data and cost of compliance.

13.35 These guidelines were examined by the Expert Group. The Group is of the opinion that these guidelines need to be evolved as a complete policy with regard to cost accounting records and cost audit in the corporate sector. Broad issues that require examination, as these relate to cost audit, are:

- How the companies should be selected for cost audit or should it be ordered for all non-exempted companies?
- How to maintain the confidentiality of cost data?
- Should all stakeholders be given access to the cost audit report, in full or in part?
- The new policy should help in improving the existing system of Investor Protection, Enterprise Governance, Segmental Reporting, Transfer Pricing, etc; all requirements under WTO agreements on Anti-dumping, subsidies, safeguards, valuation, etc; providing necessary cost data to all the regulators, tariff or price fixation bodies, subsidy administration, fixation of cost-based user charges, CCI, SFIO, revenue authorities, banks & financial institutions, etc.
- Will the limited cost data be of any help in carrying out economic analysis, assessing competitiveness, free trade agreements, predatory pricing, working out standard costs, etc.?
- Will the nation not suffer due to the inefficient running of any company and its' eventual closure by loss of funds by small investors; loss of production in the country; loss of potential revenue inflow to the Government; and loss of employment.
- What is the guarantee that selective coverage of products/industries for cost accounting and cost audit will not result in increasing the existing sense of discrimination resulting in these units or industry associations pressurizing the government to withdraw the provisions selectively made applicable on them.

13.36 The Expert Group decided to have an independent and thorough review of the existing mechanism/framework and address all these key issues so as to suggest a revised scheme to the Government that should be based on a sounder and balanced approach taking into account the important issues/requirements of all the stakeholders.

Observations on the Existing Provisions/Framework:

13.37 As per report of the Working Group-III, following shortcomings have been observed in the existing structure of Cost Audit Report Rules, 2001, formats prescribed therein and the practice followed under section 233B of the Companies Act, 1956.

13.38 As per existing rules, cost audit report is required to be furnished for each unit separately. There is no provision to file even a duly reconciled unit-wise summarized data/information for the company as a whole. In addition, no cost audit report is required to be furnished for the units producing such products that are not covered under section 233B of the Companies Act, 1956. Even in a covered unit, information is furnished only for the relevant products, and not for the entire unit. Since published Annual Report is available only for the company as a whole, not for each unit/product separately, there is no mechanism to verify the correctness of data/information provided in the unit related cost audit report.

13.39 To facilitate e-filing, Form-I was introduced in 2006. The information contained in this form was intended to be a summary of the detailed data/information given in the attached cost audit report including the annexure enclosed therewith. This is not true as in many cases, the summary given in Form-I do not tally with the details given in the report. In units producing multiple products, there is no provision to provide product-wise details and hence, the data given in Form-I does not reflect true and fair view so as to make any correct & meaningful assessment of the unit's performance. Sometimes, it is not even correctly understood by the company/cost auditor and hence, wrong data is provided. Thus, it takes enormous time & efforts to verify same either from the attached cost audit report or from the annual report of the company.

13.40 Main part of the Cost Auditor's report cover issues like inventory valuation, budgetary control system, related party transactions, adverse trends in profitability, default in servicing of loans, competitive environment, export commitments, domestics & export pricing policy, scope & performance of internal audit of cost records, measures for further improvements, etc. The Group has noted that information relating to certain issues like default in servicing of loans, competitive environment, export commitments, domestics & export pricing policy, may not be relevant to the cost audit report. Generally, these are not even provided. Further, since details relating to related party transactions are already being covered in the Annual Report of the company, this information is redundant and results in duplication. Hence, structure of the existing report requires complete modification.

13.41 In the annexure attached to the cost audit report, data/information has been sought for a very large number of related/non-related issues. Considerable details in respect of practically all areas of activities/operations of the unit/company are required to be furnished. Firstly, it is extremely difficult for the unit/company to prepare so much of information. Details of all components of cost have to be included even though it may be insignificant e.g. details in respect of input materials constituting as little as 2% of the total raw materials cost have to be furnished. Sometimes, it may not be possible to extract such minute details even in a sophisticated ERP system environment. Further, few para contain so much of complexities that despite ICWAI having already issued detailed guidelines on the subject, majority do not submit it correctly. Under few para, it has been observed that the information sought is totally irrelevant that does not serve any useful purpose of the Government or in other words, it is not put to any use by any Government authority or the regulators. It only leads to extra cost to the company. Therefore, these formats need simplification. Filing of minute cost details for each factory/unit, within a factory/unit for each product, and within a product for each type/variety/description separately and all complexities in reporting have to be avoided.

13.42 As per the existing Rules, all details are required to be given for each factory/unit, within a factory/unit for each product, and within a product for each type/variety/description separately. Further, separate proforma are required to be prepared for the quantity used for captive consumption, quantity sold within the country and the quantity exported. Similarly, separate proforma are also required to be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference. This prescription results in the reports becoming too long, running into even more than 2,000 pages in few cases. It also takes enormous time and effort of the company to prepare such voluminous data/information. While so much of detailed data/information run a very high risk of losing competitive advantage, if leaked; it also encompasses huge cost to the company. Under the present e-filing mechanism, it becomes difficult to file such voluminous reports, as there is limit imposed on the size of files that can be attached to the e-form. Thus, this is then filed in parts as addendum, which does not give any acknowledgement to the company. On the user side (i.e. in MCA), linking and downloading such huge files becomes extremely difficult; lest the problems that are being faced in analyzing vast amount of data/information.

13.43 The Working Group has noted that it is only the proforma cost sheet that contains highly useful information. This need to be continued. But it has to be standardized based on the generally accepted cost accounting principles and practices. Further, since Indian accounting framework would be soon converging with IFRS, the entire framework of cost accounting and reporting will also have to be aligned with the relevant issues in IFRS.

13.44 As per the existing framework, there is no mechanism in the Central Government to know as to which company is presently covered under the relevant CARR notified under section 209(1)(d) of the Act. Hence, the Working Group observed that so far, the Government has followed a total ad hoc approach in ordering for audit of cost accounting records maintained by the companies already covered under the CARR. The Working Group has further made following observations arising from the existing practice of issue of selective cost audit orders within each industry, out of 44 industries covered so far under CARR:

a) Out of nearly 9 lakh registered companies, approximately 0.5 lakh companies (as estimated by ICWAI) are covered by 44 CARRs so far notified under section 209(1)(d) of the Companies Act, 1956. However, cost audit orders under section 233B ibid have been issued for less than 2,000 companies, thus representing merely 4% out of 0.5 lakh companies covered under 44 CARRs.

b) In many industries, no cost audit orders have been issued so far. Examples are Mining & Metallurgy and Telecommunication. Only 2 companies are covered in Electronics Industry. No auto component manufacturer has been covered so far.

c) In many other industries, very few cost audit orders exist despite very large number of companies falling within the scope of relevant CARR. Examples are,

   - Under the Steel Industry, majority of the primary and secondary steel producers are not covered.
   - Among the manufacturers of Air conditioners and Refrigerators, majority of the multinational companies and large manufacturers have been left out.
   - In the Power sector, none of the companies engaged in generation of power through non-conventional sources, captive power plants resorting to sale of power, mini-hydro plants, etc. have been covered.

- Similarly, more than 50% of the Footwear manufacturers, including the multinationals, are not covered so far.
- In Petroleum Industry, only the Public Sector companies have been covered, leaving out all private sector producers for no good reasons.
- Similar such examples exist in many other industries covered by CARR but not covered under section 233B for cost audit.

d) This practice has led to a sense of discrimination and heart burn with the few companies covered for cost audit and leaving many others out of the purview. This gets aggravated after knowing that many large companies and multinationals have been left out while other relatively smaller ones have been covered. Many instances of even ones' next door neighbour not covered for cost audit have been noticed.

e) Selective coverage within a particular industry does not give any major advantage even to the Government for carrying out anti-dumping studies, tariff related studies, pricing studies, anti-competitive studies, subsidy related studies, sectoral studies or economic analysis, etc. for the simple reason that fully representative data of the industry is not available.

f) This has, therefore, prompted few Industry Associations to request the Government for granting exemption to their member units that have been selectively covered so far.

13.45 Owing to notification of industry/product wise separate Cost Accounting Records Rules under section 209(1)(d) of the Companies Act 1956 and thus issue of multiple cost audit orders under section 233B ibid for a single company producing multiple products has led to the following anomalies/difficulties:

a) Much greater complexities and difficulties in maintaining and reporting the requisite cost data/information;

b) Causes avoidable burden in complying with multiple rules;

c) Companies cannot maintain & follow any single prudent cost accounting system as different formats/methods have been prescribed under different rules;

d) How to maintain or not maintain cost records for products not covered under section 209(1)(d) and/or section 233B of the Companies Act, 1956;

e) Appointment of multiple cost auditors within the same company/unit;

f) Required to submit multiple cost audit reports;

g) High cost of compliance for the companies;

h) It does not result in drawing full advantage either by the company or by the Government; and

i) Monitoring at the Government (MCA) level becomes too cumbersome and time consuming.

13.46 Therefore, the Working Group has noted that the existing practice of notifying industry/product wise CARR and ordering product-wise cost audit orders only on selective companies, seeking unit-wise cost details and other data/information, does not support to any justification either from the user (i.e. the Government) point of view or from the provider's (i.e. the company) viewpoint. Such a situation should be avoided and rectified.

13.47 To give authenticity to the data/information/records, it is an accepted fact that the books of account of any organisation cannot remain unaudited. In this backdrop, the Working Group has further noted that the existing practice of asking a company under section 209(1)(d) of the Companies Act, 1956 to compulsorily maintain cost accounting records as per notified CARR and thereafter not getting such records audited under section 233B ibid should be discontinued.

13.48 Further, as per existing provision of CARO, the [statutory] auditor(s) of the company appointed under section 224 of the Act, are required to include a statement in their Audit Report whether requisite cost accounts and records, as prescribed by the Central Government, have been made and maintained. As per ICAI's Guidance Note on the subject, the auditor is not required to conduct any detailed examination of such records and therefore, should conduct a general review of the cost records to ensure that the records as prescribed are made and maintained. ICAI suggested format for the auditor's statement is, *"We have broadly reviewed the books of account maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under section 209(1)(d) of the Companies Act, 1956 and are of the opinion that prima facie the prescribed accounts and records have been made and maintained."* ICAI further said that where the auditor finds that records have not been written up or not prima facie complete, it will be necessary for the auditor to make suitable comment in his report. In this regard, the Working Group observed as under:

- It is not correct to seek such a statement from the financial auditor(s) of the company who, as per the Chartered Accountants Act, 1949, are not practicing in the field of cost accountancy.

- Besides the aforesaid statement as suggested by ICAI, the auditor(s) further add *"We have not made any detailed examination of these records with respect to their accuracy and completeness"*. Therefore, such a certificate does not serve any meaningful purpose.
- In many cases, the Working Group was informed that while the company is actually maintaining cost records as per CARR but the auditor(s) have certified in negation and conversely, while the auditor(s) have given certificate in affirmation, the company was found not even covered by any of the CARRs. In case of companies for which no cost audit orders exist, it is not verified by any agency in the Government as to whether the certificate provided by the auditor(s) is correct or not.
- Therefore, the Ministry of Corporate Affairs, in their internal Policy Guidelines framed in 2006, said that the existing system of compliance by Statutory Auditors under CARO to be reviewed periodically.
- Therefore, the Working Group has noted that the existing mechanism/framework of selective cost audit and getting a compliance certificate from the financial auditors does not serve any purpose, and thus, any company (except those exempted) covered by section 209(1)(d) should also be covered under section 233B of the Companies Act, 1956.

13.49 As per existing provisions, cost auditors are appointed by the Board of Directors of a company after obtaining prior approval from the Central Government (i.e. MCA). All other provisions applicable to the Financial (Statutory) Auditors equally apply to the Cost Auditors as well. Since the cost audit reports are not required to be placed before the general meeting and are reports to the Central Government, it is considered that the Board of Directors of a company may itself make the appointment of the cost auditor with the approval of the Central Government. However, the Working Group is of the view that this has to be reviewed in the context of Irani Committee recommending for doing away with the prior approval of Central Government in appointment of cost auditors.

13.50 Under the present proviso to sub-section (1) of section 233B, it is provided that

> *"if the Central Government is of the opinion that sufficient number of cost accountants within the meaning of the Cost and Works Accountants Act 1959 are not available for conducting the audit of cost accounts of companies generally, that Government may, by notification in the Official Gazette direct that, for such period as may be specified in the said notification, such chartered accountant within the meaning of the Chartered*

> *Accountants Act 1949, as possesses the prescribed qualifications, may also conduct the audit of the cost accounts of companies, and thereupon a chartered accountant possessing the prescribed qualifications may be appointed to audit the cost accounts of the company".*

13.51 On the issue of inclusion of Chartered Accountants in the proviso to sub-section (1) of section 233B, the Joint Select Committee had said:

> *"It was represented to the committee that the number of cost accountants in practice in this country is extremely limited and that, therefore, cost audit, if it was to be extensive, will have to be entrusted to chartered accountants also. The committee are of the opinion that this difficulty could be got over by providing specifically that the chartered accountants who may possess the prescribed qualifications should also be allowed to undertake cost audit under this clause."*

13.52 The Working Group noted that the sub-section (1) as amended by the Companies Amendment Act, 1974 now expressly requires that a cost auditor *"shall be a cost accountant within the meaning of the Cost and Works Accountants Act 1959"*. By reason of this amendment which came into force in February 1975, the Rules framed under the Cost Audit (Qualification) Amendment Rules 1972 which had provided that a practicing Chartered Accountant also might be appointed as a cost auditor, if he possessed the qualifications prescribed by those Rules have ceased to have effect. The proviso to sub-section (1) newly added by the said Amendment Act of 1974 makes it clear that a Chartered Accountant possessing the prescribed qualifications can be appointed as a cost auditor only in the event of non-availability of sufficient number of cost accountants and the Central Government issuing notification in consequence thereof as provide in the Proviso.

13.53 The Working Group further noted that when this proviso to sub-section (1) was provided in 1965, sufficient number of qualified cost accountants were not available in the country. Now that number has touched nearly 45,000. Further, compliance/adherence to the cost accounting standards by the companies can only be ensured by the Members of ICWAI and not by the Members of ICAI. Hence, continuation of this proviso in the present circumstances is not relevant.

Utility of Cost Audit and Need for Review

13.54 Why Audit? In joint stock companies, management is divorced from the ownership. Thus, management is accountable to the investors/ various stakeholders. Therefore there is need of an agency to stand in between the shareholder/various stakeholders and the management. Audit of annual accounts of a company by a qualified Chartered Accountant is therefore compulsory and it has become an indispensable part of incorporated business. Hence authenticity of information provided in the annual report is the prime object of financial audit. Same is true of cost audit. Audit of cost accounting records and authentication of cost data/information of a company by a qualified Cost Accountant is equally necessary and therefore, should be compulsory, for the benefit of all stakeholders.

13.55 With regard to the utility of cost audit reports, cost data/information, and the need to review the existing mechanism/framework, the Working Group made following observations.

13.56 In terms of utility of cost audit report, besides the company management, these reports and the cost data is of immense use to the Regulators and various agencies of Government in areas like, subsidy determination; administered pricing; detection of cases of evasion of direct & indirect taxes; determination of goods for inclusion under free trade agreements; transfer pricing for related party transactions under the Income Tax Act; predatory pricing under Competition Commission; to check cases of unfair trade practices such as price-rigging, cartelization, over-charging, discriminatory pricing, profiteering, siphoning of funds, etc; valuation of goods under antidumping & other agreements under WTO; valuation of goods for captive consumption under the Excise Act; valuation of imports under the Customs Act; valuation of assets and also for IPR; etc. As in case of various advanced countries, cost data is very useful for defence contacts where large potential exists. Similarly, Government has been emphasizing for determination of cost-based user charges.

13.57 Cost audit data could also be used by various other stakeholders like banks & financial institutions (to make performance analysis, inter-firm comparison and monitoring), lenders & creditors, shareholders, employees, consumers, etc. Similarly, such data can also be of immense use for undertaking economic analysis, competitiveness studies and bench-marking studies by various academic institutions, research bodies, management schools, etc. Cost related issues are also relevant in determination of fair price and in various Accounting Standards such as AS2, AS10, AS17, and AS18.

13.58 With regard to cost audit, various industry associations are of the view that the cost audit methodology as structured originally under Section 233B and the existing Cost Audit Report Rules needs re-look. What needs to be done is to redefine the audit objectives without losing the legal backup and the mandatory force it gives for compliance. Instead of the attestation perspective, which was emphasized earlier for price control, the efficiency review aspect should be blown in full force to enable better corporate governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness. There is need to revisit the current methodologies of cost auditing and reporting frameworks. Present formats of Cost Audit Report need to be restructured.

13.59 A view has also been expressed that in a liberalized but regulatory framework operating under global competition, there is need to align the revised structure of Cost Audit Report with the IFRS issued by the International Accounting Standards Board so as to achieve complete harmony in the reporting framework.

13.60 As far as Ministry of Corporate Affairs is concerned, the existing mechanism of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism built under MCA-21 has ensured complete confidentiality of cost details of the company. However, as the information is shared by MCA with other government agencies like Competition Commission, Anti Dumping Authority, Sectoral Regulators, etc., there is no mechanism to ensure complete confidentiality of sensitive cost data/information by these Government agencies. Therefore, companies should not be asked to provide in the cost audit report any information which may adversely affect their cost competitiveness.

13.61 In large number of companies, especially the medium size ones, the present cost accounting and cost audit mechanism is providing vital inputs to the company management for decision making. Various Government departments/agencies and the regulators make use of cost audit data/information to draw important policies/programmes which in-turn give benefits to the companies themselves and also to the economy at large. In addition, cost auditors generally make very valuable observations and suggestions for improvement of the company's operations. Therefore, there is need to continue the cost audit mechanism. However, to save costs, to ensure complete confidentiality of company's sensitive cost data and to avoid any possible misuse, present structure of cost audit report need to be simplified.

Initial Views of the Expert Group

13.62 Based on above, views that initially emerged in the Expert Group, as given in the questionnaire, are:

- The term "class of companies" should be removed from section 209(1)(d) and included in section 233B for the purpose of coverage of companies for cost audit. For this, the Group may suggest minimum threshold limit based on size of capital base, annual turnover, etc. The feasibility of exempting certain specific category of companies such as SME companies, section-25 companies, companies limited by guarantee and associations not for profit, etc. from the ambit of cost audit may also be examined.

- Existing Cost Audit Report Rules and the formats prescribed therein may be reviewed. In place, a simple abridged form of cost statement requiring minimum but important disclosures may be prescribed. In addition, guidelines for undertaking detailed cost data analysis may also be suggested for the benefit of company management.
- Only the abridged cost statement along with the cost auditor's report may be filed with the Government i.e. MCA. In addition, any Government organisation or the Regulators may directly seek such additional cost details from the relevant companies as may be prescribed by them. For example, presently TRAI has prescribed their own formats seeking detailed (audited) cost data from the telecom service providers.
- No part of cost details may be circulated to the shareholders. However, possibility of circulating only the cost auditor's report together with important efficiency parameters and also the suggestions made, if any, to the shareholders may be examined.
- Cost auditors may continue to be appointed by the Board of Directors. However, the existing provision of seeking prior approval of Central Government may be dispensed with.
- Existing mechanism of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism under MCA-21 has already ensured complete confidentiality of cost details of the companies.

Global Scenario and IFAC

13.63 Governments of various countries have traditionally played a major role in the evolution of cost accounting & assurance practices. Policy intervention, administered pricing, social pricing, funding plans and so on and so forth could be the reasons for such a role. As a result they have put forward detailed requirements on cost accounting in judicial or even a quasi judicial form. Taxation laws and/or the price control environment in various countries exerted a major influence on the adoption of cost accounting standards. Details of evolution of various principles & practices in the field of cost accounting and assurance, in a legal environment, in different parts of the world have been given in a separate chapter of this report. A summary of same is given in the ensuing paragraphs. The fundamental driving principle would be the maturity and corporate discipline; in matured context they are voluntary but in an evolutionary phase they had always been mandatory.

13.64 In United Kingdom, cost accounting was integrated into the main body of accounting knowledge after the outbreak of the First World War. Since then, there has been considerable development in this field. For all significant project proposals, the UK Government expects use of Full Economic Costing as a more accurate way of helping to determine whether an activity or a project is worthwhile and sustainable. The UK Treasury's *Green Book, Appraisal and Evaluation in Central Government*, applies to government departments although full economic costing is required in other public sector/non-for profit organizations such as in the University sector. In regulated industries, regulators require cost accounts, statistics, business plans, capital expenditure projections, or operating expenditure calculations from participants. These are used to compile an overall picture of the sector, for general monitoring, and sometimes to set price-caps and other price controls. The focus of the Regulatory bodies is on the efficient and fair working of the markets they oversee, and hence their scope is wider than accounting information. There are penalties for the submission of false or inaccurate information, and the regulator may conduct selective checks on a proportion of the information it receives. In some cases, there is a legal requirement to report some cost data. Examples of regulated industries in UK are Airports, Communications, Education, Energy, Food standards, Pensions, Postal services, Railways, Health care, Social care and Water.

13.65 In Germany, many regulatory bodies are interested in accessing the Cost information of a business entity. The German Tax legislation requires current and fixed assets to be valued in financial reporting at their purchase price or production cost less depreciation. Under *Handelsgesetzbuch (German Commercial Code), Section 255, subsection 2 and paragraph 2 lay down the cost elements which are includible and not includible for arriving at the inventory value.*

13.66 The accounting of allowable costs in the case of contracts with public authorities is necessary for the calculation of the cost prices of the contracted output. In Germany, various statutory instruments have been enacted to achieve uniformity and consistency in accounting for contracts with public authorities and to avoid calculation of cost price at excessive rates. In Germany, most of the Public procurement contracts are awarded on Cost Plus basis and the costs are monitored continuously. There are many local prescriptive guidelines followed by public authorities while issuing such contracts but ultimately the principle of “Market Appropriate Cost” applies.

13.67 Article 14 of the European Commission regulations has mandated the adoption of uniform cost accounting practices across EUROPE by amending legal framework. The amendments in effect were to bring standard cost accounting practices to be consistently applied. Germany has also applied this provision. Through this provision, the required cost accounting principles have been standardised.

13.68 In Germany, all companies have distinct Cost & Management Accounting departments. It is said that cost accounting is traditionally the “heart” of German management accounting and German companies have on average 584 cost centres (spread from 12 to 40,000). Considering the application of cost information in public works contract management, taxation and pricing the following can be said to be the major interest groups on cost and management accounting:

- Regulators
- Taxation authorities
- Public works contract departments
- Postal authorities for implementing Article 14
- Corporate sector
- Management accounting departments of business entities
- SAP as a major stakeholder in building cost and management accounting modules in the software, and
- Academician from business schools

13.69 In Canada too, the Tax authorities as a regulatory body are interested in accessing Cost and Management Accounting information. Canada is a market based economy and so costs are dictated by the market place rather than by formula or edict except in cases where in a regulator steps in. The tax authorities would look for an objective evidence of whether the cost information provided by the company is correct and computed by way of an arm’s length transaction.

13.70 Interestingly, the Tribunal constituted under Canada’s Competition Commission has extensively dealt with cost accounting terminologies and their relevance for judging on predatory pricing in the *case of Air Canada.* In Phase I of the Air Canada case, the Tribunal declared that it would consider the following four questions relating to avoidable cost:

- What is the appropriate unit of capacity to examine?
- What categories of cost are avoidable and when do they become avoidable?

- What is the appropriate time period to examine? And
- What if any, recognition should be given to the concept of beyond contribution?

13.71 Besides above, in Ontario the CMAs are allowed to sign balance sheets and profit and loss accounts like chartered accountants and hence are subject to the jurisdiction of the Securities Commission. The Accountability Act also requires assurance of certain management accounting information submitted to the Parliament. Following entities can be considered to be the interested groups in the CMA profession:

- Certain regulators like the Competition Commission.
- Securities Commission of certain provinces like Ontario.
- Governmental institutions such as Auditor General Offices.
- Corporate and non corporate sector of the business
- All chapters of CMA in the provinces of Canada.

13.72 In Canada, usually the Public supply contract specifies the components and the methodology of cost accumulation. Cost plus contract is generally used in awarding contracts. It is the responsibility of the purchasing entity to certify whether the costs reflect the content of the contractual agreement. Each contract or series of similar contracts would contain guidelines as to the nature and quantum of allowable costs. The Supply Manual of the Public Works and Government Services of Canada lays down the Guidelines relating to Cost and Profit.

13.73 USA has been at the centre of seminal developments in the field of cost & management accounting from 1980 onwards. Lack of advancements in management accounting has been cited to be a major reason for the loss of competitive edge of United States. This led to a spate of research in applied cost & management accounting resulting in new tools and techniques such as Activity Based Costing, Activity Based Management, Lean Accounting, Theory of Constraints, Cost of Quality reporting and so on and so forth. In USA, various public utility regulation entities, the Federal Trade Commission, and the U.S. Department of Justice are interested in accessing the Cost Information of any business entity. Besides US Reforms commission, including the National Performance Review of 1993, a number of federal regulations have affected financial reporting requirements with cost linkages. This is not exclusive to the private sector, but is actively underway in the public sector as well.

13.74 The Securities & Exchange Commission (SEC) of USA has also prescribed various formats for disclosures by the corporate America which will need the adoption of standard cost accounting practices. In the annual/quarterly returns sent to the US-SEC, the companies are required to include information relating to risk factors, quantitative & qualitative disclosures about market risks, controls & procedures, related party transactions, selected financial data and management's discussion and analysis of financial condition and results of operations explaining the reasons for material changes that include changes in the various elements which determine revenue and expense levels such as unit sales volume, prices charged and paid, production levels, production cost variances, labour costs and discretionary spending programs.

13.75 The US Federal Government has constituted a Cost Accounting Standards Board under the Office of Federal Procurement Policy, which is an independent legislatively-established board. The Board has the exclusive authority to make, promulgate, and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts with the United States. The standards are mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating and reporting costs in connection with pricing and administration of and settlement of disputes concerning all negotiated prime contract and subcontract procurement with the United States in excess of US $5 million. The Board has so far issued 19 Cost Accounting Standards.

13.76 In USA, one of the Treasury Department's order said that the state auditor shall annually make a cost-audit examination of the books and records of the county road engineer and make a written report thereon to the county legislative authority. The expense of the examination shall be paid from the county road fund. Similarly, in another order of 20th December 2000, it said that any company in the aerospace, telecommunications, electronics or engineering fields (Or any other field where provided for in the contract), which is classed as a mandatory supplier under a government contract, can be liable to a post factum cost price review.

13.77 In USA, interest groups do exist to the extent that cost & management accounting affects external reporting. These would include:

- Various regulatory bodies
- Cost Accounting Standards Board constituted in the President's office is a major stake holder in the domain of cost and management accounting.
- Major business analytics/software solution companies such as SAS, Oracle, etc.
- Academicians and business schools show considerable interest

- Governmental departments (such as the Securities and Exchange Commission)
- Financial analysts,
- Professional associations (including the Institute of Management Accountants and the Association of Governmental Accountants).

13.78 Cost competitiveness has been at the heart of the Japanese success in 1980s. The tripod of Cost–Quality-Delivery has been inextricably embedded into the manufacturing strategy of the Japanese lean enterprises as they are called. Target Costing and Kaizen Costing are two mantras contributed by the Japanese to the lexicon of management accounting. Contrary to the belief that Cost Accounting Standards do not exist in the developed part of the world, an economy like Japan has experienced the evolution of cost accounting standards as a part of the pre and post world war build up of economic revival. The Japanese cost accounting systems have evolved through in various stages. The Business Accounting Deliberation Committee of the Ministry of Finance, formerly the Business Accounting Standard Committee of the Economic Stabilization Board, started to develop the Cost Accounting Standards on 16 November 1950 but did not succeed until 8 November 1962. Japan has so far issued 10 Cost Accounting Standards.

13.79 In a research paper on *Cost Accounting in Small and Medium Sized Japanese Companies* by *Trevor Hopper* from University of Manchester and *Tsutomu Koga* from Fukuoka University (1997), it has been said that the Japanese cost accounting, e.g. target costing, continuous cost reduction etc. was necessarily used in simpler smaller companies (SME's). In addition, given cost pressures stemming from Japan's changing socio-economic circumstances, it was surmised that SME's and their costing systems were undergoing significant pressures for change. In general, the research found that the costing systems of the SME's were similar to those of larger Japanese firms.

13.80 Academicians, Policy makers in the Government and Industry associations can be considered as external groups interested in costing information. For example the preventive maintenance business entities in civil segment were subject to the cost accounting standards prescribed in the manual of the Building Department of the Ministry of Construction ever since 1991. Ever since the world wars the following external entities have played a major role in shaping the cost accounting culture of the Japanese economy. These interest groups under various context of the socio economic context of Japan have been interested in the cost accounting information for financial statements.

- Product Cost accounting Rule of the Government established in November 1937 also called as Seizou genkakeisan junsoku
- Cost Accounting Rules of the Army
- Cost Accounting Rules of the Navy
- Economic Stabilization Board
- Business Accounting Deliberations Committee
- Cost Accounting Committee for small companies
- Defence Equipment Society
- Board of Audit

13.81 In Australia, the Cost and Management Accounting interest groups exist both internal as well as external to a business entity. The Institute of Certified Management Accountants (ICMA) of Australia is of recent origin as a body. Cost Accounting mechanism also exists as per the insistence of some regulatory authorities. In Australia, other than Tax Office who is interested in accessing the cost information of any business entity, some regulators also access the cost information. In fact, cost accounting principles have also been publicly debated by some regulators such as railways before adoption.

13.82 The ICMA is proposing ‘Strategic Audits’ in Australia for the business to adhere to the Cost accounting principles. The Australian Competition and Consumer Commission is the antitrust body which depend on costing data for regulation of monopolistic trade practices. The Government gathers information on cost while formulating policies on Free Trade agreements/Restricted Trade Agreements through Australian Bureau of Statistics and other information gathering bodies.

13.83 In China, Ministry of Commerce and Ministry of Finance are the only two Regulatory Bodies interested in accessing the cost information of any business entity. The State Asset Administration is interested in the cost information of state owned enterprises. The adoption of the 2006 Accounting System for Business Enterprises (ASBE) by the Chinese companies has made external reporting closer to international standards that has addressed a number of cost related issues. In a recent survey conducted by the Institute of Management Accountants of USA on the Chinese costing practices, it was found that costing practices employed by companies are now largely in conformance with the 2006 ASBE.

13.84 Article 103 of ASBE states that an enterprise should determine the cost centres, cost items and cost calculation methods according to the characteristics of the production and operating process and the needs of the management. Once determined, they should not be changed arbitrarily. Article 105 says that an enterprise must clearly identify the costs and expenses for the current period and those for subsequent periods. It must not accrue or defer expenses arbitrarily. An industrial enterprise must clearly identify the costs of each product. It must clearly identity the costs of work-in-progress and the costs of finished goods, and must not overstate or understate such costs.

13.85 The Rules on Cost Accounting of Power Transmission and Distribution have been published by China's State Power Regulatory Commission. They will take effect as of January 1, 2006. The rules include 19 articles in five chapters, specifying the cost target and cost items.

13.86 Unlike the situation in the United States or the United Kingdom, where only industries dealing with the Government need to follow certain rules for product cost calculation, the French approach, *in a spirit of facilitating fair competition, applies to all industries,* whether or not they have dealings with state agency. French management accounting practice is different from what is found in most national traditions in the field. France’s originality lies in having an almost universally *accepted single version of cost analysis and product costing, applicable to all industrial and trade sectors, both for profit and not for profit.* The current version of this system is described in a decree of the Ministry of Finance and Economy published as Title III of the 1982 *Plan Comptable General.*

13.87 After the financial debacle of 1990s, Korea issued cost accounting standards applicable to Korean companies by amending the Accounting regulations. The regulations clearly state that these are meant for measuring product costs in preparing financial statements. Initially, these standards were for adoption by the manufacturing companies. Subsequently, these were also made applicable to non-manufacturing companies and later to the banks and financial institutions in 1999. Korea’s Cost Accounting Standards have covered all the key aspects in three major sections, viz. General Provisions; Actual Cost Accounting System; and Standard Cost Accounting System. Korea’s Financial Accounting Standards require publication of a separate schedule of manufacturing cost (form no. 23) and schedule of cost of sales (form no. 25). The auditors have access to the cost accounting information generated by applying these regulations.

13.88 The Malaysian Institute of Accountants (MIA) is the only accounting institute in Malaysia recognized by IFAC. MIA has not issued cost accounting standards. Instead it has adopted verbatim all the International Management Accounting Practice Statements issued by FMAC of IFAC. All the seven IMAPs have been reissued under the banner of MIA to be referred to by Malaysian companies as best practice. This is a unique position which no country has done.

13.89 The end of the system of protection that had shielded Spanish industry from international competition until the mid 1970s, acted as a major force for the development of cost & management accounting systems in Spain thereafter. In Argentina the removal of tariff barriers with the country's 'Mercosur' partners (Brazil, Paraguay and Uruguay) has been seen as stimulating competition and consequently increasing the demand for strong cost management. In Brazil, it has been noted that the industries that have led the way in developing innovative approaches to costing have been those which do not enjoy protection, starting with the textile industry in the 1950s. The competitive pressures of a global economy are cited to explain the growing interest in advanced CMA techniques in Italy.

13.90 An extensive survey was conducted recently in some of the companies numbering to roughly 181 in the Estonian manufacturing sector which is basically the Eastern European economic region. This survey was conducted by scholars from the University of Tartu. The responding companies in Estonia represented 15 different branches of manufacturing such as energy, wood, food, tobacco, chemicals, metal, textile, etc. The categories of information that have been included into the survey cover various aspects of CMA such as cost measurement and appraisal in financial accounting, cost element accounting, cost centres accounting, costing methods, pricing principles, budgeting, and internal performance measurement systems. The respondents to the above survey in Estonian companies on CMA practices have admitted that mainly two driving forces had made them develop their companies' CMA systems namely, the need for more detailed divisional performance (segmental) information and changes in the organizational structure. Thus the growing market pressure has raised the companies' awareness about the need for more detailed cost information.

13.91 The Internal Audit group in Hong Kong has developed diagnostic tool kits to assist in enhancing operational efficiency and reducing costs to improve an organisation's competitiveness. The reviews focus on 9 key business areas viz. General Management Control; Billings and Receivables; Procurement and Payment; Expenditure and Expenses; Inventory Management; Cash Management; Human Resources; Financial Accounting and Management Reporting; and Information Technology. This review will produce a list of opportunities for cost reduction/efficiency improvement, and estimated potential cost savings/improvements if implemented. Typical reasons for this service are (1) management wishes to reduce costs to maintain profits in view of reducing revenues, and (2) to increase competitiveness under the current economic climate.

13.92 In Pakistan, Institute of Cost & Management Accountants of Pakistan (ICMAP) has been able to generate considerable interest in the domain from the business and the students' community. The presence of ICMAP and its participation is felt across the international bodies such as CAPA and SAFA. It has also been able to successfully bring on the concept of cost audit in the company legislation of Pakistan. The entities who can said to be the interest groups of the cost and management accounting information in Pakistan are Central Board of Revenue of Pakistan, Chambers of Commerce, Securities and Exchange Commission of Pakistan, Ministry of Finance, Regulatory bodies such as Oil and Natural gas and Power sector, and State Bank of Pakistan.

13.93 Despite being the youngest of the statutorily started CMA professional institute in the SAARC region, similar role has been played by the Institute of Cost & Management Accountants of Bangladesh (ICMAB). The entities who are said to be the interest groups of the cost and management accounting information in Bangladesh are Ministry of Commerce, Chambers of Commerce, Regulatory bodies such as power sector regulator, and Global organizations such as UNDP which are keen on capacity building of the CMA profession in Bangladesh.

13.94 In India, various apex level industry associations have been playing key role in infusing a sense of cost consciousness among the member companies so as to enhance their competitiveness in the global market. For example, the Confederation of the Indian Industry (CII), which is a pioneer in several aspects as an association of business, initiated a movement of Total Cost Management (TCM). This movement has been in vogue for almost 6 to 7 years and has been attempting consistently drive home the message of a structured approach to the needs of cost management in a competitive environment. Since we as a nation are building our manufacturing and service competitiveness in the global arena, it is important that the CMA skills are honed to perfection and we do not mistakenly focus on measuring the end financial short term results through accounting standards as the only way of performing cost and management accounting.

13.95 While the business started recognizing the need for a structured movement on quality management, customer relations, etc., on the cost front, it has confined the efforts to waste elimination and lean manufacturing strategies without considering cost management as a holistic process. Industry federations such as Confederation of Indian Industry commenced movements such as Total Cost

Management which is yet to gain critical mass such as TQM or TPM. Just like in Japan adherence to a minimum cost accounting plan is considered as a part of the social discipline and corporates adhere to the same without demur a base line plan for good cost accounting practices is yet to be accepted in India. When it comes to cost accounting the business is yet to come to terms with a base line adherence legally which one finds in countries like France, Japan, and Korea. For that matter in countries which are self disciplined in this aspect like Canada or UK consider the pronouncements of the CMA bodies in those countries (which do not have a legal status like ICWAI) as best practice. Besides this context, till a matured behaviour of the stakeholder emerges as India continues with the reforms process cost accounting discipline needs to be considered as an enabler of healthy competition and insurance against predatory behaviour. To top all the developments, there needs to be a check on the presence of a good cost accounting mechanism as a part of the risk management environment for ensuring good governance. The underlying spirit being, a business enterprise without a sound decision making including proper cost information is prone to more business risk.

13.96 Apart from the practices adopted in various countries, the United Nations also propagated the concept of cost accounting and cost audit. For example, the Audit Committee of the Program & Budget Committee of the United Nations, in its report in 2006, on the World Intellectual Property Organisation’s new construction project recommended *Cost Audit* of the estimated budget of the project that had been agreed by the Member States in 2005 and suggested that such task could be assigned to an independent party, possibly FIPOI *(Fondation des immeubles pour les organisations internationales)* or the External Management Firm itself.

13.97 On the issue of audit, assurance & good governance, International Federation of Accountants (IFAC), in its various documents, has made the following observations:

- Creation and optimization of stakeholder value should be the objective of governance.
- The conformance and performance dimensions of governance are both important to optimize shareholder value.
- Effective and efficient enterprise risk management should form an integral part of an organisation’s governance system.
- Resource utilization should align with strategic direction.
- The governing body should ensure that reasonable demands from stakeholders for information are met on timely basis.

- Cost accounting that includes the accumulating and assigning of costs to the organization's various activities enables the organization's cost structure to be understood, explained and improved.
- Costing is an important tool in assessing organizational performance in terms of shareholder and stakeholder value.
- 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 improvement; and
    - guide product mix and investment decisions.
- Costing methodologies applied in organizations, measures the consumption of economic resources and support the accountability of business performance. This is best achieved within a financial management system that
    - delivers both cost information and operational feedback for planning, budgeting, cost, and financial accounting purposes, and for operational improvement;
    - helps to ensure the fulfilment of external reporting and other compliance requirements; and
    - helps to manage an organization.
- Larger and more complex organizations usually aim for a single costing system to develop reliable costing information to support both performance and conformance (against legal and regulatory requirements) decisions at both operational and strategic levels.
- Organizations with a single costing system typically derive cost data from a common data source to support the needs of both external users (investors, regulators, and tax authorities) and internal managers and employees.
- The ability to account for, analyze, interpret, and present costs is necessary for an informed understanding of the drivers of profit and value, and is therefore an essential part of good financial management and decision-making.
- Cost information used to support strategic and operational decisions, performance management, or reporting should be appropriate for the specific purpose, context, and legal requirements.
- Cost audits help to ascertain whether an organization's cost accounting records are so maintained as to give a true and fair view of the cost of production, processing, manufacturing, and

mining of a product. Therefore, cost audits can be used to the benefit of management, consumers and shareholders by (a) helping to identify weaknesses in cost accounting systems, and (b) to help drive down costs by detecting wastage and inefficiencies. Cost audits are also of assistance to governments in helping to formulate tariff and taxation policies.

- Further, in a public sector context, using full cost information along with non-financial information on program outputs and outcomes can aid governments, managers, and other stakeholders to make decisions on service delivery. The full costing of public service programs (or the output of a responsibility centre) generally involves compiling the sum of direct and indirect costs that contribute to the program or output. This compilation also includes the full costs of intermediate activities, processes, projects, or programs that need to be measured to calculate the full costs of their outputs. This can enable better evaluation of the merits of a public service policy or program (although program outcomes may require separate measurement).

13.98 From the aforesaid cross-country cost & management accounting practices and the statements of IFAC, the Expert Group observed that these largely depend upon the maturity level of each economy in terms of its competitiveness, liberalisation & globalization, business pattern/models, average size/scale of an enterprise, risk-management models, market & information network, level of corporate/enterprise governance, strategic strengths & weaknesses, cost-leadership movement, sustainable cost reduction practices, extent of applied research, benchmarking, etc. Three maturity levels are recognized regarding the Regulation System in an economy:

13.99 **LEVEL-I**: This is lowest level in the maturity scale of regulation. It is characterized by lack of self motivation to discipline themselves; lack of appreciation for regulation and no perceived benefits of regulation by the players in the economy. This is a level where the Government has to perform role of regulation completely by itself. It makes detailed rules, procedures etc.; it monitors them whether they are properly followed; and punish those who are not abiding by these rules. This provides practically no flexibility to the players for necessary growth with the change in time and conditions; enforcement of the rules is usually through by force; and it leads to sometime unnecessary interference from the side of the Government.

13.100 **LEVEL-II**: This is a higher level of maturity where the players in the economy have become more matured; they start appreciating role of discipline in the economy; started coming out voluntarily with models of self discipline; Government role reduced to provide necessary direction and guidance so as to achieve the desired objectives of the economy. At this level, usually Government directly do not monitor the functioning of the companies to ensure whether the players are following necessary guidelines or not; rather some independent institution or regulator or some agency has been given the responsibility of monitoring and ensuring the necessary discipline among the players of the economy.

13.101 **LEVEL-III**: This is the highest level of maturity among the players of the economy. At this level, every player is well conscious about his/her responsibilities; develops systems to ensure that necessary self-disciple mechanism exists so as to achieve the objectives of the whole economy and as well as those of stakeholders. At this stage, the Government role is practically non-existent in the regulation mechanism; market forces more dominant in disciplining the market.

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

13.103 The transitory phase through which economies like India are passing, having moved from being under-developed to developing and now to a fast developing and finally gradually heading towards the developed stage still require suitable regulatory mechanism. Thus, besides routine financial information and other disclosures, companies should be subjected to a cost-effective cost & management information system, enabling the Government and regulatory authorities to play their intended role in enhancing the competitiveness of Indian industry and ensuring a fair-play for all stakeholders.

Recommendations of Working Group-III

13.104 The Working Group-II, in its report to the Expert Group, have made the following recommendations:

- The existing practice of notifying industry/product wise CARR and ordering product-wise cost audit orders only on selective companies, seeking unit-wise cost details and other data/information, should be immediately stopped.

- The existing practice of a company (except such class of companies that have been recommended for exemption from cost audit) covered under section 209(1)(d) of the Companies Act, 1956 and not covered under section 233B ibid should also be stopped.
- The Group recommends that cost audit orders under section 233B of the Companies Act, 1956 should be issued on all such companies that are not specifically exempted. MCA-21 data should be used to identify such companies.
- Existing Cost Audit Report Rules, 2001, as amended in 2006, should be replaced with the new Cost Audit Report Rules, 2008. A sample copy is enclosed as Annexure-XVIII.
- Only abridged statement containing product group-wise cost statements along with cost auditor's report should be filed with the Government. All other cost details, statements, schedules, etc. should remain with the company. The revised structure should do away with providing detailed cost statements of individual products since the same compromises with the confidentiality and competitive edge of individual companies. A sample of the modified Form-I is enclosed as part of Annexure-XVIII.
- Regulators, user Ministries/Departments, Financial Institutions/ Banks and other Government Authorities may be left free to directly seek such additional cost details as may be required by them, based on legal/quasi legal requirement, but should ensure complete confidentiality of the sensitive cost details.
- The existing provision of a Statutory (Financial) Auditor’s certificate under CARO certifying maintenance of cost records by the company, without certifying their accuracy and completeness, should be deleted.
- Cost auditors should be appointed by the Board of Directors of a company without seeking any prior approval from the Central Government (i.e. MCA) and report the same in the Directors’ Report to the shareholders.
- In order to ensure transparency, efficiency, and credibility of the systems followed by the company and also to ensure better compliance, companies should be encouraged to rotate cost auditors after every 3-5 years.
- In view of sufficient number (about 45,000) of qualified cost accountants now available in the country and compliance of cost accounting standards to be ensured only by the ICWAI members, the existing proviso under sub-section(1) of section 233B of the Companies Act, 1956 may be deleted.

- Present exemption to SSI units from the provisions of section 233B of the Companies Act 1956 relating to cost audit should be continued. Keeping in line with the provisions in the Micro, Small and Medium Enterprises Development Act 2006, and also in the Companies (Accounting Standards) Rules, 2006, all Small and Medium Sized Companies (SMC) should be exempted from the provisions of cost audit and accordingly, the threshold limit should be enhanced to Rs.10 crore for investment in plant & machinery and annual turnover to Rs.50 crore in the immediately preceding accounting year. While calculating annual turnover, any turnover from trading operations, consultancy services, other incomes, etc. in a manufacturing organisation will not be considered. But turnover from job work or loan license operations would stand included.

- In addition, other special categories such as section-25 companies, companies limited by guarantee and companies/associations not for profit, except those where any part of surplus income is allowed for distribution among the shareholders, companies having their total operations outside India, etc. should also be exempted from the ambit of cost audit.

- Among the SMCs, other conditions that would apply to all the medium size companies [having investment in plant & machinery exceeding Rs.5 crore but not exceeding Rs.10 crore and annual turnover exceeding Rs.25 crore but not exceeding Rs.50 crore in the immediately preceding accounting year] to avail exemption from cost audit shall be:

    a) The company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

    b) It is not a bank, financial institution or an insurance company;

    c) It does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

    d) It is not a holding or subsidiary company of a company which is not a small and medium sized company.

- As at present, periodicity of cost audit should remain on annual basis. In addition, the Group recommends quarterly internal audit of cost records. Possibility of introducing quarterly limited review of cost details, in case of listed companies, may be examined in consultation with SEBI.

- Circulation of selected information to the shareholders of the company, containing cost trends, key performance indicators, risk assessment or key risk indicators, CSR details, trends or factors like external economic conditions and internal efficiency, etc., as part of the management analysis section of the annual report to meet with the overall objectives of good corporate governance, should be left to the discretion of the management. ICWAI should work out a model format in consultation with SEBI.

Views of various Stakeholders

13.105 The Expert Group devised a detailed Questionnaire on the related issues of cost accounting and cost audit in the corporate sector, also including therein issues relating to confidentiality of company cost data and cost of compliance, cost accounting standards, etc. A copy of the questionnaire is placed at Annexure-XI. This questionnaire was circulated to all the interest groups/stakeholders seeking their views on the questions set-out therein. Further open-house consultations were also held at select places in the country that were widely participated by representatives of all the interest groups/stakeholders. As regards audit of cost accounting records, following questions were raised:

a) Do you agree with the revised structure of cost audit broadly proposed by the Expert Group?

b) Do you agree that there should be a threshold limit for exemption from cost audit? If yes, what threshold limit would you like to suggest? Should the exemption limit be equal to:

  a. Annual turnover of Rs.10/20/25/50 crore; or

  b. Paid-up capital or Net Worth or Investment in Fixed Assets of Rs.5/10 crore; or

  c. 10%/20%/50% level of public participation (including through Banks/FIs/MFs) in share capital as well as loans; or

  d. A combination of above?

c) Would you recommend e-filing a combined cost audit report with the Government (i.e. MCA) containing only a simple abridged cost statement?

d) Do you agree that any Government organisation or the Regulators may be left free to directly seek copy of the detailed cost audit report and such additional cost details from the relevant companies as may be prescribed by them?

e) Internationally accepted basic dictum of any audit is, it should be "independent". In view of this, how would you suggest the mechanism to appoint the cost auditors?

    a. Should the existing mechanism of appointment of cost auditor be continued i.e. the Board of Directors (BOD) will appoint with the prior approval of the Central Government; or

    b. The Board of Director may appoint without any approval of the Central Government; or

    c. The shareholders in AGM should appoint the cost auditors?

f) Further, do you suggest that in case of exempted companies, the power to get the cost records audited be vested with the 10% shareholders by making a request to the Government?

g) Similarly, would you also suggest that in such companies, a right be vested in secured creditors with stakes more than 50% of net worth to seek a special audit of the cost records of the company?

h) As proposed by CII, would you suggest circulation of any part of cost management trends to the shareholders?

i) What should be the periodicity of cost audit? Should it be annual or half-yearly or quarterly linked with the corporate governance and segmental reporting (at least in case of listed companies)?

j) Do you agree that the above mechanism would provide complete confidentiality and fuller utility of sensitive cost data?

13.106 These responses have been tabulated and analyzed by the Working Group-I. According to the Working Group-I report, majority of all the respondents, including various regulators & user departments/ agencies; Navratna/Miniratna PSUs; major private sector industrial conglomerates/ companies; major industry associations; IIMs, and ISB, Hyderabad; ICWAI and leading management consultants have agreed with the revised framework as proposed by the Expert Group. Gist of the response received on audit of cost accounting records, as per the report of the Working Group-I, is as under:

a. As regards cost audit, majority of respondents have general agreement with the revised structure broadly proposed by the Expert Group. Their specific views have been duly incorporated in the respective paras.

b. As regards fixing a threshold limit for exemption from cost audit, there are divergent opinions. For example, the suggested limits based on annual turnover varies from

Rs.10 crore to Rs.250 crore; size of paid-up capital or net worth or investment in fixed assets varies from Rs.5 crore to Rs.50 crore; and level of public participation (including through Banks/FIs/MFs) in share capital as well as loans varies from 10% to 50%. In general, majority respondents have favoured an exemption limit comprising Rs.5-10 crore investments in fixed assets and/or Rs.25-50 crore annual turnover. No such exemption to be granted to the listed companies. While a few have suggested retaining the existing limits or as fixed for SSI units under the Industrial (Development & Regulations) Act, 1951; others have suggested no exemption for any size/scale of companies i.e. making it mandatory for all companies. A few have even suggested fixing industry-wise specific exemption norms. Generally speaking, fixing multiple criteria has not found favour among all types of respondents.

c. In particular, SEBI has favoured exemption based on paid-up capital or net worth for unlisted companies and no exemption for the listed ones. Tea Board has argued for no exemption to any tea company. Other user organisations have either argued for no exemption or to only SSI units as per Industrial (Development & Regulation) Act, 1951. Without specifying any limits, CII has said that the exemption should be based on a combination of aforesaid factors. ICWAI in their reply has said that all such companies coming under the purview of cost accounting records but having investment in fixed assets up to Rs.10 crore or turnover up to Rs.50 crore should be exempted from the provisions of cost audit.

d. The respondents have widely welcomed the suggestion regarding e-filing a combined cost audit report with the Government (i.e. MCA) containing only a simple abridged cost statement and the respective regulators to be left free to directly seek such additional cost details from the relevant companies as may be prescribed by them. Only abridged statement containing product group-wise cost statements along with cost auditor's report should be filed with the Government. This will avoid filing information which is of less utility. This will also remove apprehensions regarding confidentiality of cost data. The abridged cost statement may be standardized so that uniformity is maintained across various companies/products/ services. The revised structure should do away with providing detailed cost statements of individual products since the same compromises the confidentiality and competitive edge of individual companies. The cost statement in the report should be limited to disclosure of broad elements of cost for a family of products duly reconciled with the financial books. It is suggested that the cost audit report to be submitted to the Government should certify that the systems are as per generally accepted cost accounting principles and should contain material changes in the system, abnormal/non-recurring costs and also the audit observations with respect to the cost and productivity. There should be e-filling of Form-I, cost auditors' certificate and cost sheet. There should not be e-filling of para 1 to 28. The present e-form should be modified suitably to allow filing of one report for a company instead of filing it unit-wise and product-wise. A three tier system has been suggested viz. (i) a short report giving assurance to the stakeholders that organization has satisfactory Cost Management practices, (ii) a more detailed report may be sent to Government, and (iii) a very exhaustive report could be given to the company.

e. On the issue relating to review of the existing structure of cost audit report and e-filing with the government, the ICWAI Council in their reply has said that a complete revised structure of the cost audit report addressing the key concepts of Cost Competitiveness, Corporate Governance, efficient resource management, investor protection, consumer protection, tariff and price fixation and regulatory issues has to be made. The revised structure is necessary in view of the following issues:

   a) Redefining "class of companies" and moving away from the product/industry concept of applicability of cost records to making cost records applicable to all companies engaged in production, processing, manufacturing or mining activities. This would necessitate restructuring the cost audit report for submission to authorities (Central Government) so that a company engaged in manufacturing diversified products as well as service is not required to submit multiple cost audit reports.

   b) Considering preparation of separate report structures for submission to the Central Government (abridged form) and a detailed report for submission to the company.

f. The Council further said that in view of the fact that a large number of companies are engaged in manufacturing/processing of diversified products, the report structure should be such that the report for submission to the Central Government through e-filing should provide summary cost statement of a family of products/segments along with key performance indicators. The cost statement in the report should be limited to disclosure of broad elements of cost for a family of products duly reconciled with the financial books. The summary should be prepared only after the detailed cost accounting records are prepared. A detailed report with product-wise and unit-wise details should be submitted to the Company certified by the cost auditor. An abridged certified report should be filed with the Central Government. The present e-form should be modified suitably to allow filing of one report for a company instead of filing it unit-wise and product-wise. Provision should be made in the form to enable multiple segments to be reported separately and a consolidated reconciliation format.

g. As far as the issue relating to regulators & other Government agencies seeking additional information from the companies is concerned, respondents have given various suggestions. Government and regulators have powers to call for any type of information required to discharge their functions directly from the companies. Therefore, MCA should only seek simple abridged cost statement and the regulators may be left free to directly seek such additional cost details as may be required by them. The regulators should ask only the relevant data/information and ensure complete confidentiality of the sensitive cost details. Additional disclosures required by a regulatory authority should be based on legal/quasi legal requirement where they have a role in guiding the relevant industry like fixing tariffs, prices etc. It has also been suggested that the Financial Institutions/Banks/SFCs may be empowered to seek requisite cost audit data/records to protect the public money invested.

h. Regarding appointment of cost auditors, there seem to be no consensus among the respondents. Cutting across the type of respondent, there is almost equal voting in favour of all the three modes of appointment viz. retaining the existing arrangement; appointment by the Board of Directors without any Central Government approval; and appointment by shareholders in the AGM like statutory auditors. Among the companies and regulators, about 50% have voted for appointment by the Board of Directors without any Central Government approval; about 35% have favoured appointment by shareholders in the AGM like statutory auditors; and balance 15% are in favour of retaining the existing arrangement. Among the practicing cost accountants, while 50% have demanded appointment by shareholders, about 30% favoured existing arrangement and balance desired appointment by BOD. Suggestions have been made that the Board of Directors may appoint the cost auditor and report the same in the Directors' Report to the shareholders or report to the Central Government. Few have also suggested appointment by the Government or the MCA out of a panel maintained for this purpose, like appointment of statutory auditors by the C&AG in Government companies. It has also been suggested that in order to ensure transparency, efficiency, and credibility of the systems followed by the company and also to ensure better compliance, companies should be encouraged to rotate the cost auditor after every 3-5 years.

i. Among the important ones in favour of appointment of cost auditors by the shareholders in AGM, SEBI has said that the shareholders are the real owners of a company and they should be given right to appoint cost auditors as cost audit would be useful to them in making performance analysis, inter-firm comparison, etc. Therefore, SEBI recommended that shareholders in AGM should appoint the cost auditors and the existing provision of seeking prior approval of Central Government may be dispensed with. CCI opined that the Board of Directors may appoint cost auditors with the consent of shareholders in AGM. CERC also said that cost auditors should be appointed by the shareholders in AGM. ICSI and Chief Adviser Cost have also favoured this view. Contrary to this, the CII has said that the Board of Directors can appoint the cost auditor without any approval of the Central Government.

j. ICWAI Council is of the view that the cost auditor should be appointed in the AGM. As part of good corporate governance practice, data should be shared with the shareholders. World over the Corporate Governance is getting transformed into Enterprise Governance and sharing of performance efficiency information with the shareholders is a part of the transformation. The financial statements, which are now submitted to the shareholders, combine all types of income and expenses whether related to the business or not into a single statement camouflaging the real performance of the corporate. The real long term accretion to the shareholder wealth can only be through normal business profits and not once in a while non operational income. Since the cost statements exclude all such non cost items the summary cost information product segment wise will be a major revealing factor helping corporate governance.

k. As regards granting any special powers either to minority shareholders or to the secured creditors seeking special audit of cost records of the company, even though few respondents have answered in affirmation and have also suggested fixing particular limits, majority have not agreed to grant of any such special powers to them as they feel that sufficient provisions already exist in the Companies Act, 1956 to safeguard the interests of minority shareholders and/or the secured creditors. Contrary to the majority view, SEBI has said that under certain special circumstances 10% shareholders and the secured creditors may be vested with the power to get cost records audited. Such special circumstances should be spelled out clearly to avoid subjective interpretation and misuse of such power. Few companies have also subscribed to this view. Similarly, it has also been argued that Financial Institutions/Banks/SFCs may be empowered to seek a special audit of the cost records to protect the public money invested.

l. Similarly, there is no agreement on sharing any part of cost management trends/information/data with the shareholders. While many respondents have said "YES" in reply to the question, a few others have either said "NO" or offered different views. On this issue, CII has said that the cost management trends may form part of the "Management Discussion & Analysis" part of the Annual Report as currently also done by many companies. The ICWAI Council has said that as part of good corporate governance practice, data should be shared with the shareholders. However the data once shared, becomes public information and cost data is sensitive in the competitive environment and therefore, it is proposed that key-performance indicators may be shared with the shareholders in the Annual Report. SEBI said that the possibility of circulation of cost auditor's report along with important efficiency parameters and also the suggestions made to the shareholders may be explored. Among the suggestions received from other respondents are:

   ➢ As part of good corporate governance, circulation of selected cost information also as part of the management analysis section of the annual report.

- Shareholders have the right to know about cost management trends as cost has direct link with profitability and shareholders' value.
- Limited report containing key performance indicators, risk assessment, mitigation, fuel/energy efficiencies, R&D expenditure and arm's length pricing of product may be circulated to the shareholders.
- Management observations on cost audit reports may form part of discussion of Director's report or requisite cost data may be attached as annexure to the director's report.
- As per the current report, para 4, 18, 19, 22 & 24 may be provided to the shareholders.
- The cost audit report may be appended to the annual report and circulated to the shareholders.
- Shareholders can be informed of the trends or factors like external economic conditions and internal efficiency.
- Concise, meaningful and abridged statement may be presented to the shareholders.
- Only comparison from previous years may be circulated in percentage terms without any absolute figure.
- Steps taken by the company towards better cost management may be mentioned to the shareholders.
- As a part of management discussion and analysis given in Annual Reports, the company should be encouraged to comment on the cost trends/pressure on margins and any abnormalities in cost incidence.
- May be considered as this will facilitate the shareholders to have knowledge of the cost and pricing policy of the organisation.
- Circulation of cost management trends may be recommendatory but should not be mandatory.
- A suitable annexure to the Director's Report can be introduced in the printed balance sheet which will give the broad consumption and efficiency parameters. This type of information will replace the particulars of conservation of energy given in the balance sheet. Alternatively, a separate annexure may be attached to the profit & loss account as an integral part which will give all the particulars duly verified by the cost auditor.

- Summarized cost audit report with disclosures and suggestions of cost auditor should be circulated. It is not necessary to circulate the cost records details.
- Broad details containing cost auditor's report together with important efficiency parameters may be circulated.
- Companies should have discretion on information to be shared with the shareholders since cost date is sensitive in the competitive environment.
- Shareholders are concerned with the profitability of the company and not the internal details like cost. Moreover, it can hamper the secrecy of sensitive information.
- No part of the cost details should be circulated to shareholders as this will result in shift of management perspective from control to compliance.

m. Regarding periodicity of cost audit, majority opinion (including by CII) is in favour of annual audit only. Few companies and regulators have suggested half-yearly or quarterly audit or limited review may be in case of listed companies. Few have suggested that initially this may be left to the discretion of company management. There is another suggestion to recommend quarterly internal audit of cost records.

n. On this issue, SEBI has said that in case of listed companies, it may be quarterly linked with the corporate governance and segmental reporting in line with requirement of quarterly reporting of financial results and in case of unlisted companies, it may be yearly. The ICWAI Council in their reply has said that the real assessment of the improvement in performance or otherwise can be judged only when there is a trend analysis over the quarterly reporting system is done. This will also be a fair disclosure of performance of different segments of the company over the period and enable comparison of one segment against the other. While the annual review will only have a compliance focus, the quarterly limited review will have a performance management focus. The inefficiencies disclosed by such limited review may be more useful to the company for cost control and cost reduction. However, Cost Audit should be conducted annually irrespective of whether it is a listed company or not. A limited review of key parameters that appear in the cost audit report should be considered by the Audit Committee on a quarterly basis for listed companies.

o. There is complete agreement among all the respondents that the above mechanism would provide complete confidentiality and fuller utility of sensitive cost data. In fact, it has been said that the Government should not give any importance to the urge for confidentiality countering the stand of transparency and disclosure.

Observations/Recommendations of the Expert Group

13.107 The Expert Group deliberated, in greater detail, on the observations/suggestions/recommendations made by the Working Group-III, the global practice and the opinions expressed by various stakeholders/interest groups in the replies sent to the questionnaire and those expressed in various open-house consultative meetings and make the following observations/recommendations.

13.108 The Expert Group noted that owing to notification of industry/product wise separate Cost Accounting Records Rules under section 209(1)(d) of the Companies Act 1956 and thus issue of multiple cost audit orders under section 233B ibid for a single company producing multiple products has led to large number of anomalies/difficulties viz., (a) much greater complexities and difficulties in maintaining and reporting the requisite cost data/information; (b) causes avoidable burden in complying with multiple rules; (c) companies cannot maintain & follow any single prudent cost accounting system as different formats/methods have been prescribed under different rules; (d) how to maintain or not maintain cost records for products not covered under section 209(1)(d) and/or section 233B of the Companies Act, 1956; (e) appointment of multiple cost auditors within the same company/unit; (f) companies required to submit multiple cost audit reports; (g) high cost of compliance for the companies; (h) it does not result in drawing full advantage either by the company or by the Government; and (i) monitoring at the Government (MCA) level becomes too cumbersome and time consuming. Therefore, the existing practice of notifying industry/product wise CARR and ordering product-wise cost audit orders only on selective companies, seeking unit-wise cost details and other data/information, does not support to any justification either from the user (i.e. the Government) point of view or from the provider's (i.e. the company) viewpoint. Such a situation should be avoided and rectified. **In view of this, the Expert Group recommends that the existing practice of notifying industry/product wise CARR and ordering product-wise cost audit orders only on selective companies, seeking unit-wise cost details and other data/information, should be dispensed with.**

13.109 With regard to the utility of cost audit reports, cost data/information, and the need to review the existing mechanism/framework, the Group noted the following observations made by the Working Group-III.

- In terms of utility of cost audit report, besides the company management, these reports and the cost data is of immense use to the Regulators and various agencies of Government in areas like, subsidy determination; administered pricing; detection of cases of evasion of direct & indirect taxes; determination of goods for inclusion under free trade agreements; transfer pricing for related party transactions under the Income Tax Act; predatory pricing under Competition Commission; to check cases of unfair trade practices such as price-rigging, cartelization, over-charging, discriminatory pricing, profiteering, siphoning of funds, etc; valuation of goods under antidumping & other agreements under WTO; valuation of goods for captive consumption under the Excise Act; valuation of imports under the Customs Act; valuation of assets and also for IPR; etc. As in case of various advanced countries, cost data is very useful for defence contacts where large potential exists. Similarly, Government has been emphasizing for determination of cost-based user charges.
- Cost audit data could also be used by various other stakeholders like banks & financial institutions (to make performance analysis, inter-firm comparison and monitoring), lenders & creditors, shareholders, employees, consumers, etc. Similarly, such data can also be of immense use for undertaking economic analysis, competitiveness studies and bench-marking studies by various academic institutions, research bodies, management schools, etc. Cost related issues are also relevant in determination of fair price and in various Accounting Standards such as AS2, AS10, AS17, and AS18.
- With regard to cost audit, various industry associations are of the view that the cost audit methodology as structured originally under Section 233B and the existing Cost Audit Report Rules needs re-look. What needs to be done is to redefine the audit objectives without losing the legal backup and the mandatory force it gives for compliance. Instead of the attestation perspective, which was emphasized earlier for price control, the efficiency review aspect should be blown in full force to enable better corporate governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness. There is need to revisit the current methodologies of cost auditing and reporting

frameworks. Present formats of Cost Audit Report need to be restructured.

- A view has also been expressed that in a liberalized but regulatory framework operating under global competition, there is need to align the revised structure of Cost Audit Report with the IFRS issued by the International Accounting Standards Board so as to achieve complete harmony in the reporting framework.

- As far as Ministry of Corporate Affairs is concerned, the existing mechanism of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism built under MCA-21 has ensured complete confidentiality of cost details of the company. However, as the information is shared by MCA with other government agencies like Competition Commission, Anti Dumping Authority, Sectoral Regulators, etc., there is no mechanism to ensure complete confidentiality of sensitive cost data/information by these Government agencies. Therefore, companies should not be asked to provide in the cost audit report any information which may adversely affect their cost competitiveness.

- In large number of companies, especially the medium size ones, the present cost accounting and cost audit mechanism is providing vital inputs to the company management for decision making. Various Government departments/agencies and the regulators make use of cost audit data/information to draw important policies/programmes which in-turn give benefits to the companies themselves and also to the economy at large. In addition, cost auditors generally make very valuable observations and suggestions for improvement of the company's operations. Therefore, there is need to continue the cost audit mechanism. However, to save costs, to ensure complete confidentiality of company's sensitive cost data and to avoid any possible misuse, present structure of cost audit report need to be simplified.

13.110 The Expert Group also noted that in a country-wide survey conducted, it was found that different stakeholders/interest groups are in total support of continuation of the existing mechanism of cost audit, but with simplification of the structure/formats as contained in the existing Cost Audit Report Rules, 2001. Majority companies, both public and private, and industry associations supported this view.

13.111 Further, such practices of cost accounting, audit & assurance do prevail in many developed/developing countries, across the globe, in varying degrees, content and structure. Large numbers of external interest groups for cost data/information exist in these economies. The fundamental driving principle would be the maturity and corporate discipline; in matured context they are voluntary but in an evolutionary phase they had always been mandatory.

13.112 On the issue of audit, assurance & good governance, the International Federation of Accountants (IFAC), in its various documents, has observed that (a) creation and optimization of stakeholder value should be the objective of governance; (b) the conformance and performance dimensions of governance are both important to optimize shareholder value; (c) cost accounting that includes the accumulating and assigning of costs to the organization's various activities enables the organization's cost structure to be understood, explained and improved; and (d) costing is an important tool in assessing organizational performance in terms of shareholder and stakeholder value. IFAC further said that costing methodologies applied in organizations, measures the consumption of economic resources and support the accountability of business performance. This is best achieved within a financial management system that helps to ensure the fulfilment of external reporting and other compliance requirements. As per IFAC, larger and more complex organizations usually develop reliable costing information to support both performance and conformance (against legal and regulatory requirements) decisions at both operational and strategic levels. Cost audits help to ascertain whether an organization's cost accounting records are so maintained as to give a true and fair view of the cost of production, processing, manufacturing, and mining of a product. Therefore, cost audits can be used to the benefit of management, consumers and shareholders by (a) helping to identify weaknesses in cost accounting systems, and (b) to help drive down costs by detecting wastage and inefficiencies. Cost audits are also of assistance to governments in helping to formulate tariff and taxation policies.

13.113 From the aforesaid cross-country cost & management accounting practices and the statements of IFAC, the Expert Group observed that these largely depend upon the maturity level of each economy in terms of its competitiveness, liberalisation & globalization, business pattern/models, average size/scale of an enterprise, risk-management models, market & information network, level of corporate/enterprise governance, strategic strengths & weaknesses, cost-leadership movement, sustainable cost reduction practices, extent of applied research, benchmarking, etc. Three maturity levels are recognized regarding the Regulation System in an economy. The Group strongly believes that the Indian economy is at a maturity level II. Therefore, instead of strict rules and laws, Indian industry needs directions, principles and guidance from the Government. At this maturity level, the Group feels that the industry should be given more freedom and flexibility and ultimately, over a period of time, the industry will achieve sufficient maturity level where driving force will be self discipline rather than any law of the Government. Till Indian industry reaches at the highest level of maturity, there is a need for compliance & monitoring mechanism. The transitory phase through which economies like India are passing, having moved from being under-developed to developing and now to a fast developing and finally gradually heading towards the developed stage still require suitable regulatory mechanism. Thus, besides routine financial information and other disclosures, companies should be subjected to a cost-effective cost & management information system, enabling the Government and regulatory authorities to play their intended role in enhancing the competitiveness of Indian industry and ensuring a fair-play for all stakeholders.

13.114 **In view of above, the Expert Group strongly endorses the Working Group's recommendation that there is need to continue the cost audit mechanism. However, to save costs, to ensure complete confidentiality of company's sensitive cost data and to avoid any possible misuse, present structure of cost audit report need to be modified and the formats prescribed therein needs to be simplified.**

13.115 The Group noted that in the existing framework, there is no mechanism to capture data/information with respect to all such companies that are covered by the provisions of section 209(1)(d) of the Companies Act, 1956 and the Rules notified there under. The Group further noted that in the absence of such data/information, Government finds it difficult to decide as to which companies should be covered under the cost audit under section 233B of the Act. Hence, the Group noted that selective coverage of companies for cost audit not only leads to adopting total ad hoc & arbitrary approach but also results in a sense of discrimination and heart burn among companies belonging to the same industry. This gets aggravated after knowing that many large companies and multinationals have been left out while other relatively smaller ones have been covered. The Group further noted that selective coverage within a particular industry does not give any major advantage even to the Government for carrying out anti-dumping studies, tariff related studies, pricing studies, anti-competitive studies, subsidy related studies, sectoral studies or economic analysis, etc. for the simple reason that fully representative data of the industry is not available. It was noted that to give authenticity to the data/information/records, it is an accepted fact that the books of account of any organisation cannot & should not remain unaudited.

13.116 In this regard, the Expert Group also noted the following statements of the then Hon'ble Finance Minister of India, Shri T.T. Krishnamachari, made in 1965 in reply to the Debate in Rajya Sabha on introduction of sections 209(1)(d) and 233B in the Companies Act, 1956 that very clearly supported the view that when we would have sufficient number of cost accountants in the country (presently there are nearly 45,000 cost accountants in India), every producing/manufacturing company shall be covered by the mechanism of cost accounting records and cost audit.

> *"while we have made it obligatory or rather semi-obligatory to employ Cost Accountant, it is our intention to ask certain industries to have a cost accountant's report."*
>
> "*when we can have sufficient number of Cost Accountants so as to make it obligatory for every company, every producing concern and every manufacturing concern, to have a cost accountant's* report."
>
> "*we are really making it possible for the institution of Cost Accountants to grow so as to enable the Government some time later to make every manufacturing company employ a Cost Accountant, and have a cost accountant's report in regard to the cost of product that it produces.*"

13.117 **Keeping the aforesaid in view, the Group recommends that,**

(a) **The existing practice of a company covered under section 209(1)(d) of the Companies Act, 1956 and not covered under section 233B ibid (except medium size companies that would be required to maintain cost accounting records but have been recommended for exemption from cost audit) should be discontinued;**

(b) **All companies should be asked to furnish information, either in Form 23AC (relating to e-filing of Balance Sheet) or in Form 23ACA (relating to e-filing of Profit & Loss Account), whether the company is covered under section 209(1)(d) of the Companies Act, 1956 relating to maintenance of cost accounting records;**

(c) **Cost audit orders under section 233B of the Companies Act, 1956 should be issued on all such companies that are not specifically exempted; and**

(d) **MCA-21 data should be used to identify such companies.**

13.118 **The Group has already recommended that all micro, small and medium size companies, engaged in the production, processing, manufacturing or mining activities, having investment in plant & machinery up to Rs.10 crore and annual turnover up to Rs.50 crore in the immediately preceding accounting year, subject to certain conditions, should be exempted from the provisions of cost audit under section 233B of the Companies Act, 1956. In addition, the Group recommends that other special categories such as section-25 companies, companies limited by guarantee and companies/associations not for profit, except those where any part of surplus income is allowed for distribution among the shareholders, companies having their total operations outside India, etc. should also be exempted from the ambit of cost audit.**

13.119 As regards existing structure/contents/formats of the cost audit report, as prescribed in the Cost Audit Report Rules, 2001 (amended in 2006), the Group noted that (a) as per existing rules, cost audit report is required to be furnished for each unit separately. Since published Annual Report is available only for the company as a whole, not for each unit/product separately, there is no mechanism to verify the correctness of data/information provided in the unit related cost audit report; (b) data given in Form-I does not reflect true and fair view so as to make any correct & meaningful assessment of the unit’s performance and it takes enormous time & efforts to verify same either from the attached cost audit report or from the annual report of the company; (c) information relating to certain issues may not be relevant or is redundant or it results in duplication as it is already contained in the company’s annual report; (d) it is extremely difficult for the unit/company to prepare so much of information as sought for in the annexure attached to the cost audit report; (e) sometimes it is not even possible to extract such minute details even in a sophisticated ERP system environment; (f) few para contain so much of complexities that despite ICWAI having already issued detailed guidelines on the subject, majority do not submit it correctly; (g) under few para the information sought is totally irrelevant that does not serve any useful purpose of the Government or any Government authority or the regulators; (h) it results in the reports becoming too long, running into even more than 2,000 pages (in few cases) that takes enormous time and effort of the company to prepare such voluminous data/information; (i) so much of detailed data/information run a very high risk of losing competitive advantage, if leaked; (j) it also encompasses huge cost to the company; (k) under the present e-filing mechanism, it becomes difficult to file such voluminous reports, as there is limit imposed on the size of files that can be attached to the e-form; and (l) on the user side (i.e. in Government), linking and downloading such huge files becomes extremely difficult; lest the problems that are being faced in analyzing vast amount of data/information.

13.120 Therefore, the Group agrees with the conclusion of Working Group that the structure of existing cost audit report requires complete modification. In this context, the Group also endorses the Working Group's observation that it is only the proforma cost sheet that contains highly useful information which needs to be continued; but it has to be standardized based on the generally accepted cost accounting principles and practices. Further, since Indian accounting framework would be soon converging with IFRS, the entire framework of cost accounting and reporting will also have to be aligned with the relevant issues in IFRS.

13.121 The Expert Group also noted that (as reported on the MCA's website) the existing Schedule-VI of the Companies Act, 1956 is under revision, in consultation with the ICAI and NACAS. The Expert Group is of the view that many of these concepts as used for reporting the financial statements, equally apply to the reporting of cost statements. These are, readable, useful, transparent and user friendly form; minimum disclosure requirements which are considered essential; not to be burdened with too many disclosure requirements; remove requirements of disclosures no longer considered relevant in view of the changed socio-economic structure and level of development of the economy; remove disclosure requirements which are meant for statistical purposes only; have inherent flexibility for amendments and industry/sector specific improvements from time to time and to cater to industry/sector specific disclosure requirements; harmonize and synchronize the general disclosure requirements with those prescribed in the Accounting Standards by removing the existing inherent anomalies; and attain compatibility and convergence with the International Accounting Standards and practices.

13.122 The Expert Group further noted that all respondents, who participated in the country-wide survey, have unanimously supported the view that while there is strong need to continue with the cost audit mechanism, especially for large size companies, the existing formats need to be simplified. The respondents suggested a three tier system viz. (i) a short report giving assurance to the stakeholders that organization has satisfactory Cost Management practices, (ii) a more detailed report may be sent to Government, and (iii) a very exhaustive report could be given to the company.

13.123 **Keeping these issues in mind, the Group recommends as under:**

(a) **Existing concept of filing unit-wise and product-wise cost audit report, introduced in 2001, should be dispensed forthwith. Filing of minute cost details for each factory/unit, within a factory/unit for each product, and within a product for each type/variety/description separately and all complexities in reporting have to be avoided. The revised structure should do away with providing detailed cost statements of individual products since the same compromises with the confidentiality and competitive edge of individual companies;**

(b) **Existing Cost Audit Report Rules, 2001, as amended in 2006, containing very detailed and complex reporting formats should be replaced with the new Cost Audit Report Rules, 2008;**

(c) **Only abridged statement containing product group-wise cost statements along with cost auditor's report should be filed with the Government. All other cost details, statements, schedules, etc. should remain with the company; and**

(d) **Cost auditor should submit detailed unit-wise and product-wise cost statements, duly certified by him, to the company, which may be called for by any Government agency and/or regulator depending upon the need.**

(e) **A sample copy of modified Cost Audit Report Rules, containing modified Form-I & other formats is enclosed as Annexure-XVIII.**

13.124 Having recommended submission of product group-wise cost statements (instead of unit-wise, within a unit for each product, and within a product for each type/variety/description separately), the Expert Group felt necessity to define the term "product group" that can be universally understood and used by all industries/companies and cost auditors, without any ambiguity. A product group can be defined as *"a group of homogenous and alike products, produced from same raw materials & by using similar or same production process, having similar physical/chemical characteristics & common unit of measurement, and having same or similar usage/application"*. It can be considered as an alternate to "product family". However, it cannot be considered as an alternate to the term "business segment" or "geographical segment" or "reportable segment" as defined in the Accounting

Standard 17 for the purposes of reporting segment-wise financial results. Further, to avoid any ambiguity, the Group feels that ICWAI should issue a Guidance Note on the subject within a period of three months, in consultation with national level industry associations. The Group also feels that, for the time being, the companies may be left free to correctly interpret the term “product group”, in consultation with the cost auditor, as best suited to their product range. **Accordingly, the Groups recommends as under:**

a) **Product Group means a group of homogenous and alike products, produced from same raw materials & by using similar or same production process, having similar physical/chemical characteristics & common unit of measurement, and having same or similar usage/application;**

b) **Product Group can be considered as an alternate to “product family”. However, it cannot be considered as an alternate to the term “business segment” or “geographical segment” or “reportable segment” as defined in the Accounting Standard 17 for the purposes of reporting segment-wise financial results;**

c) **ICWAI should issue a Guidance Note on the subject within a period of three months, in consultation with national level industry associations; and**

d) **For the time being, the companies may be left free to correctly interpret the term “product group”, in consultation with the cost auditor, as best suited to their product range.**

13.125 The Expert Group noted that the requirements of cost data/information by various regulators, user ministries/departments, financial institutions & Banks and other government authorities differ depending upon their purpose. Presently, they seek such details from the cost audit reports filed with MCA. In addition, few regulators have also prescribed their own formats seeking requisite cost details from the concerned companies. The Group feels that meeting with the need & requirements of all such organisations from the same cost audit report would make it too complex and unwieldy and also all companies would be unnecessarily forced to give such data/information. **Therefore, as opined by all stakeholders/interest groups and recommended by Working Group-III, the Expert Group recommends that apart from using the data/information available in the (modified) cost audit reports e-filed with MCA, all Regulators, user**

Ministries/Departments, Financial Institutions/Banks and other Government Authorities may be left free to directly seek such additional cost details from the concerned companies, as may be required by them based on legal/quasi legal requirement as mandated under their respective statutes.

13.126 The Expert Group noted that, as per existing provision of CARO, the [statutory] auditor(s) of the company appointed under section 224 of the Act, are required to include a statement in their Audit Report whether requisite cost accounts and records, as prescribed by the Central Government, have been made and maintained. In this regard, the Working Group observed that (a) it is not correct to seek such a statement from the financial auditor(s) of the company who, as per the Chartered Accountants Act, 1949, are not practicing in the field of cost accountancy; (b) the auditor(s) in their statement further add *"We have not made any detailed examination of these records with respect to their accuracy and completeness"*, thus, such a certificate does not serve any meaningful purpose; (c) in many cases, the certificate provided by the auditor(s) is not correct and there is no mechanism in the Government to verify its correctness; (d) in the changed principle based mechanism, adherence to CAS can be ensured by members of ICWAI. Ministry of Corporate Affairs, in their internal Policy Guidelines framed in 2006, also said that the existing system of compliance by Statutory Auditors under CARO should be reviewed periodically.

13.127 Further, the Expert Group has recommended a modified framework of cost accounting and cost audit in the corporate sector. As per this, all micro and small sized companies are fully exempted from the provisions of cost accounting and cost audit. All medium sized companies would also be exempted from the purview of cost audit; however, they would maintain the necessary cost accounting records and submit a compliance report to the Government duly certified by a Cost Accountant. For large sized companies, detailed mechanism of cost audit has been recommended. Therefore, no such certificate under CARO would be required. In fact, it would be a duplicate exercise causing extra burden on the companies. **In view of above, the Working Group recommended that the existing provision of a Statutory (Financial) Auditor's certificate under CARO certifying maintenance of cost records by the company should be discontinued. The Expert Group endorses this and recommends for immediate implementation.**

13.128 On the issue of appointment of cost auditors, the Expert Group noted the Irani Committee's recommendation that *"Government* *approval for appointment of Cost Auditor for carrying out such Cost Audit was also not considered necessary".* Further, in the survey done, there was no consensus among the respondents. Cutting across the type of respondent, there is almost equal voting in favour of all the three modes of appointment. Among the companies and regulators, about 50% voted for appointment by the Board of Directors without any Central Government approval; and among the practicing cost accountants, 50% have demanded appointment by the shareholders. Among the important ones, SEBI, CCI, CERC, ICSI, Chief Adviser Cost, and ICWAI Council, all are in favour of appointment of cost auditors by the shareholders in AGM for the reasons that the shareholders are the real owners of a company and they should be given right to appoint cost auditors as cost audit would be useful to them in making performance analysis, inter-firm comparison, etc. Contrary to this, the CII has said that the Board of Directors of a company without seeking any prior approval from the Central Government (i.e. MCA) and the same be reported in the Directors' Report to the shareholders. **The Expert Group has deliberated upon this issue and opines that transparency, accountability as well as independence of the cost auditor are very important determinants of good enterprise governance, and therefore, shareholders should be given the right to appoint cost auditors and have the cost auditor's report for better evaluation of the company's performance & risk management. However, until such time, it is decided to share any part of the cost audit report with the shareholders, the appointment of cost auditors by the shareholders is not practicable and hence the Expert Group suggests that this issue may be examined separately. However, to begin with, the shareholders must know that their company is covered by the cost audit mechanism. Therefore, the Expert Group endorses the recommendation of the Working Group that the cost auditors should be appointed by the Board of Directors of a company without seeking any prior approval from the Central Government (i.e. MCA) and reports the same to the shareholders in the Board of Directors' Report.**

13.129 The Working Group-III, in its report, recommended that in order to ensure transparency, efficiency, and credibility of the systems followed by the company and also to ensure better compliance, companies should be encouraged to rotate cost auditors after every 3-5 years. In this regard, the Expert Group noted that such a provision for rotation of auditors neither exist in the Indian laws nor found in any other country. However, a voluntary & healthy practice of rotating the lead auditors does prevail in many large size multinational companies. **Therefore, the Expert Group**

recommends that Indian companies should also follow this healthy practice of voluntarily rotating the cost auditors after every 3-5 years.

13.130 The Expert Group noted that as per provisions of section 233B of the Companies Act, 1956, only Cost Accountants within the meaning of the Cost & Works Accountants Act, 1959 can be appointed as cost auditors. However, in the proviso to sub-section (1) of section 233B, even Chartered Accountants possessing the prescribed qualifications may also be appointed to conduct the audit of the cost accounts of companies. The Group noted that this proviso was provided in 1965 when sufficient number of qualified cost accountants was not available in the country. By virtue of amendment of the Act in February 1975, the Rules framed under the Cost Audit (Qualification) Amendment Rules 1972 which had provided that a practicing Chartered Accountant also might be appointed as a cost auditor, if he possessed the qualifications prescribed by those Rules have ceased to have effect. The Group noted that the number of qualified cost accountants has touched nearly 45,000. Hence, continuation of this proviso in the present circumstances is not relevant. **Therefore, the Group recommends that the existing proviso under sub-section (1) of section 233B of the Companies Act, 1956 may be deleted.**

13.131 Regarding periodicity of cost audit, the Expert Group noted that the majority opinion (including by CII) is in favour of annual audit only. Few companies and regulators have suggested half-yearly or quarterly audit or limited review may be in case of listed companies. Few have suggested that initially this may be left to the discretion of company management. There is another suggestion to recommend quarterly internal audit of cost records. The Group further noted that on this issue, SEBI has said that in case of listed companies, it may be quarterly linked with the corporate governance and segmental reporting in line with requirement of quarterly reporting of financial results and in case of unlisted companies, it may be yearly. The ICWAI Council in their reply has said that the real assessment of the improvement in performance or otherwise can be judged only when there is a trend analysis over the quarterly reporting system is done. This will also be a fair disclosure of performance of different segments of the company over the period and enable comparison of one segment against the other. While the annual review will only have a compliance focus, the quarterly limited review will have a performance management focus. The inefficiencies disclosed by such limited review may be more useful to the company for cost control and cost reduction. However, Cost Audit should be conducted annually irrespective of whether it is a listed company or not. A limited review of key parameters that appear in the cost audit report should be considered by the Audit Committee on a quarterly basis for listed companies. **In view of this, the Expert Group recommends that as at present, periodicity of cost audit should remain on annual basis. In addition, the Group recommends quarterly internal audit of cost records. The Group further recommends that the possibility of introducing quarterly limited review of cost details, in case of listed companies, may be examined in consultation with SEBI.**

13.132 On the issue of sharing any part of cost management trends/information/data with the shareholders, the Expert Group noted that there was no consensus among the different stakeholders/interest groups. On this issue, CII has said that the cost management trends may form part of the "Management Discussion & Analysis" part of the Annual Report as currently also done by many companies. The ICWAI Council has said that as part of good corporate governance practice, data should be shared with the shareholders. However the data once shared, becomes public information and cost data is sensitive in the competitive environment and therefore, it is proposed that key-performance indicators may be shared with the shareholders in the Annual Report. SEBI said that the possibility of circulation of cost auditor's report along with important efficiency parameters and also the suggestions made to the shareholders may be explored. Like this, varied suggestions were made, which were evaluated by the Working Group. **After evaluating the pros & cons, the Working Group-III recommended that circulation of selected information to the shareholders of the company, containing cost trends, key performance indicators, risk assessment or key risk indicators, CSR details, trends or factors like external economic conditions and internal efficiency, etc., as part of the management analysis section of the annual report to meet with the overall objectives of good corporate governance, should be left to the discretion of the management. ICWAI should work out a model format in consultation with SEBI. This would align with the findings of IFAC survey on external financial reporting. The Expert Group endorses this. The Expert Group also recommends that in line with the earlier issue of appointment of cost auditors in the AGM, this issue may also be re-examined separately.**

13.133 As unanimously opined by all stakeholders/interest groups, as part of their replies to the questionnaire, the Expert Group strongly believes that the above mechanism would provide complete confidentiality of sensitive cost data of companies; provide fuller utility to all stakeholders; and considerably reduce the company's cost of compliance.

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CHAPTER-14: COST ACCOUNTING STANDARDS

Constitution of Working Group

14.1 One of the principle terms of reference assigned to the Expert Group was to review and, if required, give suggestions for redrafting the existing Cost Accounting Standards in the Indian context in light of international best practices, and to align them with the international cost accounting standards. For this purpose, a separate Working Group (WG-V) was constituted by the Expert Group, under the chairmanship of Shri M. Gopalakrishnan, Chairman, Cost Accounting Standards Board, ICWAI and Member, Expert Group. Other members of this Working Group were:

1. Shri Vinod Jain, representative of ICAI
2. Shri S.C. Vasudeva, Government Nominee, ICWAI
3. Dr. Asish K. Bhattacharyya, Professor-F & C, IIM, Kolkata
4. Shri P. Thiruvengadam, Senior Director, Deloitte Touche Tohmatsu India Private Limited, Bangalore
5. Shri R. Krishnamoorthy, Member, CERC

14.2 The aforesaid Working Group held several meetings and detailed deliberations on the subject. They submitted their report that was considered and taken on record by the Expert Group in its meeting held in New Delhi on 18th November, 2008. Relevant issues highlighted by the Working Group and its' recommendations have been discussed in the ensuing paragraphs.

14.3 This issue, being interrelated with the other terms of reference, has also figured in the reports of other Working Groups as well. Therefore, any views and/or recommendations made by other Working Groups have also been suitably incorporated in this chapter.

Background

14.4 The International Federation of Accountants (IFAC), a global organisation in the accountancy profession, in their mission statement has given due emphasis to the public interest and then recognised that a fundamental way to protect this public interest is to develop, promote, and enforce internationally recognized standards as a means of ensuring the credibility of information upon which investors and other stakeholders depend. IFAC, therefore, strives to serve the public interest through the development of standards in the areas of auditing, education, ethics, and public sector financial reporting; by advocating transparency and convergence in financial reporting; by providing best practice guidance for professional accountants employed in business; and by implementing a membership compliance program.

14.5 In line with this framework, and even much prior to the foundation of IFAC, all professional bodies all over the world have been developing the accounting standards based on generally accepted principles & practices followed in their countries. These have, then been either enforced through law or promoted by the regulatory mechanism or voluntarily followed by all business entities ensuring uniformity and consistency in the preparation and reporting of various financial statements. In India, the Institute of Chartered Accountants of India (ICAI), being the only statutory body to develop, promote & regulate the financial accounting & auditing profession, has developed large number of accounting and auditing standards. These accounting standards were initially recognised under law by the Companies (Amendment) Act, 1999 and later replaced by the Companies (Accounting Standards) Rules, 2006; hence attained binding power for all companies to follow.

14.6 Later, with the turn of century, focus shifted entirely towards the functioning of large business corporations spread across globe. Compliance attained a high priority and corporate governance became the buzz word. In this background, the Institute of Company Secretaries of India, being a statutory body to develop, promote & regulate the profession of company secretary, has developed a number of secretarial standards, which prima facie deals with the legal compliance and procedural aspects to be followed by the corporates.

14.7 Similarly, in the field of cost accountancy, post second world war, there was tremendous interest created by one & all – developed, developing and newly formed countries. All economies, irrespective of the economic structure followed, laid much greater emphasis on the cost accounting principles and ensured that all business organisations follow these (at least) when dealing with the state. Cost accounting got developed as a separate discipline in the field of accountancy that promoted efficiency in the resource utilisation. Gradually, new skills developed in this field and slowly, it attained a prime position in any organisation's functioning. In this context, the following words of IFAC are relevant:

> *"The creation, operation, alteration, and cessation of every action and function in an organization, whether within the private, public, or voluntary sector – all incur costs. Costing - the accumulating and assigning of costs to the organization's various activities – enables the organization's cost structure to be understood, explained and improved. Costing is therefore an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It informs how profits and value are created, and how efficiently and effectively operational processes transform input into output. It includes*

product, process, and resource-related information covering the organization and its value chain. Costing information can be used to provide feedback on past performance, and should be used effectively to motivate future performance. It is most useful if it communicates not only what the costs are, but also how and why they are incurred."

14.8 IFAC has further said that in all organizations, enhancing value, whether it is for shareholders and/or a wider range of stakeholders, entails finding the optimal balance between revenue, cost, and risk. Costing, and the many costing methodologies applied in organizations, measure the consumption of economic resources, highlight issues of operational efficiency, pinpoint areas requiring management attention, and assist in measuring and rewarding performance. Appropriate understanding and analysis of costs is essential to operational management, increased efficiency, and productivity, understanding the impact of investment decisions, and evaluating pricing decisions and the profitability of products, services, and customers. Therefore, although costing has historically provided awareness of the cost of operations (what, when, and where), which allows an organization to manage costs, its greater value lies in its forward-looking perspective (how and why), to help planning and better-informed decision-making at a strategic and operational level.

14.9 In this context, IFAC said that to better support decision-making, costing establishes and interprets relationships between financial, operational, and other data. Therefore, selecting the most appropriate approach for costing information and analysis, and using their output, requires the exercise of careful professional judgment and sound logic. Costing is not an exact science, but the selected costing approach should be rigorously applied. Regardless of their perspective, professional accountants in business have important roles to play in

- ensuring that cost data is 'fit for purpose',
- clarifying decision requirements, and
- deciding how best to present information and analysis, including method of delivery.

14.10 As per IFAC, analysis and presentation of costs is best accomplished within a financial management system that

- delivers both cost information and operational feedback for planning, budgeting, cost, and financial accounting purposes, and for operational improvement,
- helps to ensure the fulfilment of external reporting and other compliance requirements, and

- presents information clearly in a way that helps manage an organization.

14.11 Keeping in line with the aforesaid, various governments in the past have laid greater emphasis on the structured approach to the cost accounting principles & practices and have developed cost accounting standards for application by the business organisations, either in the matter of dealing with the state or for attaining a competitive edge over their counterparts in the world. Details of such efforts made by a few developed countries have been given elsewhere in this chapter.

Need for Cost Accounting Standards

14.12 In addition to these developments, Working Group-V observed that in India, the Cost Accounting Records Rules framed by the Government for 44 industries, deal with the various items of cost and the way in which they have to be reported in the Cost Statement in accordance with the cost accounting principles. Since the "normally accepted cost accounting principles" have not been clearly laid down, these are left to be understood by each company or by each cost accountant, as they understand or with reference to the explanations given in various text books on the subject. This often leads to adoption of practices resulting in lack of uniformity in preparation and presentation of cost statements. In order to promote uniformity, there is an urgent need to integrate, harmonize and standardize the cost accounting principles and practices. Therefore, the "generally accepted cost accounting principles and practices" have to be clearly defined and well documented in the form of Cost Accounting Standards.

14.13 It further said that the primary utility of the Cost Accounting Standards arises from the following:

- To provide a structured approach to measurement of costs in manufacturing process or service industry;
- To integrate, harmonise and standardize cost accounting principles and practices;
- To provide guidance to the users to achieve uniformity and consistency in classification, measurement, assignment and allocation of costs to products and services;
- To arrive at the basis of computing the cost of product, activity or service where required by legal or regulatory bodies;
- To enable practicing member to make use of Cost Accounting Standards in the matter of attestation of General Purpose Cost statements; and
- To assist in clear & uniform understanding of all the related

issues by various user organisations, government bodies, regulators, research agencies, academic institutions, etc.

14.14 Working Group-II also referred to the urgent need for issue of cost accounting standards by ICWAI so that the maintenance of cost accounting records by the corporate entities can be prescribed based on such principles enshrined in such standards. In its report, WG-I said:

> *"In order to promote uniformity and consistency, there is an urgent need to integrate, harmonize and standardize the cost accounting principles and practices. Similar such need has been felt to standardize the auditing and assurance practices. This not only helps in better (clear & in uniform manner) understanding of all the related issues by the companies and/or by the professional fraternity, but it also helps various user organisations, Government bodies, regulators, research agencies, academic institutions, etc. Therefore, there cannot be a second argument to the fact that the country requires "generally accepted cost accounting principles and practices" to be clearly defined and well documented. For various good reasons, this cannot be done solely by the Government through the Rules. This is a highly professional job that can only be done by the concerned professional bodies in the country. Precisely for these reasons, various national level apex institutes have issued or are in the process of issuing standards in areas falling under their domain. For example, the Institute of Chartered Accountants of India has been issuing financial accounting and auditing standards; Institute of Company Secretaries of India has been issuing secretarial standards; and the Institute of Cost & Works Accountants of India has been issuing cost accounting and audit standards. The Group is of the view that ICWAI should assign topmost priority for issue of all the required cost accounting standards. These should be prepared in consultation with all the stakeholders and fully aligned with the Financial Accounting Standards issued by ICAI with regard to the common aspects, which are applicable to both. Since, Cost Accounting Standards have been already issued by different countries; CAS issued by ICWAI should incorporate their best practices."*

Existing Cost Accounting Standards

14.15 To meet with these objectives, the Institute of Cost & Works Accountants of India (ICWAI) had constituted a Cost Accounting Standards Board (CASB) in 2001. CASB issued the following Cost Accounting Standards:

- CAS-1 on *"Classification of Costs"* released on 8th April, 2002

- CAS-2 on *"Capacity Determination"* released on 23rd January, 2003
- CAS-3 on *"Overheads"* released on 23rd January, 2003
- CAS-4 on *"Cost of Production for Captive Consumption"* released on 23rd January, 2003
- CAS-5 on *"Determination of Average (equalized) Cost of Transportation"* released on 21st July, 2005

14.16 All these standards issued by CASB are, till date, recommendatory in nature and every member of the Institute (ICWAI) is expected to honour the same. These are applicable to the preparation of cost statements and other documents where the concepts embedded in the standard were relevant. All cost auditors are required to adopt and encourage the adoption of these standards, wherever applicable, in the maintenance of cost accounting records under the Cost Accounting Records Rules notified under section 209(1)(d) of the Companies Act, 1956 and report deviations, if any, in the Cost Audit Reports under section 233B *ibid*.

14.17 The WG-V further reported that while the first three standards so far issued by the CASB are primarily on the basic principles of cost accounting, the subsequent two deals with the application areas. The Group also noted that the all the CAS already released so far has proved to be of great use to the industry and regulators. CAS-4 has already been approved and notified by the Central Board of Excise & Customs(CBEC) and has been very useful in settling long pending cases of valuation of captive consumption between the department and the assessees. Since CAS-4 has to be read together with CAS-1 to 3, hence all these CAS also attain relevance in the notification issued by the CBEC recognising CAS-4. Similarly, the Competition Commission of India (CCI) in their draft regulations on "determination of cost of production" has extensively referred to and drawn upon the CAS-1 to 4. The members in profession are also drawing reference to CAS 1-5, wherever there is a need for determination of cost of production, cost of equalised transportation costs etc., under different statutes. The CAS-5 on determination of average (equalized) cost of transportation has also been similarly useful to the members of the accounting profession, by the industry, regulators and other users.

14.18 As per the report of WG-V, the CAS have been designed to achieve uniformity and consistency in classification, measurement, assignment and allocation of costs in arriving at the cost of production so as to facilitate determination of fair price by the manufacturers as well as by the Government authorities and regulators.

Revised Framework of Cost Accounting Standards

14.19 The Working Group-V felt that all the Cost Accounting Standards (CAS) issued/to be issued should be principle based, dealing with the principles of costing and provide the guidance on the preparation of General Purpose Cost Statements, which require to be attested by the cost accounting profession, wherever applicable. A format of the General Purpose Cost Statements is appended to their report as a reference, which is available at Annexure-XX. The Cost Accounting Standards Board (CASB) should also keep in focus the generally accepted cost accounting principles and codify them so that with the passage of time, an accepted framework of generally accepted cost accounting principles can evolve capable of being adopted by all users of the standards like industry, professionals & other stakeholders.

14.20 The Working Group informed that a Revised Framework of CAS has been adopted by the Cost Accounting Standards Board of ICWAI with the following structure viz., Introduction, Objective, Scope, Definition, Principles, Assignment, Presentation and Disclosures. The contents of the different components of the structure are given briefly below:

- *Introduction:* This section will provide brief details about the topic, its role in the cost statements.
- *Objectives:* The basic objective which has necessitated framing of the standard will be provided.
- *Scope:* The scope of applicability of the standard will be defined in this section.
- *Definitions:* The terminology used in the standard will be defined.
- *Principles of Measurement:* The principles applicable behind the ascertainment, measurement, determination and categorization of elements of cost are spelt out in this section.
- *Assignment of Costs and Revenue:* The basis of assignment of costs to the cost of product or service and the generally accepted cost accounting principles behind such assignment will be discussed in this section.
- *Presentation:* The essence of the standard is spelt out in this section and is of prescriptive nature to be followed for any certification requirement.
- *Disclosure:* The section will deal with any specific disclosures required in the presentation which will provide clarity to the objective of the Standard.

14.21 As informed, the aforesaid revised framework also provides for issue of Application Guidance for each Cost Accounting Standard. The application guidance will provide the explanatory notes and interpretations of various terminologies and methodologies referred to in the cost accounting standards with suitable illustrations and formats for presentation of cost statements.

14.22 The Working Group accepted that the revised framework adopted by the CASB of ICWAI is aimed to bring the CAS on a principle based approach and is in line with the current requirements of the users of the Cost Accounting Standards. Therefore, the Working Group-V suggested that the existing Cost Accounting Standards will also have to be restructured to adopt the revised framework.

14.23 The CASB of ICWAI has identified 39 areas for developing the Cost Accounting Standards, which include the 5 standards issued so far. Of these, 21 areas relate to components of cost and the balance 18 are on cost accounting methodologies. These areas for which the Cost Accounting Standards have been identified are broadly in line with the Cost Accounting Records Rules (CARR) already framed by the Government and in vogue for different industries. A complete list of these 39 areas duly linking with the relevant Paragraph in the Cost Accounting Records Rules is given in Annexure-XIX. Since the CARR has been in force for a considerable period, the corporate covered have gained experience in preparing cost statements according to CARR. This in turn has enabled identification of common practices in cost accounting that can be built into the Cost Accounting Standards, where applicable.

14.24 The Working Group also felt that, if any particular legal and/or statutory authority prescribes a particular method of treatment of cost, their views have to be considered while drafting the CAS. For example, CAS 4-Valuation for Captive Consumption is for exclusive use of Excise Department where definition of cost of production may have specific meaning for specific purpose. Therefore, revision of all the existing CAS under the revised framework as already approved by the CASB, would also have to be done in consultation with the concerned legal and/or statutory authority in the government (viz. Excise Department for CAS-4), so that the adoptability of use of these revised standards by such organisations is not disturbed. Rather, it should strengthen the same by incorporating suitable clarifications based on the experience of working with the CAS.

14.25 Since, the CAS provide guidance to the users to achieve uniformity and consistency in measurement, assignment and allocation of costs to products and services, a model General Purpose Cost Statement illustrating the use of the relevant CAS (Annexure-XX to this Report) was also attached by the Working Group. The Expert Group has taken note of this.

Timeframe for issue of Cost Accounting Standards

14.26 Expert Group has, in their initial views proposed complete shift for the maintenance of cost accounting records by the corporate sector from the existing rule/format based mechanism (that is backed by Cost Accounting Records Rules notified by the Government for each industry separately) to a principle based mechanism (that should be backed by the cost accounting standards and generally accepted cost accounting principles & practices). Revised mechanism should address issues like deregulation, changing dynamics of economy, regulatory framework, WTO requirements, unfair trade practices, etc. and above all, cost competitiveness of India Inc. and global benchmarking. Thus, this mechanism should result in value addition to the industry. Hence, all the existing Cost Accounting Record Rules (CARRs) may be replaced with Government prescribing maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards.

14.27 In accordance with the suggested approach of the Expert Group, the Working Group felt that all the CAS have to be brought out in a time bound manner so as to enable shift from rule based to principle based approach. ICWAI have to assign topmost priority for issue of cost accounting standards in consultation with all stakeholders and fully aligned with the Financial Accounting Standards notified by the Government with regard to the common aspects, which are applicable to both. Since, Cost Accounting Standards have been already issued by different countries, CAS issued by ICWAI should incorporate their best practices. The Working Group has enclosed CAS-wise issue plan for the proposed Cost Accounting Standards that is placed at Annexure-XXI to this Report.

14.28 Current status of these CAS, till the submission of this report, is as under:

Final CAS Released:

- CAS-7 on *"Materials Cost"*

Exposure Draft of CAS Released:

- CAS-8 on *"Employees Cost"*
- CAS-9 on *"Cost of Utilities"*
- CAS-11 on *"Direct Expenses"*
- CAS-12 on *"Packing Material Cost"*
- CAS-13 on *"Repairs & Maintenance Cost"*

Draft CAS under Consideration:

- CAS-6 on *"Determination of Arm's Length Price"*
- CAS-10 on *"Administrative Overheads"*

- CAS-13 on *“Repairs & Maintenance Cost”*
- CAS-14 on *“Joint Product & By-Product Cost”*
- CAS-15 on *“Production/Operation Overheads”*
- CAS-16 on *“Selling Overheads”*
- CAS-17 on *“Distribution Overheads”*
- CAS-18 on *“Head/Corporate Office Overheads”*
- CAS-19 on *“Service Department Expenses”*
- CAS-20 on *“Depreciation”*
- CAS-21 on *“Amortization”*

Statutory Recognition of Cost Accounting Standards

14.29 The Expert Group has been of the view that all companies (except the exempted ones) should be asked to comply with these cost accounting standards. For exempted companies, compliance of CAS may be optional. Any deviations to CAS should be disclosed in the cost accounting policies. To ensure this, all the Cost Accounting Standards issued/to be issued by ICWAI have to be accorded statutory recognition under relevant provisions of the Companies Act, 1956.

14.30 In clause 3(3) of the Cost Accounting Records (Chemical Industry) Rules, 2004, notified by Government of India on 2nd September 2004, it has been said as under:

> *“The statistical and other records shall be maintained in accordance with the provisions of the Schedule annexed to these rules and in line with Cost Accounting Standards issued by the Institute of Cost and Works Accountants of India, in so far as they are applicable, in such a manner as to enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in utilization of resources. These records shall also provide the necessary data which may be required to be furnished under Cost Audit Report Rules, 2001 as prescribed under section 233B of the Companies Act, 1956 and amended from time to time.”*

14.31 As per these Rules, Government of India has already accorded statutory recognition to the cost accounting standards issued by the Institute of Cost & Works Accountants of India; to the extent these are applicable under the extant rules.

14.32 Further, as per the Institute of Chartered Accountants of India, Compendium of Guidance Notes, Volume 1, as on January 1, 1998 (5th Ed.), page 15.1, the cost accounting records also form part of the “Proper books of account” within the meaning of section 227(3)(b). In this regard, the Institute of Chartered Accountants of India has issued the following Guidance Note laying down the responsibility of the statutory auditors of companies to report on the maintenance of the Cost Accounting Records prescribed under section 209(1)(d) of the Companies Act, 1956.

> *"The Institute of Cost and Works Accountants of India (ICWAI) has framed following Cost Accounting Standards, inter alia, to provide guidance as to standard approach towards maintenance of Cost Accounting Records by companies under the Act. These standards, apart from assisting the management of companies to follow standard cost accounting practices in the matter of compliance of statutory obligations, will guide the Cost Accountants in reporting the deviations, if any, in the Cost Audit Reports furnished by them pursuant to provisions of section 233B.*
>
> - *CAS-1: Classification of cost*
> - *CAS-2: Capacity Determination*
> - *CAS-3: Overheads*
> - *CAS-4: Cost of Production for Captive Consumption"*

14.33 The above guidance note was issued in context of the Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1988. Since this Order has been later replaced by the Companies (Auditor's) Report Order, 2003, hence ICAI guidance note has also been revised accordingly. However, the aforesaid extracts from their earlier guidance note clearly depict that the statutory auditors to take due cognizance of the cost accounting standards issued by ICWAI.

14.34 To enable the Government to accord statutory recognition to the cost accounting standards, the Working Group has recommended setting-up of an independent legislative body similar to the Cost Accounting Standards Board constituted by the US Federal Government or on the lines of National Advisory Committee on Accounting Standards in India, for issue of Cost Accounting Standards under the relevant provision of the Companies Act.

14.35 The Expert Group has deliberated on the issue in greater detail. Setting-up of a separate Cost Accounting Standards Board as constituted by the US Federal Government may not be a feasible proposition as primary issue of such standards is the prerogative of apex-level statutory professional body (i.e. ICWAI) already set-up in India, as is done by the ICAI for issue of financial accounting standards. However, a National Advisory Committee for Accounting Standards (NACAS) has already been constituted by the Government under section 210A of the Companies Act, 1956. This body has adequate representation from all the three professional institutes viz. ICAI, ICWAI and ICSI. Therefore, either the existing mandate of NACAS may be modified or a similar body be set up advising the Central Government on the formulation and laying down of cost accounting policies and standards for adoption by companies or class of companies under the Act. Meanwhile, the cost accounting standards issued by ICWAI may be recognised as that prescribed by the Central Government.

Synergy of Cost Accounting Standards with Financial Accounting Standards, International Practices & IFRS

14.36 On this issue, the Expert Group had initially said that all the cost accounting standards should be issued in-consultation with all stakeholders & industry associations and fully aligned with the financial accounting standards originally issued by ICAI and finally adopted as Companies (Accounting Standards) Rules, 2006, cost accounting standards issued by other developed countries, international best practices, IFRS, and other IFAC guidelines.

14.37 While agreeing with this suggestion, the Working Group also felt that with regard to the common aspects, there should not be any conflict between the Cost Accounting Standards and the Financial Accounting Standards. Where appropriate and where there is a specific issue related to cost for the purpose of Cost Statement, the measurement and presentation may be as per the requirements of the respective Cost Accounting Standard. In case of issues where same item require differing treatment under the Financial Accounting Standard and the Cost Accounting Standard, the same can be disclosed as a reconciliation item between the Cost and Financial records. The Working Group recommended that the CASB of ICWAI should prepare a list of items which needs harmonization in two sets of standards i.e. Financial Accounting Standards and Cost Accounting Standards and update the list periodically. Since the Indian Accounting Standards will be converging with IFRS, the CAS will also have to be reviewed and aligned with the relevant issues in IFRS. The Model Financial Statement prepared on the lines of IFRS is attached (Source: Deloitte; IAS Plus Guide by Global IFRS Leadership Team) with the Working Group Report highlights the areas where the line items in the financial statement have relevance to the CAS. This is placed as Annexure-XXII.

14.38 On the issue of alignment with international practices, the Working Group noted that many countries such as USA, Japan, Korea and Germany have also issued Cost Accounting Standards. For example, the US Federal Government has constituted a Cost Accounting Standards Board under the Office of Federal Procurement Policy, which is an independent legislatively established board. The Board has the exclusive authority to make, promulgate, and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts with the United States. The standards are mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating and reporting costs in connection with pricing and administration of and settlement of disputes concerning all negotiated prime contract and subcontract procurement with the United States in excess of US $5 million.

14.39 Similarly, Korea has Cost Accounting Standards issued by their Accounting Body, which is applicable to both manufacturing and other than manufacturing industry. They have covered all the key aspects in one standard itself. The major sections in this standard are (1) General Provisions; (2) Actual Cost Accounting System; and (3) Standard Cost Accounting System.

14.40 A summary of the international practices mentioned above, as prepared by the Working Group and suitably amended by EG, is appended to this report as Annexure-XXIII.

14.41 The Working Group decided that the relevant practices in Cost Accounting, which find place in the Cost Accounting Standards issued by various countries, should be suitably incorporated in the Indian CAS also, without sacrificing the objectives and also the intent.

Synergy of Cost Accounting Standards with MAG/IGPG issued by International Federation of Accountants (IFAC)

14.42 The International Federation of Accountants (IFAC) has not issued any Cost Accounting Standards so far. The Professional Accountants in Business (PAIB) Committee (formerly FMAC), has started issuing International Good Practice Guidance (IGPG), which are principle based pronouncements at a non mandatory level.

14.43 The mission of the International Federation of Accountants (IFAC) is to serve the public interest by strengthening the global accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession’s expertise is most relevant.

14.44 In furtherance of its objectives, the International Federation of Accountants (IFAC) lays down the policies for developing standards, statements, information papers, guidance, and special reports in the financial accounting, financial reporting and management accounting areas, through its various committees. The management accounting areas are looked after by the

Professional Accountants in Business Committee (PAIB) under IFAC. The Committee in its earlier years has brought out many Management Accounting Guidelines (MAG). All of them represented the best management accounting practices practiced globally and put in a codified and structured form. The MAGs were voluntarily adopted by users and were known to represent the accepted view of the accounting profession as well as the users. They can be called as principle based as against the rule based approach followed by the Government oriented standard setters. The MAGs also contain certain portions which can be used as a part of a Cost Accounting Standard. The Management Accounting Guidelines (MAG) have been subsequently withdrawn by IFAC and at present only International Good Practice Guidance on Management Accounting are only issued.

14.45 The PAIB Committee serves IFAC member bodies and the more than one million professional accountants worldwide who work in commerce, industry, the public sector, education, and the not-for-profit sector. Its aim is to enhance the role of professional accountants in business by encouraging and facilitating the global development and exchange of knowledge and best practices. The PAIB Committee has identified International Good Practice Guidance (IGPG) as a major focus area to identify, encourage and facilitate best practices in business. The Preface to IFAC's International Good Practice Guidance, identifies the principles, which is generally accepted internationally, and capable of being applied to organizations of all sizes in commerce, industry, the public sector, education, and the not-for-profit sector. The principles term under the IGPG has been defined as:

> *"Principles represent fundamental generalizations that professional accountants in business should use as the basis of their reasoning and conduct. Principles typically provide a broad frame of reference, and stress starting points and boundaries rather than prescriptive rules. Principles, therefore, encourage the appropriate exercise of sound professional judgment by professional accountants in business."*

14.46 The Committee has issued/processing the following IGPGs. It was suggested by the Working Group that the principles enshrined in the IGPG and the MAGs issued earlier can be followed in the CAS, wherever it is applicable.

- Project Appraisal Using Discounted Cash Flow
- Code of Ethics for Professional Accountants
- Costing to Drive Organizational Performance (Exposure Draft)
- Evaluating and Improving Governance in Organisations. (Exposure Draft)

Recommendations of Working Group-V

14.47 The Working Group-V, in its report to the Expert Group made following recommendations:

a) The Cost Accounting Standards (CAS) issued/to be issued should be principle based, dealing with the principles of costing and provide guidance on the preparation of General Purpose Cost Statements.

b) The Cost Accounting Standards (CAS) issued/to be issued should be aligned with the following key objectives:

   - To provide a structured approach to measurement of costs in manufacturing process or service industry;
   - To integrate, harmonise and standardize cost accounting principles and practices;
   - To provide guidance to the users to achieve uniformity and consistency in classification, measurement, assignment and allocation of costs to products and services;
   - To arrive at the basis of computing the cost of product, activity or service where required by legal or regulatory bodies;
   - To enable practicing members to make use of Cost Accounting Standards in the matter of attestation of General Purpose Cost statements; and
   - To assist in clear & uniform understanding of all the related issues by various user organisations, government bodies, regulators, research agencies, academic institutions, etc.

c) The revised framework adopted by the Cost Accounting Standards Board of The Institute of Cost and Works Accountants of India (ICWAI) is aimed to bring the CAS on a principle based approach and is in line with the current requirements of the users of the Cost Accounting Standard.

d) The existing Cost Accounting Standards 1 to 5 issued by ICWAI should be revised and restructured as per the revised framework. The revision should be done in consultation with the concerned legal and/or statutory authority in the government (e.g. Central Board for Excise and Customs for CAS-4), so that the adoptability of use of these revised standards by such organisations is not disturbed.

e) The Cost Accounting Standards should be aligned with the Financial Accounting Standards with regard to the common aspects, which are applicable to both. On specific cost related issues, the divergence can be disclosed as reconciliation between cost and finance. It is recommended that the Cost Accounting Standards Board of ICWAI should prepare a list of items which need harmonization in two sets of standards i.e. Accounting Standards and Cost Accounting Standards and update the list periodically. Since the Indian Accounting Standards will be converging with the International Financial Reporting Standards (IFRS), the Cost Accounting Standards will also have to be reviewed and aligned with the relevant issues in IFRS.

f) The Working Group also recommends setting-up of an independent legislative body similar to the Cost Accounting Standards Board constituted by the US Federal Government or on the lines of National Advisory Committee on Accounting Standards in India, for issue of Cost Accounting Standards under the relevant provisions of the Companies Act.

g) Since, Cost Accounting Standards are also issued by different countries; the possibility of incorporating the best practices, without sacrificing the objective of the CAS can be done. In addition the principles enshrined in the current International Good Practice Guidance and the Management Accounting Guidelines issued earlier by International Federation of Accountants can be followed in the CAS, wherever it is applicable.

Views of various Stakeholders

14.48 The Expert Group devised a detailed Questionnaire on the related issues of cost accounting and cost audit in the corporate sector, also including therein issues relating to confidentiality of company cost data and cost of compliance, cost accounting standards and the need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors and also to various Government projects/schemes, departmental undertakings, etc. A copy of the questionnaire is placed at Annexure-XI. This questionnaire was circulated to all the interest groups such as user ministries/departments, regulators, companies (public, private & cooperative), eminent academicians, experts, management consultants, practicing professionals, all the central council members and past presidents of ICWAI, etc. seeking their views on the questions set-out therein. Further open-house consultations were also held at select places in the country that were widely participated by representatives of all the interest groups/stakeholders. As regards Cost Accounting Standards, following questions were raised:

- Do you agree that for ensuring a complete shift from the existing rule-based to principle-based cost accounting & audit mechanism and also for the sake of uniformity in preparing accepted cost statements under WTO and other Statutes, there is an urgent need for the country to have Cost Accounting Standards based on generally accepted cost accounting principles?
- If yes, would you agree that all companies should be asked to comply with such cost accounting standards?
- If yes, do you also agree that ICWAI should assign topmost priority for issue of cost accounting standards in consultation with all stakeholders?
- Would you suggest that all cost accounting standards should be aligned with the cost accounting standards issued by other developed countries, international best practices, IFRS, and other IFAC guidelines?

14.49 These responses have been tabulated and analyzed by the Working Group-I. According to WG-I report, majority of all the respondents, including various regulators & user departments/agencies; Navratna/Miniratna PSUs; major private sector industrial conglomerates/ companies; major industry associations; IIMs, and ISB, Hyderabad; ICWAI and leading management consultants have agreed with the revised framework as proposed by the Expert Group. A gist of the response received on Cost Accounting Standards, as per the report of the Working Group-I, is as under:

a) Almost all the respondents have agreed that for ensuring a complete shift from the existing rule-based to principle-based cost accounting & audit mechanism and also for the sake of uniformity in preparing accepted cost statements under WTO and other Statutes, there is an urgent need for the country to have Cost Accounting Standards (CAS) based on generally accepted cost accounting principles. It is their view that without having detailed CAS, maintaining uniformity and consistency in cost accounting practices may not be possible. However, till such time all CAS are in place based on GACAP, a new set of generally accepted cost accounting principles have to be laid down. Few have also suggested issue of cost accounting standards even if the existing system of rule based records to continue. In other words, CAS may be complimentary to the rules and not necessarily substitution to the rules, as CAS cannot replace CARR.

b) Therefore, the Expert Group proposal that all companies should be asked to comply with such cost accounting standards have found favourable response from almost all the respondents.

However, adequate time to be given to the companies to comply with such accounting standards. In addition, they have suggested that ICWAI should issue industry specific guidance notes on cost accounting methodologies. Besides companies, the respondents have also suggested that all forms of organisations or commercial entities, except those exempted from the purview of cost audit, should comply with such cost accounting standards. For exempted companies, compliance of CAS may be optional. Any deviations to CAS should be disclosed in the cost accounting policies.

c) Similarly, the suggestion that ICWAI should assign topmost priority for issue of cost accounting standards in consultation with all stakeholders has also been agreed to. In fact it has been said that ICWAI should begin this exercise immediately, in anticipation of the Expert Group Report and without waiting for formal announcement of Government policy on the subject. Hence, ICWAI should follow a time-bound programme to issue CAS for all sectors of the economy. It has been clearly said that the ICWAI should issue CAS only after ascertaining the views & in consultation with the companies, industry associations, other recognized accounting bodies such as ICAI, etc. and should also follow overall global standards. However, a few have suggested setting-up of an independent body/board for this purpose. It has been further suggested that issue of cost accounting standards may be made by amendment of the section 210A of the Companies Act, 1956 and NACAS should be renamed as National Advisory Committee on Accounting and Cost Accounting Standards or an independent legislative established Board similar to the CASB constituted by the US Federal Government.

d) To a proposal made by the Expert Group that all the cost accounting standards should be aligned with the cost accounting standards issued by other developed countries, international best practices, IFRS, and other IFAC guidelines, almost all the respondents have answered in affirmation. In addition, it has been suggested that while in the era of globalization, convergence is very much required, but the proposed cost accounting standards should not be in conflict with the existing financial accounting standards, generally accepted accounting practices (GAPP) followed in India and the provisions of the Companies Act, 1956. In other words, international standards and guidelines may only be taken as a reference to frame CAS, but largely these should align with only such guidelines that are adopted by Indian GAAP. Few respondents have cautioned that with regard to the common aspects, there should not be any conflict between the Cost Accounting Standards and the Financial Accounting Standards.

e) On these issues, the CII has said that there is need for cost accounting standards based on generally accepted cost accounting principles and except for the exempted companies, maintenance of cost records should be based on cost accounting standards that are developed by ICWAI through an industry-wise consultative process. ICWAI Council said that there is definitely an urgent need to have cost accounting standards. With the entire world of accounting moving towards convergence, the preparation of cost statements on uniform basis based on cost accounting standards will stand the scrutiny of WTO and other statutes and also emerge as a key dispute resolution mechanism in the international arena also. Keeping in view the dynamics of the emerging business environment, the Cost Accounting Standards Board of the Institute has come out with a revised framework of cost accounting standards. All companies should be asked to comply with such cost accounting standards. It will help the companies in compiling their costs in a more structured manner and thereby helping them in achieving cost efficiencies. A mechanism should be devised to make the cost accounting standards mandatory for all costing or pricing statements through legal dispensation in the similar lines of National Advisory Committee on Accounting Standards (NACAS). The Council of the ICWAI has already accorded top-most priority to this issue.

Observations/Recommendations of the Expert Group

14.50 In order to promote uniformity & consistency in the preparation and presentation of cost statements under different statutes & under WTO, there is an urgent need to integrate, harmonize and standardize the cost accounting principles and practices. Further, the Expert Group has recommended complete shift for maintenance of cost accounting records by the corporate sector from the existing rule/format based mechanism (that is backed by Cost Accounting Records Rules notified by the Government for each industry separately) to a principle based mechanism (that should be backed by the cost accounting standards and generally accepted cost accounting principles & practices). **Hence, the Group recommends issue of Cost Accounting Standards based on the generally accepted cost accounting principles & practices presently followed by the industries in India.**

14.51 **The Group recommends that all the Cost Accounting Standards (CAS) issued/to be issued should be aligned with the following key objectives:**

- **To provide a structured approach to measurement of costs in manufacturing, process or service industry;**
- **To integrate, harmonise and standardize cost accounting principles and practices;**
- **To provide guidance to the users to achieve uniformity and consistency in classification, measurement, assignment and allocation of costs to products and services;**
- **To arrive at the basis of computing the cost of product, activity or service where required by legal or regulatory bodies;**
- **To enable practicing member to make use of Cost Accounting Standards in the matter of attestation of General Purpose Cost statements; and**
- **To assist in clear and uniform understanding of all the related issues by various user organisations, government bodies, regulators, research agencies, academic institutions, etc.**

14.52 The Group noted that the revised framework of CAS already adopted by the Cost Accounting Standards Board (CASB) of ICWAI with the following structure viz., Introduction, Objective, Scope, Definition, Principles, Assignment, Presentation and Disclosures, is aimed to bring the CAS on a principle based approach and is in line with the current requirements of the users of the Cost Accounting Standards. This is also in line with the internationally accepted framework for issue of Accounting Standards. **Accordingly, the Group recommends that all the existing Cost Accounting Standards may also be restructured as per this revised framework and re-issued.**

14.53 The Group noted that the all the CAS already released so far has proved to be of great use to the industry and regulators. CAS-4 has already been approved and notified by the Central Board of Excise & Customs (CBEC) and has been very useful in settling long pending cases of valuation of captive consumption between the department and the assessees. Similarly, the Competition Commission of India (CCI) in their draft regulations on “determination of cost of production” has extensively referred to and drawn upon the CAS-1 to 4. The members in profession, industry, regulators and other users are also drawing reference to CAS 1-5, wherever there is a need for determination of cost of production, cost of equalised transportation costs etc., under different statutes. **In view of this, the Group recommends that the revision of existing CAS as per the revised framework**

should be done in consultation with the concerned legal and/or statutory authority in the government so that the adoptability of use of these revised standards by such organisations is not disturbed.

14.54 The Group expressed that the Cost Accounting Standards issued/to be issued by ICWAI would require proper understanding by all users to achieve uniformity and consistency in measurement, assignment and allocation of costs to products and services and also in the matter of preparation & presentation of cost statements. These would also be used & referred to by various regulatory authorities and statutes. **Therefore, the Group recommends that within the revised framework of CAS, ICWAI should issue Application Guidance Note for each Cost Accounting Standard. The application guidance note should provide the explanatory notes and interpretations of various terminologies and methodologies referred to in the cost accounting standards with suitable illustrations and formats for presentation of cost statements.**

14.55 The Group noted that the CASB has identified 39 areas for developing the Cost Accounting Standards, which include the 5 standards issued so far. Of these, 21 areas relate to components of cost and the balance 18 are on cost accounting methodologies. The Group also noted that the areas for which the Cost Accounting Standards have been identified are broadly in line with the Cost Accounting Records Rules (CARR) already framed by the Government and in vogue for different industries. The Group has already recommended repeal of all the existing CARR and in place, Government to prescribe maintenance of cost accounting records by the corporate sector based on the generally accepted cost accounting principles and cost accounting standards. This requires immediate need to have the desired number of cost accounting standards facilitating repeal of CARR. **Therefore, the Group recommends that ICWAI should assign utmost priority for issue of all the CAS already identified.**

14.56 Further, the Group noted that majority of these areas relate to operation of companies engaged in the production, processing, manufacturing or mining activities. The Group has already recommended that all companies (except the exempted categories) should be asked to maintain cost accounting records and be also subjected to cost audit. This includes companies engaged in infrastructure activities or those rendering services, etc; of this the proposed Companies Bill, 2008 has already included infrastructure activities. **Therefore, the Group recommends that CAS may also be issued for all those areas (excluding the common**

areas already included in the list of 39) that are of use by the infrastructure or service sector companies.

14.57 All the Accounting Standards are meant to promote uniformity & consistency in the preparation and presentation of account statements. Therefore, these are issued as well defined documents by integrating, harmonizing and standardizing the generally accepted accounting principles and practices followed by different business entities. In view of this, the internationally accepted practice is to issue any such standards after having detailed consultations with all the stakeholders and wider sections of society. **In this regard, the Group recommends that Cost Accounting Standards Board and the Council of ICWAI should also follow the same process and issue the Cost Accounting Standards in consultation with all stakeholders viz. industry associations, companies, government organisations, regulatory authorities, user agencies, professional bodies, professional accountants in public practice, professional accountants in business, etc.**

14.58 The Group expresses that all business organisations in a country should be subjected to harmonized principles of accounting. The Group further noted that both the financial accounting statements and cost accounting statements emanate from same set of books of account maintained by an organisation. **Therefore, the Group recommends that there should be complete alignment, synergy & harmonization between the Cost Accounting Standards and Financial Accounting Standards.**

14.59 **The Group further recommends that the Cost Accounting Standards Board of ICWAI, in consultation with the Accounting Standards Board of ICAI, should prepare a list of such items which need harmonization in two sets of standards i.e. Accounting Standards and Cost Accounting Standards and update the list periodically.**

14.60 **On specific cost related issues which require different treatment based on cost accounting principles, the Group recommends that any divergence should be disclosed as reconciliation between the Costing Profit & Loss Statement and Financial Profit & Loss Statement.**

14.61 The Group noted that this is the era of globalisation. While large number of multi-national foreign companies have made investments in India; similarly, many Indian companies have also made significant global presence. Cross-border trade & commerce is on the rise. In this regard, global integration of accounting information & statements has become an absolute necessity. Hence, all the Indian Accounting Standards will be soon converging with the International Financial Reporting Standards (IFRS). **Therefore, the Group recommends that all the Cost Accounting Standards will also have to be reviewed and aligned with the relevant issues in IFRS.**

14.62 The Group further noted that many countries have already issued cost accounting standards for application by the business organisations, either in the matter of dealing with the state or for attaining a competitive edge over their counterparts in the world. **The Group recommends that without sacrificing the basic objectives, the CAS should incorporate the best practices enshrined in the Cost Accounting Standards issued by different countries.**

14.63 **The Group further recommends that CAS should also follow, wherever applicable, the principles enshrined in the current International Good Practice Guidance and the Management Accounting Guidelines issued earlier by International Federation of Accountants (IFAC).**

14.64 The Expert Group has recommended that all companies (except the exempted ones) should be asked to comply with these cost accounting standards. For exempted companies, compliance of CAS may be optional. Any deviations to CAS should be disclosed in the cost accounting policies. To ensure this, all the Cost Accounting Standards issued/to be issued by ICWAI have to be accorded statutory recognition under relevant provisions of the Companies Act, 1956. The Group noted that US Federal Government has constituted an independent legislative body viz. Cost Accounting Standards Board. In few other countries, CASs are issued by their Ministry of Finance or Ministry of Commerce. The Group further noted that in India, National Advisory Committee on Accounting Standards (NACAS) has been constituted by the Government under section 210A of the Companies Act, 1956 advising the Central Government on the formulation and laying down of accounting policies and standards for adoption by companies or class of companies under the Act. This body has adequate representation from all the three professional institutes viz. ICAI, ICWAI and ICSI. **Therefore, the Group recommends that either the existing mandate of NACAS may be modified or a similar body be set up advising the Central Government on the formulation and laying down of cost accounting policies and standards for adoption by companies or class of companies under the Act. The Group further recommends that till such time, the cost accounting standards issued by ICWAI may be recognised as that prescribed by the Central Government.**

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CHAPTER-15: CONFIDENTIALITY OF COST DATA & COST OF COMPLIANCE

Constitution of Working Group

15.1 One of the principle terms of reference assigned to the Expert Group was

> *"to review the existing system with a view to make suggestions for addressing the concerns of the industry with regard to confidentiality of company cost data and cost of compliance."*

15.2 For this purpose, a separate Working Group (WG-IV) was constituted by the Expert Group, under the chairmanship of Shri P. Murugesan, General Manager-Finance, Maruti Suzuki India Limited, representing Confederation of Indian Industry (CII) in the Expert Group. Other members of this Working Group were:

1. Shri Kunal Banerjee, the then Vice-President and currently President, ICWAI
2. Shri Vinod Jain, representative of ICAI
3. Shri A.K. Kapoor, Adviser (Cost), D/o Food & Public Distribution
4. Shri G.G. Mitra, Joint Director (Cost), MCA & Member-Secretary

15.3 The aforesaid Working Group held several meetings and detailed deliberations on the subject. They submitted their report that was considered and taken on record by the Expert Group in its meeting held in New Delhi on 13th December, 2008. Relevant issues highlighted by the Working Group and its' recommendations have been discussed in the ensuing paragraphs.

15.4 This issue, being interrelated with the other terms of reference, has also figured in the reports of other Working Groups as well. Therefore, any views and/or recommendations made by other Working Groups have also been suitably incorporated in this chapter.

Existing Provisions/Framework as per the Companies Act, 1956 and Views of Industry

15.5 As per report of Working Group-IV, summary of the existing provisions/framework for maintenance of cost accounting records and audit of such records, as per the provisions contained in the Companies Act, 1956 and as these have been implemented during the last four decades, together with views of industry, is given in the ensuing paragraphs.

15.6 In 1965, the Companies Act, 1956 was amended by inserting sections 209(1)(d) and 233B relating to maintenance of cost records and cost audit. These provisions were made applicable to the companies engaged in production, processing, manufacturing and mining activities.

15.7 Under section 209(1)(d), Ministry of Corporate Affairs have framed and notified Cost Accounting Record Rules (CARR) for 44 industries/products. Accordingly, all those companies (except SSI units having turnover not exceeding Rs.10 crore) that are engaged in the activities covered under notified CARR are required to maintain cost records relating to utilization of material, labour, and other items of cost, strictly as per the formats prescribed under CARR. The Cost Accounting Record Rules were designed to bring cost consciousness among companies to ensure the best use of resources by them with a view to reduce cost of production and in turn to provide cheaper goods to the consumer. Government also felt that proper maintenance of costing records would facilitate efficiency audit in the face of large-scale inefficiency prevailing in the Indian Economy. The maintenance of cost records also helped the management to keep a check on the pricing front and remain competitive.

15.8 As regards cost audit, Government of India, Ministry of Corporate Affairs under section 233B read with section 642(I) of Companies Act, 1956 has notified Cost Audit Report Rules. These Rules were originally notified in 1968, which were later amended in 1996 and again in 2001. For online filing, a summarized Form-I was also introduced in 2006. The existing Cost Audit Report Rules contain following four segments:

- Form-I contains summarized information for 2 years with regard to physical, financial and cost parameters. It also contains few key cost/financial ratios and details of margin per unit of output.
- Part-I: It is basically a format of the Cost Auditor’s Report. It also includes other issues like inventory valuation, budgetary control system, related party transactions, adverse trends in profitability, default in servicing of loans, competitive environment, export commitments, domestics & export pricing policy, and scope & performance of internal audit of cost records.
- Part-II: This is an Annexure to the Cost Audit Report. It comprises various paras seeking information for 3 years on different aspects.
- Part-III: This is a format for the proforma cost sheet which is to be given for each product separately.

15.9 All the aforesaid details are required to be given for each factory/unit, within a factory/unit for each product, and within a product for each type/variety/description separately. Separate details are required for captive consumption, indigenous sales and exports. In few formats, the data is required to be given for the product under reference, for all other products, for the factory as a whole and also for the company as whole.

15.10 With regard to cost audit, various Industry Associations are of the view that the cost audit methodology as structured originally under section 233B and the existing Cost Audit Report Rules are not in tune with the current realities of liberalization, globalization, and competitive environment. In the changed competitive environment, the prices of most products are market driven and the market dynamics forces the industry to reduce costs in order to remain competitive. Towards this many organizations are maintaining more accurate and reliable cost data on continuous basis for management decision making. Moreover, Cost Audit Report in the present form carry lot of strategic information about cost of production, cost of sales and margin in respect of various products. Such information is of vital importance for the survival of the companies and any misuse thereof may adversely affect their competitiveness. Further, compiling the required voluminous data, as indicated above, entails a huge cost for companies in terms of time and money. Hence, there is a need to revisit the current methodologies of cost auditing and reporting frameworks. Present formats of Cost Audit Report need to be restructured and simplified. Instead of the attestation perspective, which was emphasized earlier for price control, the efficiency review aspect should be emphasized to enable better corporate governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness.

Observations & Suggestions of Working Group-IV

15.11 The Working Group-IV in their report have made the following observations and suggestions:

15.12 In the present framework of Cost Accounting Record Rules notified by the Government for each industry/product separately under section 209(1)(d) of the Companies Act, 1956 together with various forms prescribed therein, considerable time and resources have to be spent in preparing the cost statements in the prescribed formats. Further, since there are separate Rules for each industry/product, companies engaged in the manufacture of multiple products have to comply with multiple rules. Hence, besides incurring huge cost in preparing cost records as per the notified rules/formats, it leaves no room for flexibility with the company irrespective of its size, scale or type of operations. Therefore, it is considered necessary to review the existing provisions of cost accounting and cost audit under the Companies Act, 1956 and to make it more beneficial to various stakeholders, viz. Company Management, Regulators and Government departments/bodies. Towards this end, the modified approach/mechanism, as proposed by the Expert Group, would necessarily provide due flexibility to the companies and also reduce their compliance cost considerably.

15.13 As regards cost audit, as indicated above, present Rules/formats seek considerable details in respect of all areas of activities/operations of the company/unit. Therefore, this entails a huge cost for companies in terms of time and money. Thus, these rules/formats need simplification. Filing of minute cost details and complexities in reporting have to be avoided. This would also avoid any possible misuse that may lead to decline in the competitive edge of companies, as observed by the Joint Select Committee which gave final shape to Section 233B of Companies Act, 1956.

15.14 As far as Ministry of Corporate Affairs is concerned, the existing mechanism of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism built under MCA-21 has ensured complete confidentiality of cost details of the company. However, as the information is shared by MCA with other Government agencies like Competition Commission, Anti Dumping Authority, Sectoral Regulators, etc., a similar mechanism to ensure complete confidentiality by these agencies has to be put in place.

15.15 The cost of compliance has principally three components viz. the cost auditor's fee; cost of collecting, collating and presenting the desired cost data/information in prescribed formats; and cost of time & effort spent by the company. While the first component i.e. the cost auditor's fee is generally not very high, but the other two elements entail huge direct & indirect cost.

15.16 In large number of companies, especially the medium size ones, the present cost accounting and cost audit mechanism is providing vital inputs to the company management for decision making. Various Government departments/agencies and the regulators make use of cost audit data/information to draw important policies/programmes which in-turn give benefits to the companies themselves and also to the economy at large. In addition, cost auditors generally make very valuable observations/suggestions for the improvement of the company's operations. Therefore, there is a need to continue the cost audit mechanism. However, to save costs and to ensure complete confidentiality of company's sensitive cost data, present structure of cost audit report need to be simplified.

15.17 The Expert Group in its initial proposal has suggested many radical changes in the existing mechanism. These measures, if finally recommended & implemented, would go a long way in meeting with the concerns of the companies/industry associations on confidentiality of cost data and considerably reduce the cost of compliance.

15.18 Though formats for the revised cost audit report are being finalised by the Working Group-III, this Group suggests that only a concise and simple report containing the following information should be submitted to the Government. All other cost details, statements, schedules, etc. should remain with the company.

- Product Group wise summarized cost data.
- Key Performance Indicators (Operational Ratios)
- Social Costs and CSR details where social cost is involved.

15.19 Working Group-I has received suggestions from various stakeholders. All these suggestions may be analyzed by the Expert Group for finalizing its report to the Government.

Views of various Stakeholders

15.20 The Expert Group devised a detailed Questionnaire on the related issues of cost accounting and cost audit in the corporate sector, also including therein issues relating to confidentiality of company cost data and cost of compliance, cost accounting standards, etc. A copy of the questionnaire is placed at Annexure-XI. This questionnaire was circulated to all the interest groups seeking their views on the questions set-out therein. Further open-house consultations were also held at select places in the country that were widely participated by representatives of all the interest groups/stakeholders. As regards confidentiality of company cost data and cost of compliance, following questions were raised:

- ***Maintenance of Cost Accounting Records:*** Maintenance of cost data/records, as an integral part of the books of accounts, does not normally entail any additional cost to the companies. However, do you agree that the above mechanism of moving away from rule/format based to principle based maintenance of cost data/records will provide due flexibility to the companies and reduce compliance cost, if any, further?

- ***Audit of Cost Accounting Records:*** Do you agree that the above mechanism would provide complete confidentiality and fuller utility of sensitive cost data?

15.21 It may be noted that the aforesaid questions relating to confidentiality of company cost data and cost of compliance were raised as an embedded part of the overall mechanism/framework initially suggested in the questionnaire for maintenance of cost accounting records and audit thereof in the corporate sector and the replies received from various stakeholders also form part of their overall response to the modified mechanism/framework, which has been referred to in the questions and answers as "*above mechanism*". For sake of brevity, the entire mechanism/framework is not reproduced in this chapter.

15.22 These responses were tabulated and analyzed by the Working Group-I. Gist of the response received on confidentiality of company cost data and cost of compliance, as per the report of the Working Group-I, is reproduced as under:

> "***Maintenance of Cost Accounting Records:*** It has been generally agreed that the above mechanism of moving away from rule/format based to principle based maintenance of cost data/records will provide due flexibility to the companies and reduce compliance cost. In fact, few respondents have said that the issue of cost of compliance is unwarranted boogie raised by vested interests. Maintenance of cost data/records as part of books of account never entails any additional cost. Maintaining integrated accounting records under ERP system and compilation of cost statements in computerized accounting environment does not involve any major cost. In fact, it is their view that compliance is more important than the cost. In this regard, a view emerged that since cost data is very much needed for internal purposes also, cost of compliance per se is not relevant. Thus, most of the companies are of the view that more than the compliance cost, it is the flexibility which would benefit them the most. Prescription based methods involve more costs, and hence the majority respondents have favoured principle based accounting mechanism as the resultant benefits in terms of due flexibility and reduced compliance cost are possible only under the proposed principle based accounting."
>
> "***Audit of Cost Accounting Records:*** There is complete agreement among all the respondents that the above mechanism would provide complete confidentiality and fuller utility of sensitive cost data. In fact, it has been said that the Government should not give any importance to the urge for confidentiality countering the stand of transparency and disclosure."

Observations/Recommendations of the Expert Group

15.23 On the twin issues of *"confidentiality of company cost data"* and *"cost of compliance"*, Expert Group has noted the following key observation made by the Working Group-IV:

> *"The Expert Group in its initial proposal has suggested many radical changes in the existing mechanism. These measures, if finally recommended & implemented, would go a long way in meeting with the concerns of the companies/industry associations on confidentiality of cost data and considerably reduce the cost of compliance."*

15.24 Keeping in view (a) the concerns expressed in the past by various companies and industry associations on these twin issues; (b) the observations/suggestions/recommendations made by the Working Group-IV; and (c) the opinions expressed by various stakeholders & interest groups in the replies sent to the questionnaire and those expressed in various open-house consultative meetings; the Expert Group has deliberated on these issues in greater detail. The observations/recommendations of the Expert Group are as under.

15.25 As regards confidentiality of company cost data, even though a section of respondents said that the Government should not give any importance to the urge for confidentiality countering the stand of transparency and disclosure, still the Group noted that (a) the existing mechanism, introduced by the Ministry of Corporate Affairs (MCA) since late 2006, of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism built under MCA-21 has already ensured complete confidentiality of cost details of the company; and (b) the Group has recommended that only abridged statement containing product group-wise cost statements along with cost auditor's report should be filed with the Government; all other cost details, statements, schedules, etc. should remain with the company; and the revised structure should do away with providing detailed cost statements of individual products since the same compromises with the confidentiality and competitive edge of individual companies. **In view of this, the Group recommends that after implementation of various recommendations made by this Group for revised mechanism/framework of cost audit & reporting in the corporate sector, no further steps are required to ensure complete confidentiality of company cost data.**

15.26 On the issue of cost of compliance, the Group noted that the cost to a company arises at two stages, viz. (i) at the time of maintenance of cost accounting records; and (ii) at the time of audit of these records. On these issues, Expert Group noted the following observations made by the Working Group-IV:

> *"In the present framework of notifying Cost Accounting Record Rules (CARRs) for each industry/product separately together with various forms prescribed therein, considerable time and resources have to be spent in preparing the cost statements in the prescribed formats. Further, since there are separate Rules for each industry/product, companies engaged in the manufacture of multiple products have to comply with multiple rules. Hence, besides incurring huge cost in preparing cost records as per the notified rules/formats, it leaves no room for flexibility with the company irrespective of its size, scale or type of operations."*
>
> *"The present Cost Audit Report Rules & the formats contained therein seek considerable details in respect of all areas of activities/operations of the company/unit. Therefore, this entails a huge cost for companies in terms of time and money. Thus, these rules/formats need simplification. Filing of minute cost details and complexities in reporting have to be avoided. This would also avoid any possible misuse that may lead to decline in the competitive edge of companies, as observed by the Joint Select Committee which gave final shape to Section 233B of Companies Act, 1956."*
>
> *"The cost of compliance has principally three components viz. the cost auditor's fee; cost of collecting, collating and presenting the desired cost data/information in prescribed formats; and cost of time & effort spent by the company. While the first component i.e. the cost auditor's fee is generally not very high, but the other two elements entail huge direct & indirect cost."*

15.27 The Expert Group further noted that following views expressed by various interest groups/stakeholders in reply to the questionnaire:

- Modified mechanism of moving away from rule/format based to principle based maintenance of cost data/records will provide due flexibility to the companies and reduce compliance cost.
- Compliance is more important than the cost.
- Since cost data is very much needed for internal purposes also, cost of compliance per se is not relevant.
- More than the compliance cost, it is the flexibility which would benefit the companies.
- Prescription based methods involve more costs, and hence the principle based accounting mechanism is favoured as the

resultant benefits in terms of due flexibility and reduced compliance cost are possible only under the proposed principle based accounting.

- There is a need to continue the cost audit mechanism. However, to save costs and to ensure complete confidentiality of company's sensitive cost data, present structure of cost audit report need to be simplified.
- The modified mechanism of cost audit & reporting would provide complete confidentiality and fuller utility of sensitive cost data and would considerably reduce the cost of compliance.

15.28 **Keeping in view the aforesaid observations of WG-IV and the opinions expressed by various stakeholders (including companies and industry associations), the Expert Group opines that after implementation of various recommendations made by the Expert Group for revised mechanism/framework of cost accounting records, cost audit and reporting in the corporate sector, there would be substantial reduction in the cost of compliance to the companies.**

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CHAPTER-16: GOVERNMENT ORGANISATIONS AND SERVICE SECTORS

Costing Services in Non-Profits Organisations – Relevance for Economic Growth

16.1 In a liberalized economy where market forces drive price, the Expert Group has recommended shifting of the approach from Rule based Regulation to Principle based Regulation. This will allow more freedom to the regulated industries to deploy a system to suit their business convenience and at the same time adhere to the principles governing good corporate practice. This is where the attestation function gets importance, by a scrutiny and certificate, to be issued by a qualified Cost Auditor to ensure compliance.

16.2 Service sector and other economic sectors have grown to support the economy. After liberalization, there has been a marked shift in the growth structure of the economy caused by new players and sectors contributing to various economic activities at much higher levels. This is mainly due to the free market conditions, where number of larger players have entered this arena by setting up Hospitals, Educational Institutions, Insurance companies, Private Banks and Financial Institutions to cater to the need of the economy riding on increased purchasing power and consumer preferences, with better living standards.

16.3 This has brought in new players with brand name and resources to enter the fast growing economy. The services have grown steadily and is accounting for 55% of the GDP compared to 27% of the industrial sector, again out of which only 17% is by the manufacturing sector, which has relatively shown less growth compared to service sector {Report of National Manufacturing Competitiveness Council of Government of India}. This has assumed greater importance after WTO has replaced the concept of GATT to GATIS encompassing vital service activities like Finance, Energy, Health, Education, etc. It is imperative that at this stage itself, efficiency in their operations are built up, by systemic analysis of activities, so as not to be trapped with what has happened in the developed countries, which have witnessed a phenomenon that *'Free Markets and Competition do not move Together'*. It is important that a system of cost consciousness is created in these sectors, at this stage itself to maintain efficiency, performance and propriety in their operations to be competitive with larger players entering these sectors from developed countries with greater resources and better efficiency of operations. These sectors, suffer seriously, from availability of authenticated and reliable, activity-wise, input-output data which are important to eliminate waste and improve efficiency. There is only aggregate financial data, which does not lend itself for analysis and dissection leading to control. [These observations concur with the findings of the Committee on Financial Restructuring and Reforms by Dr. Raghuram Rajan to Ministry of Finance, 2008].

16.4 Basically there is no effective mechanism in place to determine the activity-wise Input-Output data, other than adopting cost accounting and maintaining cost records, wherein the physical performances are inbuilt into the system and is integrated with the aggregate financial records. The physical data reconciliation with revenue earned is assuming more importance with government expanding the revenue collection network, by roping in more activity under Service Tax coverage. This has become a more stable source of income to government where it has exceeded the targets.

16.5 In view of the above, the Working Group firmly believes and recommends maintenance of cost records, duly attested by an expert that will lead for a systematic appraisal and analysis of cost data by management as a means to improve the performance of these sectors. This will lead to application of Management Accounting Principles, apart from determination of cost of operations, by which the quality of the services will improve, leading to higher contribution to the GDP, both by itself and by the manufacturing sector, to sustain competition.

16.6 It is well established and known that the Indian economy, due to various reasons, has not evened out the benefits of liberalization resulting in growth of the economy that has not percolated to the rural sectors. While the reasons are many, the main issues are-

- The Growth sectors have concentrated only in URBAN areas.
- There is hesitancy and reluctance for qualified and skilled workforce, to move from Urban to Rural areas e.g. Health Sector where the Doctors are reluctant to serve hospitals in the rural base forcing Government to legislate this measure.
- Availability of skilled labour force has concentrated in urban areas due to concentration of higher education & employment facilities in urban areas only.
- Due to poor infrastructural development like roads and power, the companies deploying skilled labour and paying higher remunerations, have remained in and around cities e.g. IT sector.
- With the financial reforms in the offing, there will be more growth in the rural areas, by better Roads, Hospitals, Educational Institutions, Communication and Power availability.

16.7 At this stage it is better to understand the definition of Corporate Social Responsibility (CSR) which has stretched beyond the simple 'Social Costs' definition and include, Training of Work Force, Human Rights, Labour Standards, Environmental Costs, Quality Costs, and Brand Image, etc. There is an urgent need to regulate the above parameters in the activities by the companies. But it is also important to appreciate these issues in the context of organizations in the non-corporate sector. Take for example, the construction Industry in the country. The industry is one of biggest employers in the country but no formal regulation of the industry at all exists. An appropriate costing system, along with other systems that may be required, would ensure proper valuation of the steps taken by the units in the above areas. Many of these will determine the 'Value' created by the company to the shareholders and will help to sustain the growth of the company by building up public image.

16.8 It is also noteworthy to appreciate that amongst several reasons attributed to the companies who have created values in managing their business, 'COST MANAGEMENT' practiced by these companies stands uppermost, next only to training of labour force. In the drivers of Corporate Social Responsibility (CSR) of privately held business (PHB), the important factors are Recruitment\Retention of Staff (65%), Cost Management (63%), Public Attitude\Building of Brand (56%), Tax relief (44%), Saving the Planet (40%), Investor Relations (39%), and Governmental Pressure (38%). Maintaining strict cost control envisages careful management of resources whose use can contribute to lower CO_2 levels and environmental degradation. The results show widespread agreement that the need to control costs encourage "Ethical" behaviour amongst privately held business.

Constitution of the Working Group

16.9 A general congratulatory frame of mind prevails that the high economic growth rates (even at 7%) have been made possible through various policies under the economic reform package. In this context, one needs to understand first the macro economic and social trends and the role of the government and secondly, the international experiences in changing the socio-political environment. In order to ensure that the economic growth initiated is a growth with justice, socio-political imperatives cannot be overlooked. The said imperatives are reflected in the operations of variety of non-profit organizations, broadly, confining to following sectors:

- Health
- Education
- Services Sector including IT, Aviation, Transportation, etc.

- Public Utilities
- Tourism
- Insurance, Banking and Financial Services
- Local Administration including Municipalities
- Any other economic segment, irrespective of its size, including un-organised sectors and not included in any of the above.

16.10 The growth in the each of the above mentioned sectors is essential to achieve the growth of the economy as a whole. Hence, it is essential that factors determining the growth in these sectors should also be considered. In all the above noted sectors, country's resources are consumed and the output contributes to the welfare of the people at large. There can be no doubt that the resources consumption, i.e. cost of services provided, need to be regulated if not controlled. Keeping in view the relevance of costing the services of above mentioned sectors, in the economic development of the country, the members of the Expert Group decided to form a separate Working Group (WG-VI) to examine this issue and bring out the features of cost accounting systems in these sectors and usefulness of cost audit mechanism. Even though this perspective was outside the explicit scope of the Expert Group, need was felt to study the costing of services in non-profit organizations, to substantiate the ultimate goals of the study under reference.

16.11 The Expert Group, at its meeting held on March 14, 2008 at New Delhi decided to form, six Working Groups and one of them, Working Group-VI, was to review and draft the proposed framework of Cost Accounting and Cost Audit in the Non-Corporate Sectors like Health-care, insurance, Banking, Education, Public utilities, Government Projects & Other Services, etc. This Working Group was headed by Shri V. Kalyanaraman, past-President, South Asian Federation of Accountants (SAFA). Other members of this Working Group are:

1. Shri S.C. Aggrawal, Managing Director, SMC Global Securities Limited and representative of ASSOCHAM in the Expert Group;
2. Shri J.K. Puri, Former Chief Adviser Cost, Ministry of Finance;
3. Shri D.V. Joshi, Past-President, ICWAI; and
4. Dr. D. Jagannathan, Former Principal, Dayal Singh College, University of Delhi.

16.12 The aforesaid Working Group held several meetings and detailed deliberations on the subject. They submitted their report in mid-June, 2008 that was considered and taken on record by the Expert Group in its meeting held in New Delhi on 18th November, 2008. Relevant issues highlighted by the Working Group and its' recommendations have been discussed in the ensuing paragraphs.

Objectives of Cost Accounting System in Government Organisations and Service Sectors

16.13 As one walks around a factory or office or non profit making organization, one phrase one will need to use is the "cost objective". While there is an urgent need to learn the language of the management accountant; the cost objective is a fundamental part of that language. In this context, we would like to re-emphasize the meaning of cost objective.

> *"A cost object is any product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained. For example, it includes the cost of a product, or the cost of rendering a service to a bank customer or hospital patient, or cost of imparting education to a school/college student, or cost of operating a particular project like waste disposal in a city, or indeed anything for which one wants to measure the cost of resources used."*

16.14 Given the enormous amount of resources required for the economic development and the fact that there is hard pressure on the availability of resources, it is very essential that the cost of resources used in all economics units are subjected to systematic accounting procedures and subjected to professional accreditation. This is the major focus of the present analysis.

16.15 Financial management optimizes the output from the given input of funds. In the country like India where resources are scarce and the demand for funds are many, the need of proper financial management is required. In case of newly started companies, with a high growth rate, it is more important to have sound cost & financial management since finance alone guarantee their survival. It is equally important in case of non-profit organizations, which do not pay adequate attentions to these areas. However a sound system of cost & financial management has to be cultivated among bureaucrats, administrators, engineers, educationalists and public at a large.

16.16 Government priorities can drive local partnerships for waste management towards the achievement of central targets and efficiency savings rather than wider sustainable waste management objectives. Reducing levels of waste and disposing of it in environmentally acceptable ways are significant issues facing policymakers. And, as in other areas of public service delivery, partnership working is now a key component in waste management with partnerships between local authorities and between the public, private and community waste sectors involved in efforts to develop more sustainable systems. Economic pressures imposed by central government can lead to local waste partnerships prioritizing short-term targets. The major challenge in contemporary waste management is to address demand patterns, by reducing levels of waste, throughout the supply chain and managing the waste that is produced more sustainably.

16.17 The relationship between the input and output, in any economic activity, is traditionally upheld to develop Benchmarks for performance measurement and this input-output relationship has to be examined in all economic activities. This has to be done in a systematic manner so that the data is used for various policy decisions. Cost Accounting is one time-tested system of building input-output relationships. The group was asked to examine the scope for cost accounting system in services sector, especially under non-corporate form of organization, so as to achieve, to the extent feasible, the following objectives:

a) To identify the segments of economy, in non-corporate sector, where cost information is being generated, in different forms;

b) To develop relationship between resources and outcomes in selected economic segments;

c) To illustrate the existing practices followed, for generating cost data, both at national and international arena;

d) To evolve an operational framework for maintaining cost records in the selected segments;

e) To develop an assurance service mechanism that can be placed within the legal framework; and

f) To suggest amendments to the Companies Act, 1956 to comply with the provisions, if need be.

g) To address/identify the concerned Ministries/Departments/ Bodies and Regulators for this purpose.

16.18 In view of the relevance of cost information and costing system, especially in non-company form of organizations and engaged in public services like Education, Healthcare, Water provision, Waste Management, etc., the following objectives of a cost management system supported by cost audits by Qualified Cost Accountants emerges. The set of objectives outlined below would be an indicator to the concerned Ministries to take appropriate actions, including provision of statutory support to the decisions, to introduce proper Cost Management Systems and their Audits. Real scope of cost engineering functions would be (a) to provide independent, objective, accurate, and reliable capital and operating cost assessments usable for investment funding and project control; and (b) to analyze investment and development for the guidance of owners, financiers and contractors. The functions would include estimates of capital or asset costs including development costs; estimates of operating and manufacturing costs through an asset's life cycle; risk assessment and analysis; trending of scope and cost changes; decision analysis; financial analysis (e.g. net present value, rate of return, etc); project cost control; appraisals of existing assets; project analyses, databases, and benchmarking; planning and scheduling; citing studies; productive and investment needs assessment; facility management needs assessment; project feasibility and budget assessment; cost management; procurement management; contract administration; whole-life appraisals; quality audits; value management; and dispute resolution.

Regulatory Framework and Cost Accounting Standards

16.19 The goals of any system that needs to be operated in the context of the non-profit organizations in sectors like Health, Education, Local administration like Municipalities, etc. can be achieved only through mandatory regulations. Hence, it is felt that the rationality of instituting a systematic cost information mechanism in all these organization could be completed only with a statutory recognition. The cost data should be mandatorily subjected to cost audits by Cost Accountants so that objective feedback is received by the policy makers/stakeholders. The organizations should be required to maintain cost accounting system, as prescribed, duly supported by relevant statutes. However, it would be very pertinent to mention here that all organizations covered should be exposed through training programs to the benefits of costing systems and the skills required for installing the systems.

16.20 Economic growth may bring with it severe external costs, threatening growth rates and bringing with it consequences for countries in terms of global warming. Key external costs of rapid economic growth may include:

- Loss of biodiversity – this may be seen as an inter-generational equity issue.
- Deforestation - consequences can be multiple e.g. flooding of farmland because rainwater can no longer be absorbed.
- Desertification through over intensive land use.
- Contamination of water supplies
- Salination of land due to irrigation.

16.21 The impact of such factors on the cost information is quite significant and cost accounting standards need to be developed and incorporated in the accounting system of industrial sector units. While evolving accounting standards to reflect the cost implications of factors like the ones pointed above, the activities in non-profit organizations should also be considered so as to provide a strong information base for setting standards. Needless to say, the Cost Accounting Standards for basic cost information like material cost, human resources costs, overhead distribution, etc. could be better evolved through synergizing the experiences in non-profit organizations with the practices in manufacturing sectors.

Observations/Recommendations of the Committee on Subordinate Legislation

16.22 As regards coverage of services sectors within the framework of cost accounting, the Committee on Subordinate Legislation (Fourteenth Lok Sabha) in its First Report (Chapter-III) submitted on 2nd December, 2004 said as follows:

> *"3.13 Service sectors such as Banking, Insurance, Health Services, Education, Hotel, etc. have admittedly "attained strategic importance to the economy and the public at large, particularly after opening up of the economy for private/foreign companies". It has been stated that an authentic cost data base is of paramount importance to various existing and new regulatory bodies, Competition Commission and Government Departments for fixation of user charges in respect of services provided by them and would go a long way in fulfilling their respective objectives. The existing provisions of the Companies Act, however, do not require formulation of CARRs for service industries. The Committee feel that absence of 'enabling' provision in the Companies Act should not be a reason for not prescribing CARRs for service industries. If the need for cost audit is otherwise found to be vital for service industries, the Committee emphasise that expeditious action should be taken to remove the lacuna in the Companies Act by suitably amending it."*

Observations/Recommendations of Working Group-VI

16.23 Central, State and local governments have a common goal: to provide products and services to their taxpaying constituents at the lowest possible cost. Many governments, however, are not perceived to be particularly efficient in realizing this goal. There is pressure on virtually all governments to cut costs and hold the line or even cut taxes. To do that in the best way, they have to develop good cost information. Otherwise one might just decide to cut services rather than figure out a way to deliver those services more efficiently.

16.24 After examining various issues, the Working Group took few specific sectors in non-profit organizations and examined the potential for installing costing system. The rationality of such a study emanates from two important perspectives: economic activities, including provision of goods and services, involve consumption of resources and hence a sound Cost Accounting system needs to be established for all such spheres where such activities are in progress. The profession of Cost Accounting has been developed in the country specially to provide professional inputs for evolving Cost Accounting methodologies and their assurance, to all the services not merely confined to manufacturing activity and thus enabling sound synergy.

16.25 The Working Group-VI recommended the following:

a) There is an urgency to evolve sound Accounting and Cost Accounting systems in all segments of the economy to account for the economic activities and to measures costs involved therein.

b) Cost Accounting Systems to be based on sound Cost Accounting Principles adjusted to the pattern of activities, and resources consumption in the segment being covered.

c) The Ministry of Corporate Affairs to spearhead the process of inculcating Cost Accounting systems in all organizations where the need for cost information is strongly felt.

d) The Institute of Cost and Works Accountants of India to be the agency for evolving suitable Cost Accounting systems and to undertake training of the human resources in organizations where the system is to be installed.

e) The introduction of Cost Accounting system should be made mandatory through a Regulatory authority, statutorily appointed, and the Costing system should be subject to periodical Cost Audit by the professional Cost Accountants. For example, in case of Educational Institutions, bodies like the University Grants Commission, AICTE and corresponding bodies at the State level should be designated Regulators for this purpose. In case of Local Administration, like Municipalities or Water Boards, the State Government should appoint an authority to act as the Regulator. In case of organizations engaged in revenue collection, Ministry of Finance, Government of India should act as the Regulator through the concerned departments, like CBEC, IRAI, BRAI, etc.

16.26 The significance of maintaining cost data even in non-profit organization cannot be overlooked and this has been clearly highlighted by the analysis presented in the report of the Working Group-VI. In fact, the illustrative case of Educational Institution, especially the costing basis for fixing fees, could be further examined on an all India basis and definite policy indicators could be evolved. For the present, it is suggested that the Regulatory authorities in the education sector at the National level, like the

UGC or AICTE, should immediately provide for statutory clauses, in the legal mechanisms that regulates the Educational Institutions, that makes it mandatory for the maintenance of cost data and incorporate suitable system for the audit of such cost information. Again, similar steps should be taken in Health sector too. It is pertinent to highlight the information on health sector, brought out by the Working Group-VI in its report.

16.27 The National Health Service of the United Kingdom has prescribed the cost accounting system in health services and issues like costing of pathology tests in laboratories are prescribed. In this context, the report has also brought out the significance of comparison at the International level. It is essential that cost standards are developed at the behest of health sector regulatory authorities and prescribed for all health sector units so that the quality and pricing are fixed on uniform basis. A National Regulatory Authority of Health Services should, among other things, help to evolve costing mechanisms for various services of the health sector, with the help of Cost Accounting professionals in the country.

16.28 Similarly, the Working Group-VI report has also brought out the practice of providing principles and standards for a uniform approach for determining costs and to promote effective program delivery, efficiency by the local governmental units like Municipalities and better relationships between governmental units and the public at large. Such practices are found in advanced countries like the USA. It is high time that costing of Municipalities' services are documented and used for fixing prices of the services, in India too.

Global Cost Accounting Practices

16.29 Details of evolution of various principles & practices in the field of cost accounting and assurance, in a legal environment, in different parts of the world have been given in a separate chapter of this report. A summary of same is given below:

- Policy intervention, administered pricing, social pricing, funding plans, taxation laws, price control environment, transfer pricing, predatory pricing, tariff determination, WTO cases, regulatory framework, etc. have exerted a major influence in the evolution of cost accounting & assurance practices in various countries of the globe.
- Detailed requirements on cost accounting are put forward in judicial or even in a quasi judicial form.
- World over, various statutory instruments have been enacted to

(a) achieve uniformity and consistency in accounting for contracts with public authorities;
(b) avoid calculation of cost price at excessive rates;
(c) enable use of full economic costing as a more accurate way of helping to determine whether an activity or a project is worthwhile and sustainable;
(d) adopt standard & uniform cost accounting practices;
(e) adopt cost segregation techniques;
(f) deal with anti-competitive cases;
(g) regulate monopolistic trade practices;
(h) deal with cost linkages in tax evasion cases; and
(i) for enhancing operational efficiency, waste elimination and reducing costs to improve an organisation's competitiveness.

➢ Education & research services, healthcare services, municipal services, social security services, public procurement, defence procurements, public supply contracts, public-private partnership contracts, toll roads/bridges, railways, postal authorities, telecommunication services, electricity generation & distribution, state asset administration, financial services, tourist services, environmental effects' costing, social pricing of goods, cross-subsidization impacts, pricing of agriculture inputs & outputs, etc. are major governmental and service sectors, across the globe, using cost accounting principles & practices.

➢ In regulated sectors, regulators require cost accounts, statistics, business plans, capital expenditure projections, or operating expenditure calculations from participants. These are used to compile an overall picture of the sector, for general monitoring, and sometimes to set price-caps and other price controls. The focus of the Regulatory bodies is on the efficient and fair working of the markets they oversee, and hence their scope is wider than accounting information.

16.30 Apart from the practices adopted in various countries, the United Nations also propagated the concept of cost accounting and cost audit. For example, the Audit Committee of the Program & Budget Committee of the United Nations, in its report in 2006, on the World Intellectual Property Organisation's new construction project recommended *Cost Audit* of the estimated budget of the project that had been agreed by the Member States in 2005 and suggested that such task could be assigned to an independent party, possibly FIPOI *(Fondation des immeubles pour les organisations internationales)* or the External Management Firm itself.

16.31 In USA, one of the Treasury Department's order said that the state auditor shall annually make a cost-audit examination of the books and records of the county road engineer and make a written report thereon to the county legislative authority. The expense of the examination shall be paid from the county road fund. Similarly, in another order of 20th December 2000, it said that any company in the aerospace, telecommunications, electronics or engineering fields (Or any other field where provided for in the contract), which is classed as a mandatory supplier under a government contract, can be liable to a post factum cost price review.

International Federation of Accountants (IFAC)

16.32 IFAC in their International Good Practice Guidance (IGPG-exposure draft) on *"Costing to Drive Organizational Performance"*, published in 2008, said,

- The general principles of costing and the design of costing systems in this IGPG are generally applicable to all types of organization. For example, cost information is an equally important driver of performance information and reporting in public and not-for-profit organizations.
- Some jurisdictions apply legislative expectations on performance. These legislative mandates require reporting entities to develop and report cost information on a consistent and regular basis. Rules in some jurisdictions prescribe the calculation of unit costs to (a) allow comparisons between public authorities, and (b) establish the performance of specific activities.
- The Japanese Ministry of the Environment has produced guidelines on Environmental Accounting that define environmental protection/conservation costs and benefits. More than 800 companies in Japan have voluntarily introduced environmental accounting based on these guidelines, and disclose the results in environmental or sustainability reports.
- In a public sector context it is important to note that using full cost information along with non-financial information on program outputs and outcomes can aid governments, managers, and other stakeholders to make decisions on service delivery. The full costing of public service programs (or the output of a responsibility centre) generally involves compiling the sum of direct and indirect costs that contribute to the program or output. This compilation also includes the full costs of intermediate activities, processes, projects, or programs that need to be measured to calculate the full costs of their outputs. This can enable better evaluation of the merits of a public service policy or program (although program outcomes may require separate measurement).

16.33 The extent to which cost accounting is used within governments varies from country to country. In September 2000, the Public Sector Committee (PSC) of IFAC published a Study Paper on "*Perspectives on Cost Accounting for Governments, an International Public Sector Study*". This provided useful governmental perspectives on cost accounting and is aimed at improving public sector financial management and accountability. In the *Preface*, it is said:

> *"The objectives of government are determined by the political process, and cost accounting is one of a number of tools that may be used to achieve those objectives. Although in some situations cost accounting may not be as central to achieving a particular government's objectives as it is generally for private sector entities, it nevertheless almost always provides important information to help improve the functions of government. This Study is intended to aid government financial officers and other government accountants in their efforts to develop and implement cost accounting. It provides governmental perspectives on cost accounting not available elsewhere, but it is not an in-depth exposition of the subject of cost accounting. Cost accounting is one aspect of financial management and management control, and should be used by program managers and others as a managerial tool in day-to-day operating activities and by senior managers in their supervisory and evaluative roles."*

16.34 Explaining the need for such a study, the Paper said that although great similarities exist between the public and private sectors, a number of governmental cost accounting issues have not yet been dealt with comprehensively in existing literature. One study of value that covers some of these aspects is published by the International Monetary Fund, titled *Effective Government Accounting* (1995). The need to overcome this gap in the literature and provide governmental perspectives is accentuated by today's pressures on governments to deal with shrinking budgets and meet demands for improved services. Governments must cut costs wisely and take cost-related steps to improve services. To do that, they need applicable reference material on cost accounting. Furthermore, governments do not yet make full use of cost accounting in those government agencies which provide goods and services to the public without charge. As a result, many government managers have little understanding of how to use cost accounting to improve their operations. This accentuates the need for good reference material. Even though cost accounting is today more of a management than an accounting exercise, the PSC believes that government financial officers and accountants have important leadership roles to play. They can provide much of the stimulus and knowledge needed to develop and implement cost accounting. They can provide "hands on" help to those in operating management who must participate in development and implementation if this management tool is to be used, and they can help to integrate the work of technical people, such as information systems experts. In addition, they can counsel senior management who must be involved in the resolution of basic issues concerning how cost accounting will be used and developed.

16.35 The basic purpose of this Study was to equip financial officers and accountants with a tool they can use in furthering cost accounting in their countries. This Study provided:

- a description of how cost accounting can be used to assist governmental management processes;
- information about what is happening in various countries and how cost accounting might be adopted progressively and used in other than full accrual environments;
- an understanding of the various cost concepts that can be used to satisfy government information objectives and the related cost accounting processes;
- a discussion of the accrual accounting issues whose resolution may affect the values used in determining full costs;
- guidance on how to develop cost accounting systems, raising major issues that will need resolution;
- a discussion of various options for the design of cost reports for government managers; and
- encouragement to involve senior managers in basic cost accounting issues, with suggestions on how that might be done.

16.36 On the uses of Cost Accounting in Government, it said that in addition to its historical function of determining values in the financial accounting process for inventories or other types of property, cost accounting has a number of primarily management functions, including budgeting; cost control and reduction; setting prices and fees; performance measurement; program evaluations; and a variety of economic choice decisions. When cost accounting is used in the commercial activities of governments, its applications in financial accounting and management functions need not be materially different than those in the private sector.

16.37 Other relevant excerpts of this study are reproduced in Appendix 16.1 to this chapter. Detailed Paper is enclosed as Annexure-XVI.

Views of various Stakeholders

16.38 The Expert Group devised a detailed Questionnaire on the related issues of cost accounting and cost audit in the corporate sector, also including therein issues relating to confidentiality of company cost data, cost of compliance, cost accounting standards, and the need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors and also to various Government projects/schemes, departmental undertakings, etc. A copy of the questionnaire is placed at Annexure-XI. This questionnaire was circulated to all the interest groups/stakeholders seeking their views on the questions set-out therein. Further open-house consultations were also held at select places in the country that were widely participated by representatives of all the interest groups/stakeholders. As regards the need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors and also to various Government projects/schemes, departmental undertakings, etc., following questions were raised:

k) Do you agree with the Expert Group views that there is need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors such as healthcare, education, banking, insurance, financial services, public utilities such as municipalities, electricity, water supply, city transportation, etc?

l) Similarly, do you also agree extending this framework to various Government projects/schemes, departmental undertakings, such as ordnance factories, railway locomotive/coaches manufacturing units, etc?

m) Presently, fees charged by various public service organisations do not show any correlation with the costs. In light of this, do you agree that all Government agencies should determine user charges based on most efficient costs?

16.39 These responses have been tabulated and analyzed by the Working Group-I. According to the Working Group-I report, majority of all the respondents, including various regulators & user departments/ agencies; Navratna/Miniratna PSUs; major private sector industrial conglomerates/ companies; major industry associations; IIMs, and ISB, Hyderabad; ICWAI and leading management consultants have agreed with the initial views of the Expert Group. Gist of the response received on the issue of extending the existing principles & practices of cost accounting and cost audit to the services and other social sectors and also to various Government projects/schemes, departmental undertakings, etc., as per the report of the Working Group-I, is as under:

- There is general consensus among all the respondents that cost consciousness is important in all sectors of economy and even more important in non-competitive public services. These sectors, being consumers of public money, have to emerge stronger along with the growth of economy and therefore, their health is very important. It is an urgent need to improve productivity, build competence and reduce wastages & inefficiencies in utilisation of scarce national resources in these sectors in order to make available public services at reasonable cost. There is, thus, a clear need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors such as healthcare, education, banking, insurance, financial services, transportation, information technology, public utilities & essential services such as municipalities, electricity, water supply, city transport, etc. and also to various Government projects/schemes, departmental undertakings, such as ordnance factories, railway locomotive/coaches manufacturing units, etc. All Government contracts and procurements should be covered forthwith. This would result in greater accountability of government expenditure. This would also improve transparency and uniformity across sectors. However, a few have suggested exempting sensitive sectors like defence, atomic energy, etc. from the ambit of cost audit. It has been further suggested that as such organisations are beyond the purview of the Companies Act, separate legislation/notification may be required to extend the principles & practices of cost accounting and cost audit to the services and other social sectors. In view of severe dearth of knowledgeable and qualified experts, this may be done over a period of time in a phased manner. Views of relevant segments may also be obtained. It has been suggested that the C&AG should comment on the adoption of proposed cost standards and rules by the public entities to protect the interests of people who are really the stakeholders in the economy. It may be noted that the Indian Banks Association has disagreed with the extension of such mechanism to the banking sector.

- Similarly, everybody has agreed that all Government/public agencies should determine user charges for utilities and services based on most efficient costs. These must be produced or generated in a cost effective manner avoiding wastage of scarce national resources. There should be some correlation between fees charged and cost incurred for which they should be brought under the ambit of cost accounting principles and cost audit. There is need to move towards user cost based pricing. Subsidies meant for the poor may be decided after being fully aware of the opportunity cost, social factors and the shadow price. Even where cross-subsidization is necessary, it should be transparent and made known to the public at large.

- On these issues, CII has said that the cost accounting and cost audit framework must be extended to various government projects wherein the public spending is involved; all public service organisations should determine user charges based on most efficient cost; and the objectives of extending the cost accounting and cost audit framework to the services and other social sectors need to be debated first and then carefully decided. ICWAI Council has said that the service sectors and other social sectors play a huge role in the national economy. Cost is a reality and all such public utilities and other services should be provided in a cost effective manner. This can come about only if these sectors are also mandatorily required to maintain structured cost accounting systems. Hence, for the overall interest of the economy, principles and practices of cost accounting and cost audit should be extended to all these sectors. This framework should be extended to various State and Central Government projects/schemes and undertakings, local bodies, government corporations, departmental undertakings, etc. so as to infuse a sense of efficiency and effective spending of public money. The public service organisations should determine user charges based on most efficient cost.

- The ICWAI Council has further said that the importance of the service sector can be measured by the fact that service sector contributes to 56% of the GDP as compared to a contribution of 25% by the Manufacturing sector and 19% by the Agricultural sector. This shows that only one fourth of the national economy engaged in manufacturing activities would be required to maintain cost accounting records as per the existing provisions of section 209(1)(d) provided applicability of such records is extended to the entire manufacturing and mining sector. The export of services is also increasing in the globalization era. As per the Draft Regulation 2(1)(f) of CCI (determination of Cost of Production) Regulations, the definition of product includes both goods and services. This also indicates that the service sector is getting more and more importance and contributing towards the growth of the GDP. Further, the infrastructure sector which includes roads, seaports, airports, railways, telecom, power projects, industrial parks, urban infrastructure, exploration, refining, mining, etc. is the backbone of the growth of any country. It is expected that the country needs about US$400 billion to create the required development of the infrastructure sector. Under BOT Agreement, the users of such services are required to pay a fee in the form of toll tax which is based on the project cost. In addition, there is an acute shortage of houses in India and the new houses are being constructed under private public partnership. It is therefore felt that infrastructure sector needs to be included under the provisions of section 209(1)(d) of the Companies Act, 1956.

Observations/Recommendations of the Expert Group

16.40 The Expert Group deliberated, in greater detail, on the observations/suggestions/recommendations made by the Working Group-VI, the global practice, the IFAC statements and the opinions expressed by various stakeholders/interest groups in the replies sent to the questionnaire and those expressed in various open-house consultative meetings and make the following observations/ recommendations.

16.41 The Expert Group noted that after liberalization, as per the report of the National Manufacturing Competitiveness Council of Government of India, the services sector has grown steadily and is accounting for 55% of the GDP compared to 27% of the industrial sector, out of which only 17% is by the manufacturing sector, which has relatively shown less growth. This has assumed greater importance after WTO has replaced the concept of GATT to GATIS encompassing vital service activities like Finance, Energy, Health, Education, etc. It is imperative that at this stage itself, a system of cost consciousness is created in these sectors so as to maintain efficiency, performance and propriety in their operations to be competitive with larger players entering these sectors from developed countries with greater resources and better efficiency of operations. These sectors, suffer seriously, from availability of authenticated and reliable, activity-wise, input-output data which are important to eliminate waste and improve efficiency. There is only aggregate financial data, which does not lend itself for analysis and dissection leading to control. The Group also noted that these observations concur with the findings of the Committee on Financial Restructuring and Reforms by Dr. Raghuram Rajan to the Ministry of Finance (2008). In view this, the Working Group-VI firmly believed and recommended maintenance of cost records, duly attested by an expert that will lead for a systematic appraisal and analysis of cost data by management as a means to improve the performance of these sectors. This will lead to application of Management Accounting Principles, apart from determination of cost of operations, by which the quality of the services will improve, leading to higher contribution to the GDP, both by itself and by the manufacturing sector, to sustain competition.

16.42 The Expert Group further noted that given the enormous amount of resources required for the economic development and the fact that there is hard pressure on the availability of resources, it is very essential that the cost of resources used in all economics units are subjected to systematic accounting procedures and subjected to professional accreditation. The relationship between the input and output, in any economic activity, is traditionally upheld to develop Benchmarks for performance measurement and this input-output relationship has to be examined in all economic activities. This has to be done in a systematic manner so that the data is used for various policy decisions. Cost Accounting is one time-tested system of building input-output relationships. In view of the relevance of cost information and costing system, especially in non-company form of organizations and engaged in public services like Education, Healthcare, Water provision, Waste Management, etc., the objectives of a cost management system supported by cost audits by Qualified Cost Accountants would be (a) to provide independent, objective, accurate, and reliable capital and operating cost assessments usable for investment funding and project control; and (b) to analyze investment and development for the guidance of owners, financiers and contractors. These objectives would be an indicator to the concerned Ministries to take appropriate actions, including provision of statutory support to the decisions, to introduce proper Cost Management Systems and their Audits.

16.43 The Group noted that the goals of any system that needs to be operated in the context of the non-profit organizations in sectors like Health, Education, Local administration like Municipalities, etc. can be achieved only through mandatory regulations. Hence, it is felt that the rationality of instituting a systematic cost information mechanism in all these organization could be completed only with a statutory recognition. The cost data should be mandatorily subjected to cost audits by Cost Accountants so that objective feedback is received by the policy makers/stakeholders. The organizations should be required to maintain cost accounting system, as prescribed, duly supported by relevant statutes.

16.44 The Group noted the observations/recommendations made by the Committee on Subordinate Legislation (Fourteenth Lok Sabha) in its First Report submitted on 2nd December, 2004. The Committee said that service sectors such as Banking, Insurance, Health Services, Education, Hotel, etc. have admittedly "attained strategic importance to the economy and the public at large, particularly after opening up of the economy for private/foreign companies" and an authentic cost data base is of paramount importance to various existing and new regulatory bodies, Competition Commission and Government Departments for fixation of user charges in respect of services provided by them and would go a long way in fulfilling their respective objectives.

16.45 The Group noted that the Working Group-VI has strongly recommended urgency to evolve sound Accounting and Cost Accounting systems in all segments of the economy to account for the economic activities and to measures costs involved therein; Cost Accounting Systems to be based on sound Cost Accounting Principles adjusted to the pattern of activities, and resources consumption in the segment being covered; the Ministry of Corporate Affairs to spearhead the process of inculcating Cost Accounting systems in all organizations where the need for cost information is strongly felt; the Institute of Cost and Works Accountants of India to be the agency for evolving suitable Cost Accounting systems and to undertake training of the human resources in organizations where the system is to be installed; and the introduction of Cost Accounting system should be made mandatory through a Regulatory authority, statutorily appointed, and the Costing system should be subject to periodical Cost Audit by the professional Cost Accountants.

16.46 The Group further noted that policy intervention, administered pricing, social pricing, funding plans, taxation laws, price control environment, transfer pricing, predatory pricing, tariff determination, WTO cases, regulatory framework, etc. have exerted a major influence in the evolution of cost accounting & assurance practices in various countries of the globe. Detailed requirements on cost accounting are put forward in judicial or even in a quasi judicial form. Education & research services, healthcare services, municipal services, social security services, public procurement, defence procurements, public supply contracts, public-private partnership contracts, toll roads/bridges, railways, postal authorities, telecommunication services, electricity generation & distribution, state asset administration, financial services, tourist services, environmental effects' costing, social pricing of goods, cross-subsidization impacts, pricing of agriculture inputs & outputs, etc. are major governmental and service sectors, across the globe, using cost accounting principles & practices.

16.47 The Group observed that apart from the practices adopted in various countries, the United Nations also propagated the concept of cost accounting and cost audit. In USA, the Treasury Department ordered for an annual cost-audit examination of the books and records of various companies dealing with the Government and other federal programmes/activities.

16.48 It was noted that as per IFAC, general principles of costing, design of costing systems and the cost information are important drivers of performance information and reporting in public and not-for-profit organizations. In a public sector context, using full cost information along with non-financial information on program outputs and outcomes can aid governments, managers, and other stakeholders to make decisions on service delivery. This can enable better evaluation of the merits of a public service policy or program. The extent to which cost accounting is used within governments has been published in a Study Paper on "*Perspectives on Cost Accounting for Governments, an International Public Sector Study"*. As per this document, while the objectives of government are determined by the political process, cost accounting is one of a number of tools that may be used to achieve those objectives. It always provides important information to help improve the functions of government. The need for cost accounting is accentuated by today's pressures on governments to deal with shrinking budgets and meet demands for improved services. Governments must cut costs wisely and take cost-related steps to improve services. Even though cost accounting is today more of a management than an accounting exercise, IFAC believes that government financial officers and accountants have important leadership roles to play. They can provide much of the stimulus and knowledge needed to develop and implement cost accounting. They can provide "hands on" help to those in operating management who must participate in development and implementation if this management tool is to be used, and they can help to integrate the work of technical people, such as information systems experts. In addition, they can counsel senior management who must be involved in the resolution of basic issues concerning how cost accounting will be used and developed.

16.49 On the uses of Cost Accounting in Government, IFAC said that in addition to its historical function of determining values in the financial accounting process for inventories or other types of property, cost accounting has a number of primarily management functions, including budgeting; cost control and reduction; setting prices and fees; performance measurement; program evaluations; and a variety of economic choice decisions. When cost accounting is used in the commercial activities of governments, its applications in financial accounting and management functions need not be materially different than those in the private sector. Governments do not usually have profitability and return on investment objectives for their governmental activities. They lack these economic incentives to manage costs. Government managers must take the initiative to analyze cost behaviour and then, after careful consideration of all the consequences, take appropriate action. Unless initiative is taken by government managers to analyze cost behaviour, inefficiencies may emerge, continue, and grow for a long time before the need for action becomes obvious.

16.50 The Expert Group noted that the cost information is used for preparing Budgets in New Zealand, United States, and Australia. Cost is also frequently the basis for transfer pricing between government units. For example, in the United States, unless otherwise specified by law, regulations require that prices charged to the public for government goods and services be based on market prices or the full costs incurred by the government. Canada has an initiative for cost recovery with respect to certain government goods and services provided to external users. Canada suggests that full cost is a good starting point for determining user fees. New Zealand has expanded the concept of pricing services to all activities of the government, whether sold, transferred between government units or distributed free to the general public. The United Kingdom encourages charging for services supplied between departments unless it is clear that the likely benefits would not justify the cost. Some governments, such as the United States, are showing increasing interest in performance measures. Other governments, such as the United Kingdom, have established systems for reporting this information. The cost of government programs, when combined with appropriate performance measurements and reported publicly, can help the public and legislators to evaluate the programs. Many countries use information on program costs as a basis for cost-benefit considerations. For example, Canada fosters the use of cost-benefit analysis by individual departments to improve the efficient allocation of resources among competing government programs. Making choices among alternative actions, such as whether to do a project internally or contract it out, requires cost comparisons between alternatives. Privatization decisions may involve comparing the incremental net cost or profit of continuing a government activity with the economic and other benefits of placing it in private hands. Cost studies of various types can help to decide whether to accept or reject a proposal for a government capital project, to continue or drop a government product or service, or to contract with a private sector vendor.

16.51 The Group noted that as per IFAC, the extent to which cost accounting is used within governments varies from country to country. Usage frequently depends upon the objectives of the various types of government organizations. State-owned enterprises organized for profit generally employ some form of cost accounting. Public utilities are an example of this type of organization. Non-profit revolving funds, whose objective is to maintain capital through sales of goods and services, rather than through appropriations, frequently employ cost accounting. Internal inventory and service funds which provide goods and services to general fund organizations are examples of this type of organization. By comparison, relatively infrequent use of cost accounting systems is found in governmental organizations that provide goods and services to the general public without charge. Well-managed governments are turning to cost accounting as an essential component of the management of their activities. This move has been motivated by the need to deal with increasing debt levels and shrinking budgets and by related public criticism of government management. This increasing use of cost accounting is sometimes combined with the adoption of improvements in accrual accounting and the adoption of cost-based budgeting.

16.52 For example, in Taiwan, the development of cost accounting was linked to better mid-term and long-term budget planning. In Malaysia, cost accounting is an essential part of its “value for money” concept of Government management. The “value for money” concept has been in use for some time in the United Kingdom, but recent steps to adopt cost-based budgeting will likely improve its cost accounting systems. In Canada, fiscal pressures resulted in an emphasis on “stretching the tax dollar” and led to the issuance of guides on how to deliver services and to “make or buy” in a more economical or efficient manner. In New Zealand, fiscal exigencies led to the adoption of full accrual accounting as the basis for Government financial management and also to related initiatives for the development of cost accounting as a management tool. Despite the fact that the United States continues to budget largely on a cash basis, cost accounting is now beginning to be implemented across the government. This is the result of several pieces of legislation and related actions by the executive branch of government starting with the passage of the United States Chief Financial Officers (CFO) Act in 1990. In 1995, the United States published the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as recommended by the Federal Accounting Standards Advisory Board. This requires federal entities to accumulate full cost information. The reporting of full costs is required in the SFFAS No. 7, *Accounting for Revenue and Other Financial Sources*. The Federal Financial Management Improvement Act of 1996 added the force of law to these accounting standards and also to any systems requirements established by the U.S. Joint Financial Management Improvement Program (JFMIP). JFMIP issued cost accounting systems requirements for U.S. Government organizations in February 1997.

16.53 On the possible causes of increased use of cost accounting in the Government functioning, the Expert Group noted the IFAC's observations made in the year 2000, which said that adoption of accrual accounting as the basis for budgeting and management information, following the examples of New Zealand, the United Kingdom and Australia, will obviously trigger increased use of cost accounting and the development of supporting systems. Short of that, recognition of its need in "right sizing", eliminating inefficiencies and privatization will also spur increased use and related systems development. Managers of government programs, if they are informed of the managerial advantages, will likely provide impetus for increased use. Program managers can improve operational performance from three perspectives — quality/productivity, cycle time, and cost. If cost is brought into the managerial decision-making processes along with these other measures in a balanced fashion, then better decisions can be made. Because government decision-making is subject to a number of political pressures, how reported performance measures are viewed by users of those measures will affect the pace at which cost accounting is adopted. Relating costs and the outputs of government programs is not in principle more difficult than costing products or services in the private sector. This step alone has provided legislators and Government officials with decision-relevant information. It has also provided the general public with information about the efficiency of government. Whether to move quickly or progressively to implement cost accounting obviously depends on the particular circumstances of the government.

16.54 Further, the Expert Group noted the underwritten wider public opinion received as part of its country wide survey conducted through a well drafted questionnaire on the subject:

o There was a general consensus among all the respondents that cost consciousness is important in all sectors of economy and even more important in non-competitive public services. These sectors, being consumers of public money, have to emerge stronger along with the growth of economy and therefore, their health is very important. It is an urgent need to improve productivity, build competence and reduce wastages & inefficiencies in utilisation of scarce national resources in these sectors in order to make available public services at reasonable cost. There is, thus, a clear need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors such as healthcare, education, banking, insurance, financial services, transportation, information technology, public utilities & essential services such as municipalities, electricity, water supply, city transport, etc.

and also to various Government projects/schemes, departmental undertakings, such as ordnance factories, railway locomotive/coaches manufacturing units, etc. All Government contracts and procurements should be covered forthwith. This would result in greater accountability of government expenditure. This would also improve transparency and uniformity across sectors.

- Similarly, everybody agreed that all Government/public agencies should determine user charges for utilities and services based on most efficient costs. These must be produced or generated in a cost effective manner avoiding wastage of scarce national resources. There should be some correlation between fees charged and cost incurred for which they should be brought under the ambit of cost accounting principles and cost audit. There is need to move towards user cost based pricing. Subsidies meant for the poor may be decided after being fully aware of the opportunity cost, social factors and the shadow price. Even where cross-subsidization is necessary, it should be transparent and made known to the public at large.
- On these issues, CII said that the cost accounting and cost audit framework must be extended to various government projects wherein the public spending is involved; all public service organisations should determine user charges based on most efficient cost; and the objectives of extending the cost accounting and cost audit framework to the services and other social sectors need to be debated first and then carefully decided. ICWAI Council said as the service sectors and other social sectors play a huge role in the national economy, these sectors should be mandatorily required to maintain structured cost accounting systems. This framework should also be extended to various State and Central Government projects/schemes and undertakings, local bodies, government corporations, departmental undertakings, etc. so as to infuse a sense of efficiency and effective spending of public money. All the public service organisations should determine user charges based on most efficient cost. Further, the infrastructure sector which includes roads, seaports, airports, railways, telecom, power projects, industrial parks, urban infrastructure, exploration, refining, mining, etc. is the backbone of the growth of any country. It is therefore felt that infrastructure sector needs to be included under the provisions of cost accounting and cost audit.

16.55 Keeping the aforesaid observation in view, the Expert Group recommends as under:

(a) **All the services and other social sectors such as healthcare, education, banking, insurance, financial services, transportation, information technology, public utilities & essential services such as municipalities, electricity, water supply, city transport, etc. should be brought under the mandatory mechanism of cost accounting and cost audit.**

(b) **The existing principles & practices of cost accounting and cost audit should also be extended to various Government projects/schemes, departmental undertakings, such as ordnance factories, railway locomotive/coaches manufacturing units, etc. and all the Government contracts and procurements should be covered forthwith.**

(c) **All the infrastructure sector activities which include roads, seaports, airports, railways, telecom, power projects, industrial parks, urban infrastructure, exploration, refining, mining, etc. are backbone of the growth of any country; hence needs to be included under the provisions of cost accounting and cost audit.**

(d) **All public service organisations should determine user charges based on most efficient costs. Subsidies meant for the poor may be decided after being fully aware of the opportunity cost, social factors and the shadow price. Even where cross-subsidization is necessary, it should be transparent and made known to the public at large.**

(e) **Most of these sectors, services, functions or activities presently either operate as extension of Government ministries/departments or are governed by various Central/State Government statutes and/or resolutions. These are operated in both the corporate form as well as non-corporate form of organisations. In all the non-corporate and/or not-for-profit organisations, the existing principles & practices of cost accounting and cost audit may be extended by the respective authorities by suitably amending their laws/statutes.**

(f) **Ministry of Corporate Affairs and the Chief Adviser Cost in the Ministry of Finance should take a lead role to spearhead the process of inculcating cost accounting systems in all these organizations/entities.**

(g) **The Institute of Cost and Works Accountants of India should play a supportive role in (a) evolving suitable cost accounting systems; (b) issue of relevant cost**

accounting standards & guidance notes; and (c) in undertaking training of human resources in such organizations.

(h) **The Controller General of Civil Accounts and the Accountant Generals, in consultation with the Comptroller & Auditor General of India, should take a lead role in (a) modifying the existing budgetary system of the Central/State Governments; (b) recasting the outcome budgets by correctly evaluating the costs & benefits of each program/activity; and (c) improving the public information system.**

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Appendix- 16.1

Relevant Excerpts from the IFAC's Study Paper on "*Perspectives on Cost Accounting for Governments, an International Public Sector Study*" published in September, 2000

BUDGETING

- Budgeting as a planning and control mechanism has a prominent and important role in government. Among the reasons for this is the visibility of the result and the need to allocate resources to a large number of individually important activities whose objectives are complex and often non-profit oriented.
- Budgets may be formulated and carried out on a cash basis or on an accrual basis. Where they are on an accrual basis, e.g., in New Zealand, the costs of government programs incurred in the past can be readily used as a basis for preparing budget estimates of future costs. Where they are on a cash basis, e.g., in the United States, using cost information in budget preparation requires crosswalks between the accrual basis used for cost accounting and the cash basis used to prepare the budget.
- When accrual-based budgets are adopted, incurred costs can be easily compared with budgets for control purposes. If flexible budgets are used, as they may be in the case of "for profit" government business enterprises, e.g., in Australia, then fixed and variable costs must be determined for budgeting and related control.

COST CONTROL AND REDUCTION

- As in the private sector, cost information can be used in cost control and reduction. For example, with appropriate cost information, managers can:
    - compare costs with known or assumed benefits of activities, identify value-added and non-value added activities, and make decisions to reduce resources devoted to activities that are not cost effective;
    - compare cost changes over time, identify their causes and take any appropriate action, e.g., take steps to improve efficiency;
    - identify and reduce excess capacity costs; and
    - compare costs with similar "benchmark" activities, find the causes for cost differences, and take any appropriate action, e.g., revise and improve business processes.
- But governments do not usually have profitability and return on investment objectives for their governmental activities. They lack these economic incentives to manage costs. Government managers must take the initiative to analyze cost behaviour and then, after careful

consideration of all the consequences, take appropriate action. Unless initiative is taken by government managers to analyze cost behaviour, inefficiencies may emerge, continue, and grow for a long time before the need for action becomes obvious.

SETTING PRICES, FEES AND INTER-UNIT REIMBURSEMENTS

- Cost is an important element of the decision-making process for setting prices and user fees for government-provided goods and services. Information about costs is relevant even when goods and services are provided at less than cost as a result of government policy decisions, or when prices and user fees are set on the basis of market prices. Cost is also frequently the basis for transfer pricing between government units. A number of governments have specific cost-related requirements for pricing.
- When governments are engaged in commercial type activities, private sector concepts of pricing may be relevant and, as a result, market prices may be a more determining factor than cost recovery. For example, in the United States, unless otherwise specified by law, regulations require that prices charged to the public for government goods and services be based on market prices or the full costs incurred by the government. Nevertheless, determining costs remains important in these circumstances.
- Canada has an initiative for cost recovery with respect to certain government goods and services provided to external users. This initiative is to give departments the impetus to maximize cost recovery where appropriate and to change attitudes and processes to meet higher cost-recovery expectations. Canada suggests that full cost is a good starting point for determining user fees.
- New Zealand has expanded the concept of pricing services to all activities of the government, whether sold, transferred between government units or distributed free to the general public. All outputs are costed and the costs of those distributed free to the public represent the prices Ministers pay departments and agencies for the production of goods and services.
- The United Kingdom encourages charging for services supplied between departments unless it is clear that the likely benefits would not justify the cost. The expected benefit from internal charging for support services is improvement in the “value for money” from exercising greater cost discipline upon the suppliers of services and their internal customers.

PERFORMANCE MEASUREMENT

- Some governments, such as the United States, are showing increasing interest in performance measures. Other governments, such as the United Kingdom, have established systems for reporting this information. Performance measurement includes both financial and non-financial measures and is generally more effective when these measures are interrelated. But cost itself can be a measure of financial performance.

- When cost is combined with an effectiveness measure, it can show cost-effectiveness. Thus, the service efforts and accomplishments of an entity can be evaluated with the following measures:
  - Measures of service efforts — these are resource costs and other measures of the inputs used to provide the services.
  - Measures of accomplishments — these are outputs (the services provided) and outcomes (the effects of those services).
  - Measures that relate efforts to accomplishments — these are, for example, the cost per unit of the various outputs of the entity.
- Performance measurement can be viewed as the government equivalent of private sector profitability measurements. However, selecting appropriate measurements is quite difficult and requires the exercise of judgment. While outcomes may be far more difficult to define and measure than either outputs or inputs, outcomes of government programs and activities provide the ultimate measurement of their success. Measuring outcomes is difficult because the effects may be difficult to determine and those that can be observed often represent a blend of effects from government outputs, other interventions (e.g., regulations) and non-government factors.
- While it is possible to allocate input costs to outputs, it is very much more difficult, if not impossible, to allocate the cost of outputs to outcomes in a rational way. For example, it is possible to calculate the cost of an output like surgical intervention, but it is not clear how this cost could be assigned to the different outcomes which should result, such as improved quality of life, enhanced longevity, reduced cost of medication. In some cases, the outcome might also not be known for a considerable period of time.

PROGRAM EVALUATIONS

- The cost of government programs, when combined with appropriate performance measurements and reported publicly, can help the public and legislators to evaluate the programs.
- Whether or not reported publicly, the cost of programs is a factor in making policy decisions related to program authorization, modification and discontinuation. Many countries use information on program costs as a basis for cost-benefit considerations. For example, Canada fosters the use of cost-benefit analysis by individual departments to improve the efficient allocation of resources among competing government programs.

- When considering costs in program evaluation, some consideration should be given to any collateral costs of the programs, as well as the government's own incurred costs. National governments may use laws and regulations to require local governments, private sector businesses and other non-governmental entities to take specific actions to further government programs. These actions often result in both pecuniary and non-pecuniary costs to these entities. Also, the programs themselves may have unforeseen costs to the non-Government sector which are not reflected in the outcomes or other performance measurements of those programs. Or governments may use "tax expenditures", e.g., reductions in the tax base or the tax itself, to induce taxpayers to take actions to further program objectives. Although difficult to measure, governments should be aware of the possible magnitude of any such collateral costs and give them consideration in program evaluations.

ECONOMIC CHOICE DECISIONS

- Making choices among alternative actions, such as whether to do a project internally or contract it out, requires cost comparisons between alternatives. Privatization decisions may involve comparing the incremental net cost or profit of continuing a government activity with the economic and other benefits of placing it in private hands. Cost studies of various types can help to decide whether to accept or reject a proposal for a government capital project, to continue or drop a government product or service, or to contract with a private sector vendor.

HOW WIDELY IS COST ACCOUNTING USED?

- The extent to which cost accounting is used within governments varies from country to country. Usage frequently depends upon the objectives of the various types of government organizations. State-owned enterprises organized for profit generally employ some form of cost accounting. Public utilities are an example of this type of organization. Non-profit revolving funds, whose objective is to maintain capital through sales of goods and services, rather than through appropriations, frequently employ cost accounting. Internal inventory and service funds which provide goods and services to general fund organizations are examples of this type of organization.

- By comparison, relatively infrequent use of cost accounting systems is found in governmental organizations that provide goods and services to the general public without charge. Of those governmental organizations that have not utilized cost accounting, the requirement for some form of performance evaluation or the recognized need to promote management efficiency and effectiveness often results in the adoption of cost accounting. In countries where these factors are important, there is generally more widespread use of cost accounting within government. Well-managed governments are turning to cost accounting as an essential component of the management of their activities.

- Some reasons still cited for not using cost accounting include the following:
  - All citizens are served by the government without charge and the goods and services provided are essentially governmental functions.
  - Many costs cannot be reliably calculated, e.g., natural resources.
  - Criteria for meaningful performance evaluation are lacking even if costs are known.
  - Government programs and projects are politically driven and cost is irrelevant or secondary.
  - Government budgets are on a cash basis and control of budgetary funds, not costs, is the only or primary interest of legislators.
- While these arguments continue to be made, a number of countries are moving to more widespread adoption of cost accounting. This move has been motivated by the need to deal with increasing debt levels and shrinking budgets and by related public criticism of government management. This increasing use of cost accounting is sometimes combined with the adoption of improvements in accrual accounting and the adoption of cost-based budgeting. For example, in Taiwan, the development of cost accounting was linked to better mid-term and long-term budget planning.
- In Malaysia, cost accounting is an essential part of its “value for money” concept of Government management. The “value for money” concept has been in use for some time in the United Kingdom, but recent steps to adopt cost-based budgeting will likely improve its cost accounting systems.
- In Canada, fiscal pressures resulted in an emphasis on “stretching the tax dollar” and led to the issuance of guides on how to deliver services and to “make or buy” in a more economical or efficient manner. Cost accounting on a full-cost basis is recognized by Canada as essential to these initiatives.
- In New Zealand, fiscal exigencies led to the adoption of full accrual accounting as the basis for Government financial management and also to related initiatives for the development of cost accounting as a management tool. These related initiatives were the adoption of cost recovery or charging policies where goods and services are provided to identified consumers, and the corollary requirement to determine the cost of all government outputs in order to facilitate management control and accountability.

- Although improvements in cost accounting have come about as a result of recognition by Government managers that improvements in customary accounting and management practices were needed, many times these improvements are led by new laws adopted by the legislature and new policies adopted by the top management of government. The United States is a case in point. Until recently, cost accounting has been limited in use by United States general fund organizations. Despite the fact that the United States continues to budget largely on a cash basis, cost accounting is now beginning to be implemented across the government. This is the result of several pieces of legislation and related actions by the executive branch of government starting with the passage of the United States Chief Financial Officers (CFO) Act in 1990.
- In 1995, the United States published the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as recommended by the Federal Accounting Standards Advisory Board. This requires federal entities to accumulate full cost information. The reporting of full costs is required in the SFFAS No. 7, *Accounting for Revenue and Other Financial Sources*.
- The Federal Financial Management Improvement Act of 1996 added the force of law to these accounting standards and also to any systems requirements established by the U.S. Joint Financial Management Improvement Program (JFMIP). JFMIP issued cost accounting systems requirements for U.S. Government organizations in February 1997.

POSSIBLE CAUSES OF INCREASED USE OF COST ACCOUNTING

- Adoption of accrual accounting as the basis for budgeting and management information, following the examples of New Zealand, the United Kingdom and Australia, will obviously trigger increased use of cost accounting and the development of supporting systems. Short of that, recognition of its need in “right sizing”, eliminating inefficiencies and privatization will also spur increased use and related systems development. Managers of government programs, if they are informed of the managerial advantages, will likely provide impetus for increased use. Program managers can improve operational performance from three perspectives — quality/productivity, cycle time, and cost. If cost is brought into the managerial decision-making processes along with these other measures in a balanced fashion, then better decisions can be made.
- Because government decision-making is subject to a number of political pressures, how reported performance measures are viewed by users of those measures will affect the pace at which cost accounting is adopted. Relating costs and the outputs of government programs is not in principle more difficult than costing products or services in the

private sector. This step alone has provided legislators and Government officials with decision-relevant information. It has also provided the general public with information about the efficiency of government. However, measuring the outcomes of government programs and establishing the linkage with all costs is significantly more difficult than measuring the government's incurred cost of outputs. While a number of governments are trying to do this, there is still much to be learned. If and when governments succeed in measuring outcomes satisfactorily, cost accounting will become even more important than it is today.

PROGRESSIVE IMPLEMENTATION OF COST ACCOUNTING

- Some countries may wish to move relatively quickly to implement an approach to cost accounting which meets all their known needs for cost information. But other countries may wish to move more slowly toward obtaining cost information that satisfies their needs, and they may define their initial needs modestly.
- Implementation of cost accounting can be done on a step-by-step basis. The following describes some of the many different situations that may be faced by governments, and some of the possible steps governments might wish to consider in moving progressively to implement cost accounting.
    - Governments on the cash basis of accounting can develop useful cash basis information and, at the same time, learn about the processes of cost accounting by using those processes to obtain information about expenditures that their cash basis records do not ordinarily provide. For example, the cost accounting processes described in Chapter 3 can be used to calculate amounts spent indirectly on behalf of the beneficiaries of particular government programs.
    - Governments on the cash basis may also develop approximate cost information through cost studies based on the expenditure information in their records and estimates of the effects of asset recognition and consumption. This approach is more likely to be satisfactory when inventories are not significant. Cost studies of this sort may also help cash basis governments learn about the nature and extent of their need for full cost information.
    - Governments on the cash basis may also implement a stand-alone cost system while retaining, at least temporarily, a cash basis for financial accounting. Such stand-alone systems assign cost data drawn from operating systems and other reliable sources to cost objectives.
    - Governments on a modified accrual basis for financial accounting may find that a stand-alone cost accounting system is relatively

  easy to implement if they have asset registers that can be used to compute depreciation.

  - Governments on a full accrual basis of financial accounting should be able to develop useful managerial cost information through cost analysis of information in accounting records. In a few cases, these governments may decide that their need for regular, periodic cost information is not extensive and, therefore, that no cost system is required. In other cases, these governments may decide to use cost analysis for a period of time while they evaluate the kind of system they want to implement.
  - Governments whose accrual accounting financial systems do not reflect all possible elements of full cost, e.g., interest on capital employed, may develop cost systems based on full costs and reconcile the results with the financial accounting records. Alternatively, they may develop a cost system based only on the cost data in their financial accounting records and either try to deal with unrecognized costs in some other fashion or add the missing full-cost elements to their cost system later.
  - No matter what the basis of financial accounting, countries that implement a cost system may choose to satisfy a set of limited cost information needs initially and expand the system later as they gain knowledge of their exact requirements and the likely costs of gathering the additional data required for a more comprehensive system. For example, a government might choose to implement a basic cost accounting system for all of its operating units so as to obtain needed government-wide information in a relatively short period of time. After that was accomplished, it might then encourage its individual units to expand and modify the basic government-wide system to satisfy their special needs and circumstances.

- Whether to move quickly or progressively to implement cost accounting obviously depends on the particular circumstances of the government.

CONCLUSION

- Cost accounting has a number of important uses in the efficient and effective management of government. It is a valuable tool for the management of general fund organizations as well as for commercial type activities. But the measurement difficulties associated with some of its applications should be recognized. The use of cost accounting is likely to become even more widespread than it is today as more successes are reported and the use of accrual accounting spreads. In appraising how to improve the quality of available information, governments should consider the advantages of using cost accounting for management purposes in addition to the advantages of accrual accounting for financial reporting. There are a number of approaches that governments in different circumstances can adopt to move progressively to implement cost accounting.

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CHAPTER-17: COMPANIES BILL, 2008

17.1 The new Companies Bill, 2008 introduced in Parliament on 23rd October, 2008 has proposed the following provisions with respect to the maintenance of cost accounting records and cost audit in the corporate sector.

Section 131: Central Government to specify audit of items of cost in respect of certain companies

(1) Notwithstanding anything contained in this Chapter, the Central Government may, by order, in respect of such class of companies engaged in the production, processing, manufacturing, mining or infrastructural activities, as may be specified therein, direct that particulars relating to the utilization of material or labour or to such other items of costs as may be prescribed shall also be included in the books of account kept by such class of companies:

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

(2) If the Central Government is of the opinion, in relation to any company covered by an order under sub-section (1), that it is necessary to do so, it may, by order, direct that the audit of cost records of such company shall be conducted in the manner specified therein.

(3) Where a company includes the particulars relating to items of costs in the books of account, in pursuance of a resolution passed by the company, the audit of cost records as contained in the books of account of the company 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 123 as an auditor of the company shall be appointed for conducting the audit of cost records.

(4) An audit conducted under this section shall be in addition to the audit conducted under section 126.

(5) The qualifications, disqualifications, rights, duties and obligations applicable to auditing companies 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 Director 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 and every reservation or qualification contained therein.

(7) If, after considering the cost audit report referred to under this section and the information and explanations furnished by the company under sub-section (6), the Central Government is of 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) Where any default is made in complying with the provisions of this section,-

(a) the company and every officer who is in default shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

(b) the cost auditor who is in default shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

Analysis of the proposed Provisions

17.2 In sub-section (1), the word "infrastructure" has been added to the existing "class of companies" engaged in production, processing, manufacturing or mining activities. This term has no where been defined in the entire Bill. This has been defined by various statutes/authorities/commissions/committees in different ways. The Secretariat for Committee on Infrastructure in the Planning Commission has prepared a compilation, a copy of which is available in Annexure-XXIV. Based on the information contained in this compilation, there is need to give a clear definition of the term "infrastructure" in the proposed Bill.

17.3 In sub-section (2), the qualifications of the cost auditor have not been specified though sub-section (3) provides that a cost audit under this sub-clause shall be conducted by a cost accountant.

17.4 It appears from the construction of sub-section (3) that the intention is to provide for voluntary maintenance of cost records by any company, and in such case it has been made mandatory that the audit of such cost records be conducted by a cost accountant. However, the same intention is not reflected in the construction of sub-section (2) where the audit of cost records for any company is left to be ordered by the Central Government.

17.5 From the reading of sub-section (3), it is not clear as to whether this sub-section will operate only in case of such class of companies which are exempted by the Central Government from maintenance of cost accounting records or any company falling under the purview of sub-section (1) may also switch over to this voluntary option.

17.6 It is also not clear from a reading of sub-section (3) that once a system of maintenance of cost accounting records and cost audit has been adopted by a company, it remains in perpetuity as would be the case in companies falling under the purview of sub-sections (1) and (2).

17.7 Sub-section (3) provides for audit of cost accounts in companies maintaining cost accounting records pursuant to a resolution passed by the company. This provision for cost audit may remain inoperative until a proviso is added to sub-section (1) allowing companies to maintain cost accounting records in pursuance to a resolution passed by them.

17.8 Further, in sub-section (3) it has been provided that the cost auditor shall be appointed by the Board on such remuneration as may be determined by the members in such manner as may be prescribed. From the reading of this provision, following issues have been observed:

(a) The mode of appointment of a cost auditor as specified under sub-section (3) has not been specified under sub-section (2).

(b) Since the shareholders are to decide conduct of cost audit through a resolution passed by them, therefore, the appointment of cost auditors by the Board runs contrary to the powers of the shareholders.

(c) It is not clear as to the term “members” mean members of the company or members of the Board. It is noted that “members” in the context of the Companies Act always means the shareholders of the company.

(d) While under sub-section (3) it has been provided that the manner of fixation of remuneration of the cost auditor shall be prescribed by the Central Government, no such provision exists for the cost auditor appointed under sub-section (2).

17.9 Sub-section (6) provides that the company shall furnish a copy of the cost audit report to the Central Government, prepared in pursuance of a direction under sub-section (2). No such provision exists for submission of such report to the Government in case of companies coming under the purview of sub-section (3). Further, no mechanism has been built in to know such companies complying with sub-section (3).

17.10 Even though the proposed Bill provides specifically for appointment of a firm of Chartered Accountants as auditor of a company as per the provisions of Section 124(2), no such provision has been made in case of a firm of Cost Accountants appointed as cost auditors.

17.11 Reference to section 126 in sub-section (4) need to be replaced with section 124.

Observations/Recommendations of the Expert Group

17.12 The Expert Group noted that the provisions contained in the proposed Companies Bill, 2008 are not entirely in conformity with the various recommendations made in this Report. The modified structure/framework recommended by the Expert Group, if accepted, would entail restructuring of the proposed provisions. These are briefly enumerated in the ensuing paragraphs.

17.13 The Expert Group has recommended widening the scope of maintenance of cost accounting records and cost audit framework to all companies (except certain exempted categories) in a phased manner. Accordingly, it is not necessary for the Central Government to restrict its enabling powers under sub-section (1) by restricting the same to “class of companies” engaged in only production, processing, manufacturing, mining or infrastructure activities. Therefore, the Expert Group suggests that the provisions under sub-section (1) should not contain the words “engaged in production, processing, manufacturing, mining or infrastructure activities” and under the modified provisions of sub-section (1), the Central Government would be free to decide prescribing maintenance of cost accounting records in any “class of companies” as the situation prevailing in the economy.

17.14 Alternatively, as in the case of maintenance of financial records, the Central Government may seek an enabling power to exempt any company or class of companies from the maintenance of cost accounting records and widen the scope of sub-section (1) to all class of companies.

17.15 The Expert Group has recommended shifting maintenance of cost accounting records from a rule based mechanism to a principle based mechanism based on the cost accounting standards issued by ICWAI. The proposed provisions of the Bill need suitable modification to incorporate adherence to cost accounting standards by all companies maintaining cost accounting records, either under sub-section (1) or under sub-section (3).

17.16 The Expert Group has recommended that once a company falls within the purview of maintenance of cost accounting records, it should submit either a compliance report (in case of medium sized companies) or submit a cost audit report to the Central Government. Accordingly, the proposed provisions under sub-section (2) would require modifications by making it obligatory for all such companies covered under sub-section (1) to get their cost records audited by a cost accountant and submit the report to the Central Government as specified in sub-section (6). There would be a necessity to add a proviso to sub-section (2) to enable medium sized companies to file only a compliance report in such manner as may be prescribed.

17.17 In line with the recommendations made by the Expert Group, it is necessary to make a suitable provision in the Bill to disclose the particulars of cost auditors in the Board of Directors Report.

17.18 In view of the recommendations made above, the provisions of sub-section (3) would not be required.

17.19 Other modifications in the proposed provisions would be required in line with the analysis made above.

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Annexure-I
Copy

F. No. 2/1/2008-CL.V
GOVERNMENT OF INDIA
MINISTRY OF CORPORATE AFFAIRS
*****

5th Floor, Shastri Bhawan,
Dr.R.P. Road, New Delhi-110001
Dated the 21st January 2008

ORDER

Subject: Constitution of Expert Group to review the existing Cost Accounting Standards and Cost Audit Report Rules.

It is imperative that in the present economic environment, determined by increasing competition both domestically and internationally, efficiency and economy be brought about in the operations of the manufacturing sector to catalyze and facilitate the cost competitiveness of the manufacturing sector in India. It is equally necessary to enable the industry to address issues arising from unfair trade practices such as dumping, subsidies & cartels, etc. in the International Trade.

2. Cost accounting, through the determination and allocation of costs to various products, provides a valuable service to the managements of companies in cost analysis and control. In this way, it can help to improve efficiency in the use of materials, labour and plant, maximize production and realize greater profits. At the same time, cost analysis furnishes useful information in respect of important matters such as gross margin, differential costs, replacement costs, etc. Cost analysis can be useful to the Regulators of public utilities and provide a basis for comparing claims and assessing the validity of issues arising out of international trade.

3. To enable development of relevant cost accounting methodologies and standards to increase the competitiveness of the Indian manufacturing sector and to advise the Government on suitable measures for the same, a Group of Experts is constituted comprising the following:

1	Shri B.B.Goyal, Adviser (Cost), Ministry of Corporate Affairs	Chairman
2	Shri P. Murugesan, General Manager, Maruti Udyog Limited, Gurgaon representing Confederation of Indian Industry	Member
3	Shri Lalit Bhasin, Chairman, Corporate Affairs Committee, representing the PHD Chamber of Commerce and Industry and The Federation of Indian Chambers of Commerce &	Member

	Industry	
4	Shri S.C.Aggrawal, Chairman & Managing Director, SMC Global Securities Limited, New Delhi representing The Associated Chambers of Commerce and Industry of India	Member
5	Shri Amarjit Chopra, Chairman, Accounting Standards Board, Institute of Chartered Accountants of India, representing ICAI	Member
6	Shri Chandra Wadhwa, President, Institute of Cost & Works Accountants of India representing ICWAI	Member
7	Shri M. Gopalakrishnan, Chairman, Cost Accounting Standards Board, ICWAI	Member
8	Shri Ravindra Mathur, Director (Cost), Cost Audit Branch, Ministry of Corporate Affairs	Member Secretary

4. The Group shall undertake the following tasks:-

(i) Review the Cost Accounting Record Rules and their continued relevance in the contemporary competitive environment as per the presently prescribed structure / format, and make recommendations for requisite modifications and / or alternative structures;

(ii) Review the existing Cost Audit Report Rules and formats prescribed therein, and recommend appropriate modifications to make them more relevant to the needs of different stakeholders including company management, shareholders, regulators, etc;

(iii) Review the existing system with a view to make suggestions for addressing the concerns of the industry with regard to confidentiality of company cost data and cost of compliance;

(iv) Review and, if required, give suggestions for redrafting the existing Cost Accounting Standards in the Indian context in light of international best practices, and to align them with the international cost accounting standards issued by International Federation of Accountants (IFAC).

5. The Group may complete its task latest by 30th September, 2008. Interim reports may be submitted by the Group at its discretion.

6. The Group may invite any other expert or representative of any trade or industry association as special invitee, and take up such other consultations as may be considered necessary.

Sd/-
(Diwan Chand)
Director (Inspection & Investigation)

Copy to:

1. Shri B.B.Goyal, Adviser (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.
2. Shri P. Murugesan, General Manager, Maruti Udyog Limited, Palam Gurgaon Road, Gurgaon-122015.
3. Shri Lalit Bhasin, Bhasin & Co., Advocates, 10, Hailey Road, 10th Floor, New Delhi-110001.
4. Shri S.C.Aggrawal, Chairman & Managing Director, SMC Global Securities Limited, 17, Netaji Subhash Marg, Daryaganj, New Delhi-110002.
5. Shri Amarjit Chopra, M/s GSA Associates, 8/28, 3rd Floor, W.E.A., Abdul Azad Marg, Karol Bagh, New Delhi-110005.
6. Shri Chandra Wadhwa, 705, 2nd Floor, Double Story, New Rajendra Nagar, New Delhi-110060.
7. Shri M. Gopalakrishnan,No. 1, Lakshminivas, 3rd Street, K.V. Colony, West Mambalam, Chennai-600033.
8. Shri Ravindra Mathur, Director (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.

Copy also to:

1. Dr. Ashok Haldia, Secretary, Institute of Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, Post Box. No. 7100, New Delhi-110002 with reference to his letter no. M-526/40/2007 dated 10th July 2007.
2. Shri Chandra Wadhwa, President, Institute of Cost & Works Accountants of India, 12, Sudder Street, Kolkata-700016 with reference to his letter no. Pres/06/2007 dated 27th June 2007.
3. Shri Rajesh Menon, Senior Director, Confederation of Indian Industry, The Mantosh Sondhi Centre, 23, Institutional Area, Lodi Road, New Delhi-110003 with reference to his letter dated 16th July 2007.
4. Ms. Jyoti Vij, Additional Director, Federation of Indian Chambers of Commerce & Industry, Federation House, Tansen Marg, New Delhi-110001 with reference to her letter dated 18th July 2007.
5. Shri D.S.Rawat, Secretary General, The Associated Chambers of Commerce & Industry of India, ASSOCHAM Corporate Office, 1, Community Centre, Zamrudpur, Kailash Colony, New Delhi-110 048 with reference to his letter dated 5th July 2007.
6. Shri Sanjay Bhatia, President, PHD Chamber of Commerce & Industry, PHD House, 4/2, Siri Institutional Area, August Kranti Marg, New Delhi-110016 with reference to his letter no. Comm-4-2057 dated 7th July 2007.

Copy for information to:

Senior PPS to Secretary/JS (K)/JS (M)/DII (DC)/Dir. (JS)

Annexure-II
Copy

F. No. 2/1/2008-CL.V
GOVERNMENT OF INDIA
MINISTRY OF CORPORATE AFFAIRS
*****

5th Floor, Shastri Bhawan,
Dr.R.P. Road, New Delhi-110001
Dated the 19th February 2008

ORDER

Subject: Constitution of Expert Group to review the existing Cost Accounting Standards and Cost Audit Report Rules.

With reference to this Ministry's Order of even number dated 21.01.2008 constituting the above mentioned Expert Committee, I am directed to state that Shri Vinod Jain, Chairman of the Committee on Management Accounting is included as member of subject cited Expert Committee, as representative of ICAI in place of Shri Amarjit Chopra, Chairman, Accounting Standards Board.

Sd/-
(Diwan Chand)
Director (Inspection & Investigation)
Tele: 2338 4502

Copy to:

1. Shri B.B.Goyal, Adviser (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.
2. Shri P. Murugesan, General Manager, Maruti Udyog Limited, Palam Gurgaon Road, Gurgaon-122015.
3. Shri Lalit Bhasin, Bhasin & Co., Advocates, 10, Hailey Road, 10th Floor, New Delhi-110001.
4. Shri S.C.Aggrawal, Chairman & Managing Director, SMC Global Securities Limited, 17, Netaji Subhash Marg, Daryaganj, New Delhi-110002.
5. Shri Amarjit Chopra, M/s GSA Associates, 8/28, 3rd Floor, W.E.A., Abdul Azad Marg, Karol Bagh, New Delhi-110005.
6. Shri Vinod Jain, 4696, Brij Bhawan, 21-A, Ansari Road, Daryaganj, New Delhi-110002.
7. Shri Chandra Wadhwa, 705, 2nd Floor, Double Story, New Rajendra Nagar, New Delhi-110060.
8. Shri M. Gopalakrishnan,No. 1, Lakshminivas, 3rd Street, K.V. Colony, West Mambalam, Chennai-600033.

9. Shri Ravindra Mathur, Director (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.

Copy also to:

1. Dr. Ashok Haldia, Secretary, Institute of Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, Post Box. No. 7100, New Delhi-110002 with reference to his letter no. M-526/40/2007 dated 10th July 2007.
2. Shri Chandra Wadhwa, President, Institute of Cost & Works Accountants of India, 12, Sudder Street, Kolkata-700016 with reference to his letter no. Pres/06/2007 dated 27th June 2007.
3. Shri Rajesh Menon, Senior Director, Confederation of Indian Industry, The Mantosh Sondhi Centre, 23, Institutional Area, Lodi Road, New Delhi-110003 with reference to his letter dated 16th July 2007.
4. Ms. Jyoti Vij, Additional Director, Federation of Indian Chambers of Commerce & Industry, Federation House, Tansen Marg, New Delhi-110001 with reference to her letter dated 18th July 2007.
5. Shri D.S.Rawat, Secretary General, The Associated Chambers of Commerce & Industry of India, ASSOCHAM Corporate Office, 1, Community Centre, Zamrudpur, Kailash Colony, New Delhi-110 048 with reference to his letter dated 5th July 2007.
6. Shri Sanjay Bhatia, President, PHD Chamber of Commerce & Industry, PHD House, 4/2, Siri Institutional Area, August Kranti Marg, New Delhi-110016 with reference to his letter no. Comm-4-2057 dated 7th July 2007.

Copy for information to:

Senior PPS to Secretary/JS (K)/JS (M)/DII (DC)/Dir. (JS)

Annexure-III
Copy

F. No. 2/1/2008-CL.V
GOVERNMENT OF INDIA
MINISTRY OF CORPORATE AFFAIRS

* * * * *

5th Floor, Shastri Bhawan,
Dr.R.P. Road, New Delhi-110001
Dated the 15th May 2008

ORDER

Subject: Constitution of Expert Group to review the existing Cost Accounting Standards and Cost Audit Report Rules.

With reference to this Ministry's Order of even number dated 21.01.2008 and 19.02.2008 constituting the above mentioned Expert Committee, I am directed to state that Shri G.G.Mitra, Joint Director (Cost) is included as Member Secretary of subject cited Expert Committee, as representative of Cost Audit Branch, Ministry of Corporate Affairs in place of Shri Ravindra Mathur, Director (Cost), Cost Audit Branch, Ministry of Corporate Affairs.

Sd/-
(Diwan Chand)
Director (Inspection & Investigation)
Tele: 2338 4502

Copy to:

1. Shri B.B.Goyal, Adviser (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.
2. Shri P. Murugesan, General Manager, Maruti Udyog Limited, Palam Gurgaon Road, Gurgaon-122015.
3. Shri Lalit Bhasin, Bhasin & Co., Advocates, 10, Hailey Road, 10th Floor, New Delhi-110001.
4. Shri S.C.Aggrawal, Chairman & Managing Director, SMC Global Securities Limited, 17, Netaji Subhash Marg, Daryaganj, New Delhi-110002.
5. Shri Vinod Jain, 4696, Brij Bhawan, 21-A, Ansari Road, Daryaganj, New Delhi-110002.
6. Shri Chandra Wadhwa, 705, 2nd Floor, Double Story, New Rajendra Nagar, New Delhi-110060.
7. Shri M. Gopalakrishnan,No. 1, Lakshminivas, 3rd Street, K.V. Colony, West Mambalam, Chennai-600033.
8. Shri Ravindra Mathur, Director (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.

9. Shri G.G.Mitra, Joint Director (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.

Copy also to:

1. Dr. Ashok Haldia, Secretary, Institute of Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, Post Box. No. 7100, New Delhi-110002 with reference to his letter no. M-526/40/2007 dated 10th July 2007.
2. Shri Chandra Wadhwa, President, Institute of Cost & Works Accountants of India, 12, Sudder Street, Kolkata-700016 with reference to his letter no. Pres/06/2007 dated 27th June 2007.
3. Shri Rajesh Menon, Senior Director, Confederation of Indian Industry, The Mantosh Sondhi Centre, 23, Institutional Area, Lodi Road, New Delhi-110003 with reference to his letter dated 16th July 2007.
4. Ms. Jyoti Vij, Additional Director, Federation of Indian Chambers of Commerce & Industry, Federation House, Tansen Marg, New Delhi-110001 with reference to her letter dated 18th July 2007.
5. Shri D.S.Rawat, Secretary General, The Associated Chambers of Commerce & Industry of India, ASSOCHAM Corporate Office, 1, Community Centre, Zamrudpur, Kailash Colony, New Delhi-110 048 with reference to his letter dated 5th July 2007.
6. Shri Sanjay Bhatia, President, PHD Chamber of Commerce & Industry, PHD House, 4/2, Siri Institutional Area, August Kranti Marg, New Delhi-110016 with reference to his letter no. Comm-4-2057 dated 7th July 2007.

Copy for information to:

Senior PPS to Secretary/JS (K)/JS (M)/DII (DC)/Dir. (JS)

Annexure-IV
Copy

F. No. 2/1/2008-CL.V
GOVERNMENT OF INDIA
MINISTRY OF CORPORATE AFFAIRS
*****

Shastri Bhawan, New Delhi
Dated the 3rd October 2008

ORDER

Subject: Constitution of Expert Group to review the existing Cost Accounting Standards and Cost Audit Report Rules.

With reference to this Ministry's Order of even number dated 21.01.2008, 19.02.2008 and 15.05.2008, the period for submission of the report by the above mentioned Committee to the Ministry of Corporate Affairs is extended by a period of three months till 31.12.2008.

Sd/-
(Diwan Chand)
Director (Inspection & Investigation)
Tele: 2338 4502

Copy to:

1. Shri B.B.Goyal, Adviser (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.
2. Shri P. Murugesan, General Manager, Maruti Udyog Limited, Palam Gurgaon Road, Gurgaon-122015.
3. Shri Lalit Bhasin, Bhasin & Co., Advocates, 10, Hailey Road, 10th Floor, New Delhi-110001.
4. Shri S.C.Aggrawal, Chairman & Managing Director, SMC Global Securities Limited, 17, Netaji Subhash Marg, Daryaganj, New Delhi-110002.
5. Shri Vinod Jain, 4696, Brij Bhawan, 21-A, Ansari Road, Daryaganj, New Delhi-110002.
6. Shri Chandra Wadhwa, 705, 2nd Floor, Double Story, New Rajendra Nagar, New Delhi-110060.
7. Shri M. Gopalakrishnan,No. 1, Lakshminivas, 3rd Street, K.V. Colony, West Mambalam, Chennai-600033.
8. Shri G.G.Mitra, Joint Director (Cost), Cost Audit Branch, MCA, Bikaner House Hutments No. IV, Shahjahan Road, New Delhi-110011.

Copy also to:

1. Dr. Ashok Haldia, Secretary, Institute of Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, Post Box. No. 7100, New Delhi-110002 with reference to his letter no. M-526/40/2007 dated 10th July 2007.

2. Shri Chandra Wadhwa, President, Institute of Cost & Works Accountants of India, 12, Sudder Street, Kolkata-700016 with reference to his letter no. Pres/06/2007 dated 27th June 2007.
3. Shri Rajesh Menon, Senior Director, Confederation of Indian Industry, The Mantosh Sondhi Centre, 23, Institutional Area, Lodi Road, New Delhi-110003 with reference to his letter dated 16th July 2007.
4. Ms. Jyoti Vij, Additional Director, Federation of Indian Chambers of Commerce & Industry, Federation House, Tansen Marg, New Delhi-110001 with reference to her letter dated 18th July 2007.
5. Shri D.S.Rawat, Secretary General, The Associated Chambers of Commerce & Industry of India, ASSOCHAM Corporate Office, 1, Community Centre, Zamrudpur, Kailash Colony, New Delhi-110 048 with reference to his letter dated 5th July 2007.
6. Shri Sanjay Bhatia, President, PHD Chamber of Commerce & Industry, PHD House, 4/2, Siri Institutional Area, August Kranti Marg, New Delhi-110016 with reference to his letter no. Comm-4-2057 dated 7th July 2007.

Copy for information to:

Senior PPS to Secretary/JS (K)/JS (M)/DII (DC)/Dir. (JS)

Section 209. BOOKS OF ACCOUNT TO BE KEPT BY COMPANY.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

*****

Annexure-VI

Section 233B. AUDIT OF COST ACCOUNTS IN CERTAIN CASES.

(1) Where in the opinion of the Central Government it is necessary so to do in relation to any company required under clause (d) of sub-section (1) of section 209 to include in its books of account the particulars referred to therein, the Central Government may, by order, direct that an audit of cost accounts of the company shall be conducted in such manner as may be specified in the order by an auditor who shall be a cost accountant within the meaning of the Cost and Works Accounts Act, 1959 (23 of 1959):

Provided that if Central Government is of opinion that sufficient number of cost accountants within the meaning of the Cost and Works Accountants Act, 1959, are not available for conducting the audit of the cost accounts of companies generally, that Government may, by notification in the Official Gazette direct that, for such period as may be specified in the said notification, such chartered accountant within the meaning of the Chartered Accountants Act, 1949, as possesses the prescribed qualifications, may also conduct the audit of the cost accounts of companies, and thereupon a chartered accountant possessing the prescribed qualifications may be appointed to audit the cost accounts of the company.

(2) The auditor under this section shall be appointed by the Board of Directors of the company in accordance with the provisions of sub-section (1B) of section 224 and with the previous approval of the Central Government:

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

(3) An audit conducted by an auditor under this section shall be in addition to an audit conducted by an auditor appointed under section 224.

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

(5)

(a) A person referred to in sub-section (3) or sub-section (4) of section 226 shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company.

(b) A person appointed, under section 224, as an auditor of a company, shall not be appointed or re-appointed for conducting the audit of the cost accounts of that company.

(c) If a person, appointed for conducting the audit of cost accounts of a company, becomes subject, after his appointment, to any of the disqualifications specified in clause (a) or clause (b) of this sub-section, he shall, on and from the date on which he becomes so subject, cease to conduct the audit of the cost accounts of the company.

(6) Upon receipt of an order under sub-section (1), it shall be the duty of the company to give all facilities and assistance to the person appointed for conducting the audit of the cost accounts of the company.

(7) The company shall, within thirty days from the date of receipt of a copy of the report referred to in sub-section (4), furnish the Central Government with full information and explanations on every reservation or qualification contained in such report.

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

(9) On receipt of the report referred to in sub-section (4) and the informations and explanations furnished by the company under sub-section (7) and sub-section (8), the Central Government may take such action on the report, in accordance with the provisions of this Act or any other law for the time being in force, as it may consider necessary.

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

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

*****

Annexure-VII

LIST OF INDUSTRIES AND THE PRODUCTS COVERED UNDER SECTION 209(1)(D) OF THE COMPANIES ACT, 1956

Sr.No.	Industry	Products	GSR NO. and Date	Effective from	Remarks
1	Cement	Cement, Clinker	536 (E) dt. 11.9.1997*	11.9.1997 *	The Rules,1997 notified in suppression of GSR 1402 dt. 12.9.66
2	Cycles	Cycles, component of cycles	311 dt. 2.3.1967	1.04.67	
3	Tyres & Tubes	Rubber tyres and tubes for all types of vehicles	1260 dt 10.8.1967	1.10.67	
4	Air-Conditioners	Air conditioning system or device by which air is controlled for the fulfillment of required condition of the confined space through controlling temperature, humidity, air purity and air motion for human comforts	1447 dt. 16.9.1967	1.10.67	Application clause and tile from 'Room-Airconditioners' to Air-conditioners' changed vide GSR 668(E) dt. 28.9.1999
5	Refrigerators	Refrigerators	1448 dt. 18.9.1967	1.10.67	
6	Batteries other than Dry Cell Batteries	Batteries of all types other than Dry Cell Batteries	1467 dt. 20.9.1967	1.01.68	Application clause and tile from 'Automobile Batteries' changed vide GSR 667(E) dt 28.7.1999.
7	Electric Lamps	Electric lamps of all types	1503 dt. 27.9.1967	1.01.68	Application clause changed vide GSR670(E) dt 28.9.1999
8	Electric Fan	Any type of electric fan	2298 dt. 15.9.1969	1.01.70	
9	Electric Motors	All types of electric motors	2574 dt. 24.10.1969	1.01.70	
10	Motor Vehicles	(a) All types of passenger cars, jeeps and station wagons (b) All types of commercial vehicles, delivery and pick up vans (c) Motor cycles, scooters, scooterettes & mopeds (d) Three-Wheeler Vehicles (e) All types of tractors (f) Heavy Earth Moving Equipments	537 (E) dt. 11.9.1997*	11.9.1997 *	The Rules, 1997 notified in suppression of GSR 1465 dt. 17.5.1969 No (e) added vide GSR 328(E) dt.3.6.1998.

					CAR (Tractors) Rules,1971 applicable before 1.4.1999 vide GSR 329(E) dt. 3.6.98 No.(f) added vide GSR 280(E) dt. 24.4.2001
11	Aluminum	1. Alumina 2. Aluminium 3. Aluminium ingots in any form or alloy 4.Aluminum rolled products including foil 5. Aluminum extruded products 6. Properzirod or Aluminum wire rod 7. Any other alluminium product or its alloy	334 dt. 25.2.1972	1.04.72	Application clause amended vide GSR NO 703(E) dt. 28.9.2001
12	Vanaspati	Refined vegetable oils and vegetable oil products as also Industrial Hard Oil.	1529 dt. 27.11.1972	1.01.73	Application clause amended vide GSR 287 dt. 29.5.1992
13	Bulk Drugs	Bulk Drugs under any system of medicine including Ayurvedic, Homeopathic,Siddha and Unani systems of medicine and Intermediates thereof	130(E) dt. 14.3.1974	1.04.74	Application clause amended vide GSR NO 707(E) dt. 28.9.2001
14	Sugar	Sugar by vacuum pan process and excludes jaggery and khandsari	388(E) dt. 15.7.1997*	15.7.1997 *	The Rules,1997 notified in suppression of GSR 982(E) 4.9.1974
15	Industrial Alcohol	1. Absolute Alcohol 2. Rectified spirit 3. Denatured and special denatured spirit 4. Power alcohol	532 (E) dt. 17.9.1997*	17.9.1997 *	The Rules,1997 notified in suppression of GSR 594(E) dated 30.12.1975
16	Jute Goods	Jute goods - Yarn, Twine, Fabrics or any other product made wholly from, or containing not less than 50 % by weight of, jute including bimlipattam jute or mesta fibres	590(E) dt. 29.12.1975	1.01.76	
17	Paper	Paper - used for printing, writing and wraping, newsprint, paperboard, and exercise note books	601(E) dt. 31.12.1975	1.01.76	
18	Rayon	1. Viscose staple fibre in all forms 2. Viscose filament yarn 3. Viscose tyre yarn / cord/ Fabric 4. 100% Viscose Yarn Fabric 5. Acetate yarn / fibre	606 dt. 20.4.1976	1.05.76	Application clause amended vide GSR 694 dt. 31.8.2000

		6. Rayon film (Cellophane Film)			
19	Dyes	Acid dyes, basic dyes, direct dyes, sulphur dyes, vat dyes, azoic dyes, ingrained dyes, metal complex dyes, disperse dyes, reactive dyes,oil dyes, and water soluble dyes	605 dt, 22.4.1976	1.05.76	
	Soda Ash	Soda Ash in all forms	1720 dt. 29.5.1976	1.06.76	These Rules are merged with CARR (Chemicals) vide GSR 562(E) dt. 2.9.2004
20	Polyester	1. Polyester fibre 2. Polyester filament yarn 3. Polyester Chips 4. Polyester Fibre Fill (PFF) 5. Partially Oriented Yarn (POY) 6. Processed Polyester yarn (texturised, twisted, dyed, crimped,etc.) 7. 100% Polyester fabric	126(E) dt. 24.3.1977	1.04.77	No (3) to (7) inserted vide GSR 692(E) dt. 31.8.2000
21	Nylon	1. Nylon chip 2. Nylon fibre 3. Nylon filament yarn 4. Nylon partially oriented yarn 5. Nylon tyre yarn or cord 6. Nylon tyre cord fabric 7. 100% Nylon fabrics	157(E) dt. 1.4.1977	1.04.77	Application clause amended vide GSR 695)E) dt. 31.8.2000
22	Textiles	Any art silk cloth, cloth, cotton yarn or cotton cloth, processed yarn and processed cloth, man-made fibre yarn or man made fibre cloth, silk yarn or silk cloth, wool, woolen yarn or woollen cloth, yarn or other textiles products.	417(E) dt. 28.6.1977	1.07.77	Application clause amended vide GSR 29(E) dated 19.1.1994
23	Dry Cell Batteries	All types of dry cell batteries & components thereof	45(E) dt. 31.1.1979	1.02.79	
24	Steel Tubes and Pipes	Steel Tubes & Pipes (including stainless steel) both black & galvanized	506(E) dt. 10.5.1984	26.05.84	
25	Engineering	1. Power driven pumps 2. Internal combustion engines 3. Diesel Engines 4. All type of automotive parts and accessories 5. Power Transformers 6. Electric generator 7. Machine tools	688 dt. 25.6.1984	7.07.84	No. 4 to 7 added GSR 279(E) dt. 24.4.2001
26	Electric Cables andConductors	(a) Power cables (All types- PILC, PVC, XLPE etc.) (b) VIR/Rubber covered cables & flexible wires of all types (c) PVC Insulated cables, flexible	767 dt. 7.7.1984	21.07.84	

		wires of all types including switchboard wires & cables (d) Enamelled covered wires & strips (e) Wire & strips covered with paper, glass, silk & any other types of insulating materials (f) AAC/ACSR Conductors (g) Telecommunication cables			
27	Bearings	Bearings of various types e.g. ball & roller bearings, needle bearing of various sizes	664 dt. 1.7.1985	13.07.85	
28	Milk Food	Infant Milk Food or Milk Food as malted milk food, energy food or food drink under any brand name (a) "Infant Milk Food" includes all types of milk food intended for the routine, complementary or supplementary food of infants and children up to the age of five years and other types of modified milk foods for infants which are intended for the feeding of infants and children during the treatment of gastro-intestinal disorders; (b) "Milk Food" means any food produced by mixing whole milk, partly skimmed milk or milk powder with ground barely malt or any other malted cereal grain, wheat flour or any other cereal flour or malt extract, with or without addition of flavouring agents and spices, edible common salt, sodium or potassium bicarbonate minerals and vitamins, cocoa powder, sugar or sweetening agents or other edible materials	704(E) dt.28.9.2001 *	29.9.2001 *	CAR (Infant Milk Food) Rules 1974 and CAR (Milk Food) Rules,1986 merged and application clause amended vide GSR 704(E) dt. 28.9.2001
29	Chemical	01. Acetic Acid 02. Acetic Anhydride 03. Acetone 04. Aluminium Fluoride 05. Aniline 06. Benzene 07. Boric Acid 08. Butadiene 09. Butanol 10. Calcium Carbide 11. Carbon Black 12. Caustic Soda 13. Chloro Methanes 14. Diacetone Alcohol 15. Diethylene Glycol 16. 2-Ethyl Hexanol 17. Ethylene	596 dt. 8.8.1987	8.08.87	Application clause amended vide GSR 562(E) dated 2nd September,2004

		18. Ethylene Dichloride 19. Ethylene Glycol 20. Ethylene Oxide 21. Formaldehyde 22. Isopropanol 23. Linear Alkyl Benzene 24. Maleic Anhydride 25. Methanol 26. Methyl Ethyl Ketone 27. Methyl Isobutyl Ketone (MIBK) 28. Nitrobenzene 29. Ortho Nitro Cholro Benzene 30. Para Nitro Chloro Benzene 31. Penta Erithritol 32. Phenol 33. Polyethylenes viz. LDPE, HDPE, LLDPE 34. Polypropylene 35. Polythylene Glycol 36. Propylene 37. Soda Ash 38. Sodium Tripoly Phosphate 39. Sulphuric Acid 40. Resins (excluding natural resins), Paints, Varnishes and Plastics 41. Synthetic Rubber 42. Titanium Dioxide 43. Toluene 44. Xylenes			
30	Formulations	All formulations under any system of medicine including Ayurvedic, Homeopathic, Siddha and Unani	452 dt. 22.4.1988	4.06.88	Applicability clause revised vide GSR 706(E) dt. 28.9.2001
31	Steel Plant	Steel & steel products , Steel products includes Ingot Steel, Blooms, Billets, Slabs (code as well as semi-finished); steel products produced by backward integration like Coal based Sponge Iron, Gas based hot briquetted Iron, steel products produced by forward integration like Beams, Angles, Tees, Sees, Channels, Pilings, Rails, Crane Rails, Joint Bars, Bare (Round Squares, Hexagonal, Octagonal, Flat, Triangular, Half Round); Wire, Wire Ropes, Nails, Wire Febrics, Plates, Pipes and Tubes, HR Coils/Sheets, CR Coils/Sheets	574 dt. 31.7.1990	8.09.90	'Steel Products' defined vide circular no. 52/378/CAB-86-(CLB) dt. 29.6.1992 The words 'Steel Plant' substituted for 'Mini Steel Plants' vide GSR 281(E) dt.24.4.2001
32	Insecticides	1. Insecticides 2. Fungicides 3. Redenticides 4. Nematicide 5. Weedicide 6. Plant growth Regulant	258 (E) dt. 3.3.1993	4.03.93	

		7. Herbicides 8. Fumigants 9. Bio- pesticides			
33	Fertilizers	1. Straight Nitrogenous Fertilizers 2. Straight Phosphatic Fertilizers 3. Straight Potassic Fertilizers 4. N. P. Fertilizers 5. N. P. K. Fertilizers 6. Micro Nutrients 7. Fortified Fertilzers	261(E) dt. 5.3.1993	5.03.93	
34	Soaps & Detergents	Cleansing material used for cleaning, laundry/ washing, bathing/toilet purposes and includes soaps and detergents (Whether in the form of cake, powder or liquid)	677(E) dt. 29.10.1993	29.10.93	
35	Cosmetics & Toiletries	Powders, Creams, Toothpastes, Toothpowders, Shaving Creams, After shave lotions, Shaving soaps, Shaving foams, Perfumes, Hair oils, Hair creams, Oxidation hair dyes, Mouthwash, Cologne, Shampoos-soap based, Shampoos-synthetics, detergent based, Room fresheners, Deodorants, Surfactants	678(E) dt. 29.10.1993	29.10.93	
36	Footwear	Shoes, boots, sandals, chappals, slippers, play shoes & moccasins	186(E) dt. 12.4.1996	12.04.96	
37	Shaving Systems	1. Shaving blades 2. Razors 3. Any part or component thereof 4. Any other shaving instrument	202(E) dt. 6.5.1996	6.05.96	
38	Industrial Gases	Oxygen Gas, Nitrogen Gas, Acetylene Gas, Hydrogen Gas, Nitrous oxide Gas, Argon Gas,Helium Gas, Carbon di-oxide Gas	271(E) dt. 9.7.1996	9.07.96	
39	Mining and Metallurgy	List of products (metals and non-metals,their minerals, ores and alloys) 1. Uranium 2. Thorium 3. Zirconium 4. Titanium 5. Lead 6. Copper 7. Zinc 8. Nickel 9. Cobalt 10.Chromium 11.Gallium 12.Germanium 13.Platinum 14 Molybdenum	276(E) dt. 24.4.2001	24.04.2001	
40	Electronic Products	1. All Consumer electronics such as television both black & white and colour, video cassette recorder,	277(E) dt. 24.4.2001	24.04.2001	

		video cassette player, audio compact disc player, video compact disc player, digital video compact disc player, radio receiver, tape recorder & combination, electronic watch and electronic clock, etc. 2. Industrial electronics including all control instrumentation and automation equipment. 3. Computer including personal computer, laptop, note book, server, workstations, supercomputers, data processing equipment and peripherals like monitors, keyboards, disk drivers, printers, digitizers, SMPs, modems, networking products and add-on cards. 4. Communication and broadcasting equipment including cable television equipment. 5. Strategic electronics and systems such as navigation and surveillance systems, radars, sonars, infra-red detection and ranging system, disaster management system, internal security system, etc. 6. Other electronic component and equipment such as picture tube, printed circuit board, etc.			
41	Electricity	Generation of electricity from :- (a) thermal power (b) gas turbine (c) hydro-electric power (d) atomic power (e) solar power (f) wind power(g) and other source of energy; (2) transmission and bulk supply of electricity (3) Distribution and bulk supply of electricity	G.S.R. No 913(E) dt. 21.12.2001	21.12.2001	
42	Plantation Product	1. Tea and tea products 2. Coffee and coffee products 3. Other commercial plantation products including seeds thereof	G.S.R. 685(E) dated 8th October,2002	8.10.2002	
43	Petroleum Industry	Manufacturing crude oil, gases (including compressed Natural Gas or Liquified Natural Gas and re-gasification thereof) or any other	G.S.R. 686(E) dated 8th October,	8.10.2002	

		petroleum products	2002		
44	Telecommunication	Processing of any one or more of the telecommunication activities namely:- (1) Basic telephony:- (a) Telephone access (b) Local call (c) Subscriber Trunk dialing (STD) (d) International subscriber dialing(ISD (2) Cellular mobile (3) Telex (4) Telegraphy (5) Voice mail/Audiotex service (6) Internet operations including gateway service/E-mail (7) Packet switched public data network(PSPDN) service (8) Wireless in local loop (WILL) service (9) Public mobile radio trunk service (10)Very small Aperture Terminal service (11)Global mobile personnel communication service (12)Leased circuits (13)Internet ports (14)National Long Distance Operator (15)Internet Telephony (16)Radio Paging (17)Any other telecommunication service fo			

EXTRAORDINARY

PART II-Section 3-Sub-section(i)

MINISTRY OF COMPANY AFFAIRS

NOTIFICATION

NEW DELHI, the 2nd September, 2004

G.S.R. 562(E). - In exercise of the powers conferred by sub-section (1) of section 642, read with clause (d) of sub-section (1) of section 209 of the Companies Act, 1956 (1 of 1956), and in supersession of the Cost Accounting Records (Caustic Soda) Rules, 1967, Cost Accounting Records (Soda Ash) Rules, 1976, Cost Accounting Records (Sulphuric Acid) Rules, 1980 and Cost Accounting Records (Chemical Industries) Rules, 1987, except as respects things done or omitted to be done before such supersession, the Central Government hereby makes the following rules, namely:-

(1) These rules may be called the Cost Accounting Records (Chemical Industry) Rules, 2004.

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

2. Application. - These rules shall apply to every company engaged in the production, processing or manufacture of products as specified in the Appendix to these rules :

Provided that these rules shall not apply to a company, -

(a) wherein, the aggregate value of machinery and plant installed as on the last date of the preceding financial year, does not exceed the limit as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951 (65 of 1951); and

(b) the aggregate value of the turnover made by the company from sale or supply of all its products or activities during the preceding financial year does not exceed ten crores of rupees.

3. Maintenance of records. – (1) Every company to which these rules apply shall, in respect of each of its financial year commencing on or after the commencement of these rules, keep proper books of accounts relating to utilisation of materials, labour and other items of cost in so far as they are applicable to any of the products referred to in rule 2. The books of account, so maintained, shall contain, *inter-alia*, the particulars specified in the Schedule annexed to these rules and proformae A, B, C and D prescribed in the said Schedule:

Provided that if the said company is manufacturing any other product(s) or is engaged in other activities in addition to product(s) referred to in rule 2, the particulars relating to utilisation of materials, labour and other items of cost in so far as they are applicable to such other products or activities shall not be included in the cost of the products referred to in rule 2.

(2) The books of accounts referred to in sub-rule (1) shall be kept on a regular basis in such a manner as to make it possible to calculate per unit cost of production and cost of sales of each product referred to in rule 2 for every financial year from the particulars entered therein. Every such book of account and the proformae prescribed in the said Schedule, shall be completed not later than ninety days from the close of the financial year of the company to which it relates.

(3) The statistical and other records shall be maintained in accordance with the provisions of the Schedule annexed to these rules and in line with Cost Accounting Standards issued by the Institute of Cost and Works Accountants of India, in so far as they are applicable, in such a manner as to enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in utilization of resources. These records shall also provide the necessary data which may be required to be furnished under Cost Audit Report Rules, 2001 as prescribed under section 233B of the Companies Act, 1956 and amended from time to time.

(4) It shall be the duty of every person, referred to in sub-section (6) and (7) of section 209 of the Companies Act, 1956 (1 of 1956), to take all reasonable steps to secure compliance by the company with the provisions of sub-rules (1), (2) and (3) of this rule in the same manner as he is liable to maintain accounts required under sub-section (1) of section 209 of the said Act.

4. Penalty. – If a company contravenes the provisions of rule 3, the company and every officer thereof who is in default, including the persons referred to in sub-rule (4) of rule 3 shall, be punishable as provided under sub-section (2) of section 642 read with sub-sections (5) and (7) of section 209 of the Companies Act, 1956 (1 of 1956).

5. Saving. - (1) The supersession of the Cost Accounting Records (Caustic Soda) Rules, 1967, Cost Accounting Records (Soda Ash) Rules, 1976, Cost Accounting Records (Sulphuric Acid) Rules, 1980 and Cost Accounting Records (Chemical Industries) Rules, 1987, shall not in any way affect –

a) any right, obligation or liability acquired, accrued or incurred thereunder ;
b) any penalty, forfeiture or punishment incurred in respect of any contravention committed thereunder ;
c) any investigation, legal proceeding or remedy in respect of any such right, privilege, obligation, liability, penalty, forfeiture or punishment as aforesaid, and; any such investigation, legal proceeding or remedy may be instituted, continued or enforced and any such penalty, forfeiture or punishment may be imposed as if those rules had not been superseded.

(2) Companies required to maintain records under Cost Accounting Records (Caustic Soda) Rules, 1967, Cost Accounting Records (Soda Ash) Rules, 1976, Cost Accounting Records (Sulphuric Acid) Rules, 1980 and Cost Accounting Records (Chemical Industries) Rules, 1987, shall continue to do

the same under the respective rules till the Cost Accounting Records (Chemical Industry) Rules, 2004 become applicable to them.

APPENDIX

(See rule 2)

List of products for which the rules shall apply:

01. Acetic Acid
02. Acetic Anhydride
03. Acetone
04. Aluminium Fluoride
05. Aniline
06. Benzene
07. Boric Acid
08. Butadiene
09. Butanol
10. Calcium Carbide
11. Carbon Black
12. Caustic Soda
13. Chloro Methanes
14. Diacetone Alcohol
15. Diethylene Glycol
16. 2-Ethyl Hexanol
17. Ethylene
18. Ethylene Dichloride
19. Ethylene Glycol
20. Ethylene Oxide
21. Formaldehyde
22. Isopropanol
23. Linear Alkyl Benzene
24. Maleic Anhydride
25. Methanol
26. Methyl Ethyl Ketone
27. Methyl Isobutyl Ketone (MIBK)
28. Nitrobenzene
29. Ortho Nitro Cholro Benzene
30. Para Nitro Chloro Benzene
31. Penta Erithritol
32. Phenol
33. Polyethylenes viz. LDPE, HDPE, LLDPE
34. Polypropylene
35. Polythylene Glycol
36. Propylene
37. Soda Ash
38. Sodium Tripoly Phosphate
39. Sulphuric Acid
40. Resins (excluding natural resins), Paints, Varnishes and Plastics
41. Synthetic Rubber
42. Titanium Dioxide

43. Toluene
44. Xylenes

SCHEDULE

(See rule 3)

1. MATERIALS

(1) Proper records shall be maintained showing separately all receipts, issues and balances both in quantities and cost of each item of raw material (including all direct charges upto the works) required for the production, processing or manufacturing of products under reference. The basis on which quantities, costs of issue and consumption are calculated, shall be indicated in the cost records and followed consistently. In the case of imported raw materials, proper records shall be maintained showing quantity of imported material, Free On Board value, overseas freight, insurance, customs duty and inland freight charges along with license-wise quantities allowed, actual quantities imported, actual quantities consumed, quantities in stock and quantities yet to be imported out of total licensed quantities. If both indigenous and imported materials are consumed, the records showing details of percentage mix of the same, have to be maintained for each item.

(2) The proper records shall be maintained separately showing the receipts, issues and balances both in quantities and cost of each item of intermediate, process material and catalyst used in the manufacture of the products under reference. The cost shall include all direct charges upto works. In case of catalyst, proper records shall be maintained for the value and quantity issued in a financial year suitably adjusted for consumption. If the life of the catalyst is more than one financial year, necessary adjustment should be made. If the life of the catalyst is not known, consumption may be assessed on technical basis.

(3) Where the company produces these raw materials, intermediates or process materials, separate records showing the cost of production of such items, shall be maintained in proforma ‘B’. The basis on which quantities and cost of issues and consumption of such materials produced or processed by the company are calculated, shall be indicated in the cost records and followed consistently.

(4) The issues, consumption of all raw materials, intermediates, process materials and catalysts shall be identified with the product process-wise.

(5) The proper records shall be maintained indicating the quantity as well as value of recoveries in different processes having significant value in relation to cost of material. In case the recoveries are not reused in the process and are sold or disposed of without further processing, the realisation from such sales shall be recorded and adjusted against the process concerned. In case further processing is necessary to make the recoveries usable or saleable,
as the case may be, proper records of the cost involved for such further processing shall be maintained. If such processing is done by any outside agency, proper records to show the quantity sent for processing, quantity received back after processing and cost incurred thereon shall be maintained. The net realization, if any, shall be adjusted against the major process relating

to such recoveries. The cost of recoveries shall be determined on equitable and reasonable basis and applied consistently. The records indicating the actual sales realization of recoveries shall also be maintained.

(6) The proper records shall be maintained to show the receipts, issues and balances, both in quantities and cost of each item of consumable stores, other process materials not covered by sub-rule (2), small tools and machinery spares, indirect materials etc. The cost shall include all direct charges upto works.

(7) The cost of consumable stores, small tools and machinery spares shall be charged to the relevant cost center or department or product process on the basis of actual issues. In the case of consumable stores and small tools, the cost of which are insignificant, the company may, if it so desires, maintain such records for the group of such consumable stores and tools.

(8) The proper records shall be maintained showing the quantity and value of wastage, spoilage, rejections and losses of raw materials, intermediates, process materials, consumable stores, small tools and machinery spares, whether in transit, storage, manufacture or at any other stage. The method followed for adjusting the above losses as well as the income derived from the disposal of rejected and waste materials including spoilage, if any, in determining the cost of product, shall be indicated in the cost records. Any abnormal wastage or spoilage or rejection or losses shall be indicated distinctly and separately along with reasons thereof.

(9) The proper records shall also be maintained to indicate the value of raw materials, intermediates and process materials, finished and semi-finished, consumable stores, small tools and machinery spares, which have not moved for more than twelve months.

(10) Where any credit under Central Value Added Tax (CENVAT) under the Central Excise Act, 1944 (1 of 1944) or any other benefits of the nature of CENVAT credit, are available on any item of material, the cost of such material shall be shown after adjusting such credit or benefits.

(11) If any of the input materials is processed through an outside party, proper records shall be maintained for the quantity sent for processing, quantity received after processing, balance quantity of material, losses and wastage of material during processing, by-products recovered, if any, and the cost involved in processing.

2. SALARIES AND WAGES

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

(a) piece rate wages (wherever applicable);

(b) incentive wages, either individually or collectively as production bonus or under any other scheme based on output;
(c) overtime wages;
(d) earnings of casual or contractual labour;
(e) bonus or gratuity, statutory as well as other;
(f) contribution to superannuating scheme;
(g) any other earnings of the nature specified in (a) to (f) above.

(2) The records shall be maintained in such a manner as to enable the company to book these expenses cost centrewise or departmentwise with reference to products under reference and to furnish necessary particulars under this head in Proformae A, B, C and D of Schedule annexed to these rules. Where the employees work in such a manner that it is not possible to identify them with any specific cost centre or department, the employees cost shall be apportioned to the cost centres or departments on equitable and reasonable basis and applied consistently.

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

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

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

3. UTILITIES

(1) The proper records shall be maintained showing the quantity and cost of each major utility such as power, water, steam, effluent treatment, etc. produced and consumed by the different cost centres in such detail as to enable the company to furnish the particulars for each utility separately in proforma ‘A’ of the Schedule.

(3) If a utility is purchased, proper records showing the delivered cost including all direct charges upto the works shall be maintained for the quantity and value of each utility purchased.

(3) Where a utility is produced and supplied by any other unit of the company, proper records shall be maintained to assess cost and the quantity of the utility so supplied.

(4) The cost of utility, if any, supplied to any other unit(s) of the company, shall be calculated on equitable and reasonable basis and applied consistently.

(5) The cost of utility allocated/apportioned to the cost centers and further to the individual products shall be on equitable and reasonable basis and applied consistently.

(6) Where direct power is one of the major inputs to electrolyise the raw material used in production or manufacture of any of the product under reference, such direct power shall be included in the cost of such raw material and shown accordingly.

(7) The records shall also indicate the measures taken on conservation of energy and its corresponding impact on per unit cost of production.

4. SERVICE DEPARTMENT EXPENSES

The proper records shall be maintained to indicate expenses incurred in respect of each service department or cost centre like laboratory, welfare, transport etc. These expenses shall be apportioned to other services and production departments on equitable and reasonable basis and applied consistently. Where these services are utilized for other products of the company also, the basis of apportionment of such expenses to products under reference and to the other products shall be on equitable and reasonable basis and applied consistently. The said basis shall be disclosed in the cost records also.

5. REPAIRS AND MAINTENANCE

(1) The 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. The records shall also indicate the basis of charging such expenses to different cost centres or departments. Where maintenance work is done by direct workers of any production cost centre or department, the wages and salaries of such workers shall be treated as direct expenses of the respective cost centre or department. If the services are utilized for products other than referred to in rule 2, the manner of charging a share of the cost of workshop, tool room and repairs and maintenance expenses to such products shall be on equitable and reasonable basis and applied consistently.

(2) In addition to the above, records shall indicate the amount and also the proportion of closing inventory of stores and spare parts representing items which have not moved for over twenty four months.

(3) The expenditure on major repair works from which benefit is likely to accrue for more than one financial year shall be shown separately and absorbed in the cost over the period for which such benefits are expected to accrue on

equitable and reasonable basis and applied consistently. Method of accounting along with the basis of allocation of such costs shall also be clearly indicated in cost records.

6. FIXED ASSETS, DEPRECIATION AND LEASE CHARGES

(1) The proper and adequate records shall be maintained for assets used for production, processing or manufacturing of the products under reference in respect of which depreciation has to be provided for. These records shall, inter-alia, indicate grouping of assets under each product referred under rule 2, the cost of acquisition of each item of asset including installation charges, date of acquisition and rate of depreciation.

(2) Those records which enable to identify and/or allocate gross fixed assets, accumulated depreciation up to the year and net fixed assets under the heads; land and building, plant and machinery, furniture and fixtures etc. employed for products under reference shall be maintained. The basis of apportionment of common assets to the products under reference shall be on equitable and reasonable basis and applied consistently. In case of revaluation of assets, the same shall be indicated separately and depreciation on revaluation shall not be included in the cost statement.

(3) The basis on which depreciation is calculated and allocated or apportioned to various cost centres or departments and absorbed on all products shall be clearly indicated in the cost records. If depreciation charged or chargeable to the cost centres or departments is in excess or lower than the depreciation calculated by applying the rates of depreciation prescribed under the provisions of sub-section (2) of Section 205 of the Companies Act, 1956, such amount of excess or lower depreciation shall be indicated clearly in the cost records. The cost records shall also show the effect of such excess or lower depreciation, as the case may be, on the per unit cost of each product. The cumulative depreciation charged in the cost records, against any individual item of asset shall not, however, exceed the original cost of the respective asset.

(4) The proper records shall be maintained giving details of assets taken or given on lease. The break-up of lease rental in terms of financial charges, depreciation etc. paid or received shall be maintained separately. The details shall be maintained separately for assets taken from or given to related party.

7. OVERHEADS

(1) The proper records shall be maintained for the various items of indirect expenses comprising overheads pertaining to products under reference. These expenses shall be analyzed, classified and grouped according to functions, namely, works, administration, selling and distribution as per normally accepted cost accounting principles and practices.

(2) Where the company is manufacturing products other than the products under reference, the records shall clearly indicate the basis followed for apportionment of the common overheads including head office expenses of the company to

such other products and the products under reference, including capital works. Where certain expenses forming part of overheads can be identified with a particular product, such expenses shall be first segregated and charged to the relevant product in the first instance and thereafter the residual expenses under the above categories of overheads shall be apportioned on equitable and reasonable basis and applied consistently. The overheads chargeable to capital works shall be indicated separately in the cost records. The basis of apportionment or absorption of overheads to the cost centres or departments and the products shall be indicated in the cost records. The records shall be maintained in such a manner as to indicate the details of works, administration, selling and distribution overheads.

8. ROYALTY AND TECHNICAL KNOW-HOW FEE

The adequate records shall be maintained showing royalty and/or technical know-how fee including other recurring or non-recurring payments of similar nature, if any, made for the products under reference to collaborators or technology suppliers in terms of agreements entered into with them. Such records shall be kept separately in respect of each such agreement or arrangement. The basis of charging such amount, including lump sum payment and its treatment shall be indicated in the cost records.

9. RESEARCH AND DEVELOPMENT EXPENSES

(1) The proper records showing the details of expenses, if any, incurred by the company for the research and development work on the products covered under these rules, according to the nature of development of products i.e. existing or new products and processes, development of process of manufacture - existing and new, design and development of new plant facilities and market research for the existing and new products, shall be maintained separately. The records shall also indicate the payments made to outside parties for the research and development work. The basis of charging such amount, including lump sum payment and its treatment shall be indicated in the cost records.

(2) The basis of charging these expenses to the cost of production under reference and to other products shall be indicated in the cost records. Where the utility of research and development work extends to over more than one financial year, such expenses shall be charged to the cost of products under reference and to all other products on equitable and reasonable basis and applied consistently indicating the criteria on the basis of which it has been decided to extend the utility period of these expenses to more than one financial year.

(3) The expenses incurred by the research and development department for providing technical know-how to outsiders shall be recorded separately and excluded from the cost of products under reference. The amount recovered for providing technical know-how to outsiders shall also be indicated separately and excluded from the income arising from the sale of products under reference.

10. QUALITY CONTROL

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

11. 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 product under such system. The cost variances shall be shown against the 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 products shall be indicated clearly in the cost records. The reasons for the variances shall be duly explained in the cost records and statements.

12. WORK-IN-PROGRESS AND FINISHED STOCK

The method followed for determining the cost of work-in-progress and finished stock of the products under reference 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.

13. CAPTIVE CONSUMPTION

If the products under reference are used for captive consumption, proper records shall be maintained showing the quantity and cost of each such product transferred to other departments or work centres or units of the company for self-consumption and sold to outside parties separately. The rates at which the transfers are effected shall be at cost of production as per normally accepted cost accounting principles and practices of working out such cost of production.

14. BY-PRODUCTS

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, as well as actual sales realization of by-product shall be maintained.

15. JOINT PRODUCTS

Where more than one product which is of equal economic importance arises from a process, the cost up to the point of separation of products shall be apportioned to joint products on reasonable and equitable basis and shall be applied consistently. The basis on which such joint costs are apportioned to different products arising from the process shall be indicated in the cost records.

16. PACKING EXPENSES

The 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 and/or secondary packing. Where such expenses are incurred in common for other products also, the basis of apportioning the expenses between the relevant products shall be on equitable and reasonable basis and applied consistently.

17. INTEREST AND OTHER BORROWING COSTS

(1) The proper records shall be maintained for money borrowed for each project and/or working capital and interest charged thereon. The amount of interest and other borrowing costs shall be allocated or apportioned to the products under reference and other products or activities on equitable and reasonable basis and applied consistently. The basis of further charging of the share of interest to the various types of such products shall also be equitable and reasonable and applied consistently. The basis of such allocation or apportionment shall be spelt out clearly in the cost records or statements.

(2) Net interest and other borrowing costs incurred for project under execution shall be capitalized for the period up to the date the project is ready to commence commercial activities. However, capitalization of borrowing costs should be suspended during extended periods in which active development is interrupted.

18. EXPENSES OR INCENTIVES ON EXPORTS

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

(2) The 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 should reflect this fact. If the duty free imports have been made after actual production, the statement should reflect this fact also.

19. COST STATEMENTS

1. The cost statement showing details of installed capacity, production, wastage, issues and sales and all elements of cost of the current financial year and previous year shall be prepared for each process adopted in the production of products under reference in proformae A, B, C and D.

2. The product emerging from a process, which forms raw material or an input material for a subsequent process, shall be valued at the cost of production up to the previous stage.

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

20. RECONCILIATION OF COST AND FINANCIAL ACCOUNTS

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

(2) A statement showing the total expenses incurred and income received by the company under different heads of accounts and the share applicable to other products or activities and the products under reference shall be prepared and reconciled with the financial statement.

21. PRODUCTION AND SALES RECORDS

Quantitative records of all finished goods whether packed or unpacked, showing production, issues for sales and balances of different type of the product packs under reference, shall be maintained. The quantitative details of production shall be maintained separately for self manufactured, third party on job work, loan license basis etc. Separate details of sales shall be maintained for domestic sales at control price, domestic sales at market price, export sales under advance license, export sales under other obligations, export sales at market price, and sales to related party/inter unit transfer.

22. POLLUTION CONTROL

Expenditure incurred by the company on various measures to protect the environment like effluent treatment, control of pollution of air, water, etc., should be properly recorded.

23. HUMAN RESOURCES DEVELOPMENT

Expenditure incurred by the company on the human resources development such as training of staff, workshop and seminars, health and safety education activities, shall be recorded separately.

24. STATISTICAL RECORDS

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

(2) The 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 products under reference and other products or activities to the extent such elements are separately identifiable. Non-identifiable items shall be allocated on a suitable and reasonable basis to different products and activities. Fresh investments on fixed assets for production of products under reference that have not contributed to the production during the relevant period/year shall be indicated in the cost records. The records shall, in addition, show assets added as replacement and those added for increasing existing capacity.

(3) Whenever WTO provisions are attracted, proper records shall be maintained to identify the competitiveness of the products under reference in the domestic as well as global market. Adequate statistical records shall also be maintained to identify the market share of the products manufactured and the likely impact thereon on account of competitive goods imported in to the country.

(4) In case of new major projects for product or activity referred to under rule 2, proper records shall be maintained indicating the funds raised from different sources, their utilization, stage-wise cost incurred and progress of the project as per the project report. Cost and time over run shall also be analysed with reference to the cost of services or activity and its impact on the profitability of the company.

25. 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. Reasons for shortages/surplus arising out of such verifications and the method followed for adjusting the same in the cost of the products shall be indicated in the records.

26. RELATED PARTY TRANSACTIONS

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

(a) purchase and sale of raw materials, finished products, process materials and rejected goods including scraps, etc;
(b) utilisation of plant facilities and technical know-how;
(c) supply of utilities and any other services;

(d) administrative, technical, managerial or any other consultancy services;
(e) purchase and sale of capital goods including plant and machinery; and
(f) any other payment related to production, processing or manufacturing of products under reference.

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

(3) The transactions by the following "related party relationships" shall be covered under sub-rule (1) :

(a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);
(b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;
(c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;
(d) key management personnel and relatives of such personnel; and
(e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

(4) However, the following shall not be deemed as "related party relationships":-

(a) two companies simply because they have a Director in common, notwithstanding paragraph (d) or (e) above (unless the Director is able to affect the policies of both companies in their mutual dealings);
(b) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and
(c) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process) -

  (i) providers of finance;
  (ii) trade unions;
  (iii) public utilities;
  (iv) government departments and government agencies including government sponsored bodies.

Explanation: -For the purpose of these rules, -

(a) "related party relationships" means parties who are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions;

(b) "related party transaction" means a transfer of resources or obligations between related parties, whether or not a price is charged;

(c) "control" means
(i) ownership, directly or indirectly, of more than one-half of the voting power of an enterprise; or

(ii) control of the composition of the Board of Directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise; or

(iii) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise;

(d) "significant influence" means participation in the financial or operating policy decisions of an enterprise, but not control of those policies;

(e) "an Associate" means an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party;

(f) "a joint venture" means a contractual arrangement whereby two or more parties undertake an economic product, which is subject to joint control;

(g) "joint control" means the contractually agreed sharing of power to govern the financial and operating policies of an economic product so as to obtain benefits from it;

(h) "key management personnel" means those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise;

(i) "relative" in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may connected by blood relationship;

(j) "holding company" means a holding company within the meaning of Section 4 of the Companies Act, 1956(1 of 1956);

(k) "subsidiary" means a subsidiary company within the meaning of Section 4 of the Companies Act, 1956(1 of 1956);

(l) "fellow subsidiary" means a company is said to be a fellow subsidiary of another company if both are subsidiaries of the same holding company;

(m) "state-controlled enterprise" means an enterprise which is under the control of the Central Government or a State Government.

PROFORMA `A'

Name of the company :
Name and address of the factory/unit :

Statement showing the cost of Utilities like Power, Steam, Water, etc., produced and consumed and effluent treatment during the year/period :

A. Quantitative Information:

Serial Number	Particulars	Current Year (unit)	Previous Year (unit)
1.	Installed capacity		
2.	Quantity produced		
3.	Capacity utilization		
4.	Quantity re-circulated		
5.	Quantity purchased, if any		
6.	Self-consumption including losses (to be specified)		
7.	Net units available		

B. Cost Information :

Serial Number	Particulars	Quan-tity	Rate per unit (Rupees)	Amount (Rupees)	Cost per Unit (Rupees)	
					Current Year	Previous Year
A 1.	Materials (specify) (a) (b) (c)					
2.	Process materials/ Chemicals					
3	Direct wages and salaries					
4.	Utilities (specify) (a) (b) (c)					
5.	Other direct expenses, if any					
6.	Consumable stores and spares					
7.	Repairs and maintenance					

8.	Depreciation					
9.	Lease rent, if any					
10.	Other works overhead					
11.	Sub-total (1 to 10)					
12.	Less: Credit, if any					
13.	Total cost (11-12)					
B.	Apportioned to cost centre or product : 1. 2. 3. 4. . . n.					

Signature

Name and designation of the officer-in-charge of
maintaining cost records of the company

Notes:

1. Separate cost sheet is to be prepared for each major utility having significant impact on cost, whenever such utility is functionally independent and not forming part of composite unit.

2. If any of the utilities, which are manufactured by the company, is sold to outside parties, the cost of sales and sales realisation shall be worked out in detail as illustrated in Proforma ‘C’ relating to cost of sales.

3. The proforma may be suitably modified to cover the specific features in such a way that serial numbers are maintained as per proforma with addition of items numbering them by prefixing/ suffixing alpha characters to the serial numbers.

4. Delete items not applicable.

Proforma `B’

Name of the company :
Name and address of the factory/unit :
Name of the **Process material/Intermediate/Product under reference:**

Statement showing the **cost of production** for the year/period :

A. Quantitative Information:

Serial number	Particulars	(unit : MTs)	
		Current Year	Previous Year
1.	(i) Installed capacity (ii) Capacity enhanced during the year by leasing arrangement etc.		

2.	Actual production : (i) self manufactured (ii) third parties on job work, if any (iii) loan license, if any		
3.	Capacity utilization		
4.	Quantity used for captive consumption		
5.	Quantity transferred for : (a) domestic sale (b) export sale (c) others (specify)		
6.	Opening stock (finished goods)		
7.	Closing stock (finished goods) (6+2-4-5)		

B. Cost Information:

Serial number	Particulars	Quan-tity	Rate per unit	Amount	Cost Per MT	
		unit	Rupees	(Rupees)	Current Year (Rupees)	Previous Year (Rupees)
1.	Material cost : (itemwise covering 80% of value) (a) (b) (c) …… Sub total					
2.	Process materials/chemicals (Specify)					
3.	Direct wages and salaries					
4.	Utilities (a)Power (b)Steam (c)Others (specify) Sub total					
5.	Consumable stores and spares					
6.	Depreciation					
7.	Lease rent, if any					
8.	Repairs and maintenance: (a) Building (b) Plant and Machinery (c) Others, if any					
9.	Other works overhead					
10.	Total works overheads (4 to 9)					
11.	Royalty, if any					
12.	Technical assistance/ know-how fee					
13.	Research and development					
14.	Quality control					
15.	Administrative overhead (relating to production activities) (a) salaries and wages					

	(b) others (specify) (c) Sub total (a+b)					
16.	Total (1+2+3+10 to 15)					
17.	Adjustment for variances (where standard costing system is followed)					
18	Add: Opening stock Less: Closing stock (Work-in-progress)					
19.	Less: Credits (from wastage and by-products) /Recoveries, if any					
20.	Packing cost (primary packing) (a) materials (b) others (c) Sub total					
21.	Total cost of production(16 to 20)					
22.	Finished goods purchased , if any					
23.	Add: Opening stock Less: Closing stock (Finished products)					
24.	Total (21+22+23)					
25.	Quantity and cost transferred for : (i) captive consumption, if any (ii) sales to Proforma `C' (iii) others, if any					

Signature

Name and designation of the officer-in-charge of
maintaining cost records of the company

Notes :

1. Separate proforma shall be prepared for each type of process material/intermediate/final product under reference produced.

2. Separate proforma shall be prepared for the quantity produced for sale within the country and the quantity produced for export sale. Expenses incurred on export and the incentive earned thereon shall be indicated in the proforma applicable for the quantity produced for export.

3. Separate proforma shall be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference. Separate proforma shall also be prepared for production on self manufactured, third party on Job work and loan license basis, as may be applicable, of intermediate/finished product(s) under reference.

4. The administrative overheads shall be included in the cost of production only to the extent they contribute in putting the goods produced to their present

location and condition. The balance of administrative overheads, if any, shall be included in the cost of goods sold.

5. The proforma may be suitably modified to cover the specific features in such a way that serial numbers are maintained as per proforma with addition of items numbering them by prefixing/ suffixing alpha characters to the serial numbers.

6. Delete items not applicable.

Proforma `C’

Name of the company :
Name and address of the factory/unit **:**
Name of the process material/ intermediate/ product under reference **:**

Statement showing the **cost of sales, sales realisation and margin** for the year/ period for :

A. Quantitative Information:

Serial Number	Particulars	Unit : MTs	
		Current Year	Previous Year
1.	Quantity transferred from Proforma ‘B’		
2.	Opening Stock (finished goods)		
3.	Closing Stock (finished goods)		

B. Cost Information:

Serial Number	Particulars	Quan-tity	Rate per unit	Amo-unt	Cost per MT	
		unit	(Rs.)	(Rs.)	Current Year (Rs.)	Previous Year (Rs.)
1.	Quantity and cost transferred from Proforma ‘B’					
2.	Packing cost secondary (a) Materials (b) Others (c) Sub total					
3.	Other expenses : (a) Administrative overheads (others) (b) Others (specify)					
4	Selling and distribution expenses : (a) Salaries and wages (b) Freight and transport charges (c) Commission to selling agents (d) Advertisement expenses (e) Royalty on sales, if any (f) Others (g) Sub total (a to f)					
5	Interest and other borrowing costs : (a) for manufacturing activity					

	(b) others (c) total					
6	Total cost of sales (excluding excise duty) of packed quantity sold (1 to 5)					
7	Sales realisation Less: Excise duty and other statutory levies					
8	Net sales realization					
9	Margin (8-6)					
10	Add: export benefits and incentives, if any					
11	Total margin (9+10) (including export benefits)					
12	Ex-factory price (excluding sales tax etc.)					
13	Maximum retail price (excluding sales tax etc.)					
14	Maximum retail price, if any, prescribed by the Government or statutory or regulatory body etc.					

Signature

Name and designation of the officer-in-charge of
maintaining cost records of the company

Notes :

1. Separate proforma shall be prepared in respect of each process material/ intermediate/final product under reference produced and sold.

2. Separate proforma shall be prepared for quantity sold within the country and the quantity exported. Expenses incurred on export and the incentive earned thereon shall be indicated in the proforma applicable for the quantity produced and exported.

3. Separate proforma shall be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference. Separate proforma shall also be prepared for production on self manufactured, third party on Job work and loan license basis, as may be applicable, of intermediate/finished product(s) under reference.

4. The administrative overheads shall be included in the cost of production only to the extent they contribute in putting the goods produced to their present location and condition. The balance of administrative overheads, if any, shall be included in the cost of goods sold.

5. The proforma may be suitably modified to cover the specific features in such a way that serial numbers are maintained as per proforma with addition of

items numbering them by prefixing/ suffixing alpha characters to the serial numbers.

6. Delete items not applicable.

Proforma `D’

Name of the company :

Statement showing the **allocation or apportionment** of total expenses and income of the company between the products referred to under rule 2 and other products or activities for the period/year :

Serial Number	Particulars	Total expenses as per audited financial accounts	Share applicable to products covered under rule 2 (Product 1, Product 2, etc.)	Share applicable to other products or activities	Basis of allocation
1.	Raw material				
2.	Process materials/chemicals				
3.	Direct wages and salaries				
4.	Utilities				
5.	Consumable stores and spares				
6.	Depreciation				
7.	Lease rent				
8.	Repairs and maintenance				
9.	Other works overheads				
10.	Total works overheads (4 to 9)				
11.	Royalty, if any				
12.	Technical assistance know-how fee				
13.	Research and development				
14.	Quality control				
15.	Administrative overhead (relating to production) : (a) salaries and wages (b) others (specify) (c) sub total (a+b)				
16.	Total (1+2+3+10 to15)				
17.	Stock adjustment (Work-in-progress)				
18.	Less: Credits (from wastages and by-products)/ Recoveries, if any				

19.	Cost of production (16 to 18)				
20.	Stock adjustment (finished products)				
21.	Net cost of production of unpacked finished goods (19+20)				
22.	Less: captive consumption				
23.	Net cost of materials available for sales (21-22)				
24.	Packing expense				
25	Other expenses : (a) Administrative overheads (others) (b) Others (specify)				
26.	Selling and distribution expenses : (a) Salaries and wages (b) Freight and transport charges (c) Commission to selling agents (d) Advertisement expenses (e) Royalty on sales, if any (f) Others (g) Total (a to f)				
27.	Interest and other borrowing costs				
28.	Total cost of sales excluding excise duty (23 to 27)				
29.	Total sales realization excluding excise duty				
30.	Margin (29-28)				
31.	Add: Export benefits and incentives, if any				
32.	Total Margin (30+31)				
33.	Any other expense not included in cost				
34.	Any other income not considered in cost				
35.	Margin as per Financial Accounts				

Signature

Name and designation of the officer-in-charge of
maintaining cost records of the company

Notes.-

1. Product 1, Product 2, etc. indicated above are illustrative only.

2. All items of income and expenditure in this proforma shall be reconciled with the financial accounts for the relevant period.

3. The administrative overheads shall be included in the cost of production only to the extent they contribute in putting the goods produced to their present location and condition. The balance of administrative overheads, if any, shall be included in the cost of goods sold.

4. The proforma may be suitably modified to cover the specific features in such a way that serial numbers are maintained as per proforma with addition of items numbering them by prefixing/ suffixing alpha characters to the serial numbers.

5. Delete items not applicable.

F.No.52/15/CAB-2002
A.K.Kapoor, Adviser (Cost)

Note :-1. Cost Accounting Records (Caustic Soda) Rules, 1967, were published vide G.S.R. 1261, dated the 11th August, 1967 and subsequently amended vide -

(i) GSR 85 dated 4th January, 1968;
(ii) GSR 773, dated 3rd June, 1977;
(iii) GSR 17, dated 5th January, 1983;
(iv) GSR 540, dated 22nd July, 1989;
(v) GSR 300(E), dated 24th March, 1993;
(vi) GSR 327(E), dated 3rd June, 1998;
(vii) GSR 427(E), dated 3rd August, 1998;
(viii) GSR 711(E), dated 28th September, 2001.

2. Cost Accounting Records (Soda Ash) Rules, 1976, were published vide S.O. 1720, dated the 29th May, 1976 and subsequently amended vide -

(i) GSR 790, dated 3rd June, 1977;
(ii) GSR 36, dated 5th January, 1983;
(iii) GSR 559, dated 22nd July, 1989;
(iv) GSR 319(E), dated 24th March, 1993;
(v) GSR 443(E), dated 3rd August, 1998;
(vi) GSR 725(E), dated 28th September, 2001.

3. Cost Accounting Records (Sulphuric Acid) Rules, 1980 were published vide G.S.R. 395(E), dated the 4th July, 1980 and subsequently amended vide -

(i) GSR 41, dated 5th January, 1983;
(ii) GSR 564, dated 22nd July, 1989;
(iii) GSR 324(E), dated 24th March, 1993;

(iv) GSR 448(E), dated 3rd August, 1998;
(v) GSR 730(E), dated 28th September, 2001.

4. Cost Accounting Records (Chemical Industries) Rules, 1987, were published vide G.S.R. 596, dated the 8th August, 1987 and subsequently amended vide -

(i) GSR 732, dated 4th August, 1988;
(ii) GSR 570, dated 22nd July, 1989;
(iii) GSR 34(E), dated 3rd January, 1992;
(iv) GSR 330(E), dated 24th March, 1993;
(vi) GSR 454(E), dated 3rd August, 1998;
(vii) GSR 278(E), dated 24th April, 2001;
(viii) GSR 735(E), dated 28th September, 2001**.**

MINISTRY OF LAW, JUSTICE AND COMPANY AFFAIRS
(DEPARTMENT OF COMPANY AFFAIRS)

NOTIFICATION

New Delhi, the 27th December, 2001

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

1. Short title and commencement . –

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

9. **Saving of action taken or that may be taken for contravention of Cost Audit (Report) Rules, 1996 -** It is hereby clarified that the supersession of the Cost Audit (Report) Rules, 1996, shall not in any way affect –

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

FORM OF THE COST AUDIT REPORT

[See rule 2(c) and rule 4]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Dated : this ---- date of -------- 200--
at ----------------- (mention name of place of signing this report).

SIGNATURE & SEAL OF THE COST AUDITOR(S)
MEMBERSHIP NUMBER

Notes:

(1) Delete words not applicable.

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

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

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

ANNEXURE TO THE COST AUDIT REPORT

[See rule 2(c) and rule 4]

1. GENERAL:

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

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

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

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

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

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

(6) Name and address of the Cost Auditor.

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

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

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

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

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

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

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

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

- (a) name and address of the foreign collaborators;
- (b) main terms of agreement ;
- (c) amount of royalty, lump sum payment, technical aid fee payable and the basis of calculating the same;
- (d) whether the technical collaborator has contributed to the share capital. If so, the paid up share capital so held.

(15) If the company is engaged in other activities besides the manufacture of the product under reference, the following details in respect of each such product or activity shall be given:

- (a) list of the products or activities;
- (b) list of the products or activities for which Cost Accounting Records Rules have been prescribed under section 209(1)(d) of the Act.;
- (c) whether Cost Audit Order has been issued by the government in respect of any of the products or activities. If so, number and date of the order.

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

2. COST ACCOUNTING SYSTEM:

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

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

3. PROCESS OF MANUFACTURE:

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

4. QUANITATIVE DETAILS :

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

9. Total available quantity			
10. Quantity captively consumed			
11.Quantity sold:			
(a) domestic at controlled price			
(b) domestic at market price			
(c) export under advance license			
(d) export under other obligation			
(e) export at market price			
(f) total			
12. Closing stock (finished quantity)			

Notes :

1. It should be clarified whether the installed capacity is on single shift or multiple shift basis.

2. In order to have a meaningful comparisons of production and installed capacity, wherever necessary these details should also be expressed in appropriate units, e.g. standard hours or equipment/ plant/ vessel occupancy hours, crushing hours, spindle/ loom shifts, equivalent production, production in terms of standard hours etc.

5(A). MAJOR INPUT MATERIALS / COMPONENTS CONSUMED:

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

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

5(B). STANDARD/ ACTUAL CONSUMPTION OF INPUT MATERIALS PER UNIT:

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

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

6. BREAK-UP OF COST OF INPUT MATERIALS IMPORTED DURING THE YEAR :

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

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

7 (A). POWER, FUEL AND UTILITIES :

Particulars	Current Year			Two Previous Years Separately		
	Qty.	Rate	Amount	Qty.	Rate	Amount
1. Indigenous (purchased) :						
(a) (specify)						
(b)						
(c)						
2. Self generated/ produced:						
(a) (specify)						
(b)						
(c)						
3. Imported:						
(a) (specify)						
(b)						
(c)						
4. Total						

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

7 (B). STANDARD/ ACTUAL CONSUMPTION OF POWER, FUEL AND UTILITIES IN TERMS OF QUANTITY PER UNIT OF PRODUCTION :

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

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

8. SALARIES AND WAGES:

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

9. REPAIRS AND MAINTENANCE:

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

10. FIXED ASSETS REGISTER AND DEPRECIATION:

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

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

11. GROSS BLOCK, DEPRECIATION AND LEASE RENT:

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

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

12. OVERHEADS:

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

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

13. RESEARCH AND DEVELOPMENT EXPENSES:

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

14. ROYALTY AND TECHNICAL KNOW HOW CHARGES:

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

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

15. QUALITY CONTROL EXPENSES:

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

16. POLLUTION CONTROL EXPENSES:

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

17. ABNORMAL NON-RECURRING COSTS:

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

18.(A) NON-MOVING STOCK (at the end of the year) :

Particulars	Current Year	1st Previous Year	2nd Previous Year
a1.Total direct material consumption			
a2.Closing stock of direct material			
a3. Value of non-moving stock			
a4. Percentage of a3 to a2			
b1.Total indirect material consumption			
b2.Closing stock of indirect material			
b3.Value of non-moving stock			
b4. Percentage of b3 to b2			
c1.Work-in-progress			
c2.Closing stock			
c3.Value of non-moving stock			
c4.Percentage of c3 to c2			
d1.Finished Goods			
d2.Closing stock			
d3.Value of non-moving stock			
d4.Percentage of d3 to d2			
e1.Total :			
e2.Closing stock			
e3.Value of non-moving stock			
e4.Percentage of e3 to e2			

18.(B) WRITTEN OFF STOCK (during the year) :

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

19.(A) INVENTORY VALUATION (at the end of the year) :

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

Notes :

(1) In respect of item at Sr. No. 1 and 6 details be furnished in respect of each major input material constituting at least 2% of the total material cost.
(2) In respect of items at Sr. No. 2 to 5, total amount be given without any quantitative details.
(3) Give in brief the method of inventory valuation system indicating the elements of cost included therein and the extent thereof.
(4) Capital work-in-progress to be shown separately.

19.(B) PHYSICAL VERIFICATION OF INVENTORY :

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

20. SALES OF THE PRODUCT UNDER REFERENCE:

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

Notes :

(1) Above details shall be furnished for major product groups/ varieties.
(2) Separate details shall be furnished for indigenous sales and export sales.

21. MARGIN PER UNIT OF OUTPUT:

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

Notes :

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

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

22. COMPETITIVE MARGIN AGAINST IMPORTS:

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Name of product			
2. Estimated demand of the product in the country *			
3. Total production in the country *			
4. Quantities imported in the country **			
5. Total production by the company			
6. %age share of the company in total inland production (item 5/ item 3)			
7. a. Cost of production per Unit (Inland sale) b. Cost of Sale per Unit (Inland sale) c. Cost of production per Unit (Export sale) d. Cost of Sale per Unit (Export sale)			
8. Quantity of the product imported by the company **			
9.FOB value of quantity imported by the company **			
10. Weighted average FOB rate for quantities imported by the company (item 9/ item8) **			
11. FOB value of quantity imported in the country **			
12. Weighted average FOB rate of quantities imported in the country (item 11/ item4) **			
13. Competitive margin (item 12 less item 7(A)) **			
14. Major exporting countries (other than those listed in item 4 above)			
15.(A) Total import duty paid by the company (net of CENVAT) (B) Weighted average rate of import duty paid by the company (net of CENVAT) (item 15(A)/ item 8)			
16. Bound rate of duty under WTO agreement.			

Notes :

(1) * Indicate the source of information.

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

23. VALUE ADDITION AND DISTRIBUTION OF EARNINGS :

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

24. FINANCIAL POSITION AND RATIO ANALYSIS :

Sr. No.	Particulars	Current Year			Two Previous Years Separately		
		Product under reference	Factory a a whole	Company as a whole	Product under reference	Factory as a whole	Company as a whole
1	Capital employed						
2	Net Worth						
3	Profit						
4	Net Sales						
5	Operating expenses as a percentage of Net Sales: (a) Material cost (b) Factory overheads (c) Royalty on production, if any (d) Salaries & wages (e) Research and development expenses (f) Quality control (g) Administrative overheads (h) Selling & distribution (i) Interest						
6	Profit as %age of capital employed						
7	Profit as %age of net worth						
8	Profit as %age of net sales						
9	Profit as %age of value addition						
10	Value addition as a %age of Net						

	Sales						
11	Current assets to current liabilities						
12	Net working capital in terms of number of months of cost of sales excl. depreciation.						
13	Debt-equity ratio						
14	Raw materials stock in terms of number of months of consumption						
15	Stores & spares stock in terms of number of months of consumption						
16	Work-in-progress stock in terms of number of months of cost of production						
17	Finished goods stock in terms of number of months of cost of sales						

Notes :

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

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

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

25. CAPITALISATION OF REVENUE EXPENDITURE:

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

26. RELATED PARTY TRANSACTIONS:

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

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

Note :

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

27. CENTRAL EXCISE RECONCILIATION FOR THE PRODUCT UNDER REFERENCE :

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

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

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

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

28. PROFIT RECONCILIATION:

Particulars	Current Year	1st Previous Year	2nd Previous Year
1. Profit or Loss as per cost accounting records			
2. Add: Incomes not considered in cost accounts:			
(a) (specify)			
(b)			
(c)			
3. Less: Expenses not considered in cost accounts:			
(a) (specify)			
(b)			
(c)			
4. Add: Overvaluation of closing stock in financial accounts			
Add: Under-valuation of opening stock in financial accounts			
6. Less: Under-valuation of closing			

stock in financial accounts			
7. Less: overvaluation of opening stock in financial accounts			
8. Adjustment for others, if any (specify)			
9. Profit or Loss as per financial accounts			

Explanation:- for the purpose of these rules,-

(a) **"CAPITAL EMPLOYED"** means average of fixed assets at net book values (excluding intangible assets, effect of revaluation of fixed assets, capital works-in-progress) and current assets minus current liabilities and provisions existing at the beginning and close of the financial year.

(b) **"NET WORTH"** means share capital plus reserves and surplus (excluding revaluation reserve) less accumulated losses and intangible assets.

(c) **"PROFIT"** means operating profit after providing for depreciation and all other expenses except interest on borrowings including debentures but before providing for taxes on income.

(d) **"NET SALES"** means sales excluding sales returns, excise duties, sales tax, octroi, other local taxes and expenses refundable/recoverable from buyers/customers.

(e) **"VALUE ADDITION"** means the difference between the net output value (net sales adjusted for work-in-progress and finished goods stock) and cost of bought out materials and services for the product under reference.

(f) **“NON MOVING STOCKS”** means value of raw materials and components, finished and semi-finished which have not moved for more than twelve months. The period shall be twenty four months in case of consumable stores and spare used in workshop, tool rooms or repairs and maintenance.

(g) **"NORMAL PRICE"** means price charged for comparable and similar products in the ordinary course of trade and commerce where the price charged is the sole consideration of sale and such sale is not made to a related party.

NOTES :-

(1) If there is any change in the share capital due to merger, acquisition, buy back of shares, bonus issue etc. during the year under reporting, special mention may be made with the reasons therefor.

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

(3) Wherever, there is any significant variation in the current year's figure over the previous year’s figure, reasons thereof shall be given.

(4) If the company has more than one factory producing the product under reference, separate details shall be indicated in the prescribed annexures in respect of each factory.

(5) If the factory is engaged in the production of the product under reference and any other activities, separate details shall be indicated in the prescribed annexure for the factory as a whole and for the product under reference.

(6) Figures shall be given for the year under audit and for the two preceding years in respect of paragraphs 4 to 26

Signature	Signature	Signature
Name	Name	Name
Cost Auditor	Company Secretary	Director
Seal	Stamp	Stamp
Date	Date	Date

Proforma

Name of the company :
Name and address of the factory :
Name of the product :

Statement showing the cost of production, cost of sales, sales realisation and margin in respect of the product(s) under reference produced during the year/period :

A. Quantitative Information:

Sr. No.	Particulars	(unit of measurement to be specified)	
		Current Year	Previous Year
1.	(i) Installed capacity (ii) Capacity enhanced during the year by leasing arrangement etc.		
2.	Actual production / output : (i) Self; (ii) third parties, if any;		
3.	Production as percentage of installed capacity		
4.	Captive consumption, if any		
5.	Quantity sold (a)Domestic (b)Export		
6.	Closing Stock (finished goods)		
7.	Opening Stock (finished goods)		

B. Cost Information:

Sr. No.	Particulars	Quantity	Rate per unit	Amount	Cost per unit	
		unit	(Rs.)	(Rs.)	Current Year (Rs.)	Previous Year (Rs.)
1.	Material consumed : (item-wise covering at least 80% of items by value) 1. Purchased : (a) Indigenous (specify) (b) Imported (specify) 2. Self manufactured (specify)					
2.	Process chemicals (specify)					
3.	Utilities 1. Purchased : (a) Indigenous (specify) (b) Imported (specify) 2. Self manufactured (specify)					
4.	Direct wages and salaries					
5.	Consumable stores and spares					
6.	Depreciation					
7.	Lease rent, if any					
8.	Repairs and maintenance: (a) Building					

	(b) Plant and Machinery (c) Others, if any					
9.	Other works overhead					
10.	Total Works Overheads (2 to 9)					
11.	Royalty, if any					
12.	Technical assistance/ know-how fee					
13.	Research and development					
14.	Quality control					
15.	Administrative overhead (relating to production activities) (a)Salaries and wages (b)Others (specify) (c) Total(a+b)					
16.	Total (1+ 10 to 15)					
17.	Adjustment for variances (where standard costing system is followed)					
18.	Add: Opening stock Less: Closing Stock (Work-in-progress)					
19.	Less: Credits (from wastage and by-products) / Recoveries, if any					
20.	Packing cost Primary (a)Materials (b)Others (c) Total					
21.	Cost of production (16 to 20)					
22.	Finished Goods purchased, if any					
23.	Opening Stock Closing Stock (finished products)					
24.	Total (21+22 +23)					
25.	Quantity and cost transferred for : (i) captive consumption, if any (ii)sales (iii)others, if any					
26.	Packing cost Secondary (a)Materials (b)Others (c) Total					
27.	Other expenses : (a) Administrative overheads (others) (b) Others (specify)					
28.	Selling and distribution expenses (a) Salaries and wages (b) Freight and transport charges (c) Commission to selling agents (d) Advertisement expenses (e) Royalty on sales, if any (f) Warranty expenses after adjusting income from chargeable services (g) Others (h) Total(a to g)					
29.	Interest and finance charges : (a) for manufacturing activity					

	(b) others (c) total					
30.	Total cost of sales (excluding excise duty) of packed quantity sold (24 to 29)					
31.	Sales realisation Less: Excise duty and other statutory levies					
32.	Net sales realisation					
33.	Margin(32 – 30)					
34.	Add: export benefits and incentives, if any					
35.	Total margin (including export benefits)					
36.	Ex-factory price (excluding sales tax etc.)					
37.	Maximum retail price (excluding sales tax etc.)					
38.	Maximum retail price, if any, prescribed by the Government/ statutory/regulatory body etc.					

Notes :

1. Separate proforma shall be prepared for each type/variety/ description of product(s) under reference.

2. Separate proforma shall be prepared for the quantity used for captive consumption, quantity sold within the country and the quantity exported. Expenses incurred on export and the incentive earned thereon shall be indicated in the proforma applicable for the quantity produced and exported.

3. Separate proforma shall be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference.

4. The administrative overheads shall be included in the cost of production only to the extent they contribute in putting the goods produced to their present location and condition. The balance of administrative overheads, if any, shall be included in the cost of goods sold. The proforma may be amended accordingly, if required.

5. The proforma may be suitably modified to cover the special features, if any, of the product under reference on the basis of proforma prescribed for working out cost of sales, margin, etc. of the said product in the relevant Cost Accounting Records Rules.

6. Indicate whether the prices of the product under reference are ex-factory prices, F.O.R prices, door delivery prices or any other terms. In case of ex-factory prices, whether cost of dispatch packing materials, freight, insurance and delivery charges are recoverable from the customers separately.

Signature	Signature	Signature
Name	Name	Name
Cost Auditor	Company Secretary	Director
Seal	Stamp	Stamp
Date	Date	Date

F.No.52/10/CAB-2001

(A.Ramaswamy)
Joint Secretary to the Government of India,

Note.- The principal rules were published vide G.S.R. number 511(E), dated the 4th November, 1996.

Annexure-X

The Cost Audit Report (Amendment) Rules, 2006

G.S.R.148(E).--In exercise of the powers conferred by sub-section (4) of section 233B read with sub-section (1) of section 227 and clause (b) of sub-section (1) of section 642 and section 610A of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following rules further to amend the Cost Audit Report Rules, 2001, namely:-

1. (1) These rules may be called the Cost Audit Report (Amendment) Rules, 2006.

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

2. In the Cost Audit Report Rules, 2001, -

(i) after sub-rule 2 of rule 4, the following sub-rules shall be inserted, namely: -

> "(3) The Forms prescribed in these rules may be filed through electronic media or through any other computer readable media as referred under section 610A of the Companies Act, 1956 (1 of 1956).
>
> (4) The electronic-form shall be authenticated by the authorized signatories using digital signatures, as defined under the Information Technology Act, 2000 (21 of 2000).
>
> (5) The Forms prescribed in these rules, when filed in physical form, may be authenticated by authorized signatory by affixing his signature manually."

(ii) in the Form for the heading "FORM OF THE COST AUDIT REPORT", "FORM II - THE COST AUDIT REPORT" shall be substituted;

(iii) before the existing form, the following form shall be inserted, namely:-

FORM I

[Pursuant to section 233B(4),600(3)(b) of the Companies Act, 1956 and rule 2(c) and rule 4 of the Cost Audit (Report) Rules, 2001]

Form for filing cost audit report and other documents with the Central Government

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

I. General information of the company

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

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

2 (a). Name of the company ☐

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

3. Cost audit report (CAR) pertains to:

(a) Name of the industry

(b) *Product or activities

(c) Central excise tariff chapter heading

(d) *Name and location of the unit

(e) *State where unit is located

*Financial year From (DD/MM/YYY) To (DD/MM/YYY)

4. *Location of other sites manufacturing or producing or processing or mining the product or carrying out the activity under reference (refer CAR annexure 1 .5**)**

5 (a) *Income-tax permanent account number of cost auditor

(b) *Name of the cost auditor

(c) *Membership number of cost auditor

6. *Cost audit order number dated (DD/MM/YYY)

7. *Service request number (SRN) of relevant Form 23C seeking approval of appointment of the cost auditor dated (DD/MM/YYY)

8. *Whether the cost audit report has been qualified or contains adverse remarks ○ Yes ○ No

*Whether there is any transaction with the related parties during the period to which the cost audit report pertains ○ Yes ○ No

II. *Quantitative information (for the product or activity under reference)

Unit of measurement (UoM) ☐

S. No	**Particulars**	**CAR annexure reference**	**Current year**	**Previous year**
1.	Total available capacity	4.3		
2.	Total production quality	4.5		
3.	Capacity utilisation percentage	4.7		
4.	Total available quantity	4.9		
5.	Quantity captively consumed	4.10		
6.	Quantity sold (domestic)	4.11(a+b)		
7.	Quantity sold (exports)	4.11(c+d+e)		
8.	Closing stock (finished goods)	4.12		

III. Export commitments (amount in Rs. thousands)-[As per cost auditor's certificate-para3(g)]

A. Export commitments ☐ B. Actual export towards export commitments ☐

IV. *Standard and actual consumption per unit (for the product or activity under reference)

S. No.	**Particulars**	**Unit (specify)**	**Standard (Quantity/ unit)**	**Actual (quantity/ unit)**	
				Current year	**Previous year**
	Consumption of input materials per unit [Annexure 5(B)] - specify details of major input materials, components				

1.					
2.					
3.					
4.					
5.					
	Consumption of power, fuel and utilities per unit [Annexure 7(B)]				
1.					
2.					
3.					
4.					
5.					

V. *Key information from Cost Audit Report (for the product or activity under reference)

S. No.	Particulars	CAR annexure reference	Unit (specify)	Current year	Previous year
1.	Total employee costs	8B.6	Rs. in thousands		
2.	Total repairs and maintenance	9.5	Rs. in thousands		
3.	Depreciation absorbed	10.5	Rs. in thousands		
4.	Total overheads	12(1 to 4)	Rs. in thousands		
5.	Total research and development expenses	13.5	Rs. in thousands		
6.	Total royalty and technical know how charges	14.5	Rs. in thousands		
7.	Total quality control	15.6	Rs. in		

	expenses		thousands		
8.	Total pollution control expenses	16,6	Rs. in thousands		
9.	Total abnormal non-recurring costs	17	Rs. in thousands		
10.	Total closing stock	18.(A).e2	Rs. in thousands		
11.	Total value of non-moving stock	18.(A).e3	Rs. in thousands		
12.	Non-moving stock to closing stock	18.(A).e4	Percentage		
13.	Total written off stock	18.(B)5	Rs. in thousands		
14.	Total value of inventory as per cost accounts	19.(A).10	Rs. in thousands		
15.	Total value of inventory as per financial accounts	19.(A).11	Rs. in thousands		
16.	Estimated demand of the product in the country	22.2			
17.	Total production in the country	22.3			
18.	Quantities imported in the country	22.4			
19.	Percentage share of the company in total inland production	22.6	Percentage		
20.	Net sales (excluding excise duty)	23.3	Rs. in thousands		
21.	Adjustments in stocks	23.4	Rs. in thousands		
22.	Cost of bought out materials and services	23.5	Rs. in thousands		
23.	Value added	23.6	Rs. in thousands		

24.	Capital employed (for the product)	24.1	Rs. in thousands		
25.	Net worth (for the product)	24.2	Rs. in thousands		
26.	Profit or Loss for the product	24.3	Rs. in thousands		
27.	Operating expenses as a percentage of net sales (for the product)				
(a).	Material cost	24.5a	Percentage		
(b).	Factory overheads;	24.5b	Percentage		
(c).	Royalty on production	24.5c	Percentage		
(d)	Salaries and wages	24.5d	Percentage		
(e).	Research and development expenses	24.5e	Percentage		
(f).	Quality control	24.5f	Percentage		
(g)	Administrative overheads	24.5g	Percentage		
(h)	Selling and distribution	24.5h	Percentage		
(i)	Interest	24.5i	Percentage		
28.	Profit or Loss as a percentage of capital employed	24.6	Percentage		
29.	Profit or Loss as a percentage of net worth	24.7	Percentage		
30.	Profit or Loss as a percentage of net sales	24.8	Percentage		
31.	Value addition as a percentage of net sale	24.10	Percentage		
32.	Excise duty (ED) payable	27.D.1	Rs. in thousands		
33.	ED paid through cenvat -	27.D.2.3	Rs. in		

	inputs		thousands		
34.	ED paid though cenvat - capital goods	27.D.2.b	Rs. in thousands		
35.	Personal Ledger Account (PLA)	27.D.2.C	Rs. in thousands		
36.	Total	27.D.2	Rs. in thousands		

VI. *Margin per unit of output (for the product or activity under reference)- Annexure 21

S No.	Particulars	Current Year			Previous Year		
		Cost of sales (Rs./ unit)	Sales realisation (Rs./unit)	Margin (Rs./unit)	Cost of sales (Rs./ unit	Sales realisation (Rs./unit)	Margin (Rs./unit)
	Purchased ○ Yes ○ No if yes, specify details of major products						
1.							
2.							
	Loan license basis ○ Yes ○ No if yes, specify details of major products						
1.							
2.							
	Own manufactured ○ Yes ○ No if yes, specify details of major products						
1.							
2.							
3.							
4.							
5.							

Attachments	List of attachments

1. *Cost audit report as per the Cost Audit (Report) Rules, 2001 Attach

2. Optional attachment(s) - if any Attach

☐

Remove attachment

Declaration

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

We have been authorised by the board of directors' resolution dated ☐ (DD/MM/YYYY)

to sign and submit this form.

To be digitally signed by

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

Director of the company ☐

Cost auditor ☐

Modify Check Form Prescrutiny Submit

For office signed by

This e-Form is hereby rejected

Digital signature of the authorizing officer ☐ Submit to Bo

[F. No. 1/6/2005/CL. V]

JITESH KHOSLA, Jt. Secy

Note:--The Principal rules were published in the Gazette of India vide GSR No 924(E) dated 27-12-2001.

EXPERT GROUP QUESTIONNAIRE ON THE EXISTING AND PROPOSED FRAMEWORK OF COST ACCOUNTING AND COST AUDIT

CONSTITUTION OF EXPERT GROUP:

To enable development of relevant cost accounting methodologies and standards to increase the competitiveness of the Indian manufacturing sector and to advise the Government on suitable measures for the same, Government of India, Ministry of Corporate Affairs, vide their order dated 21.01.2008 has constituted an Expert Group to undertake the following tasks. The Group comprises members drawn from the Government, professional bodies and the industry associations.

(i) Review the Cost Accounting Record Rules and their continued relevance in the contemporary competitive environment as per the presently prescribed structure / format, and make recommendations for requisite modifications and / or alternative structures;

(ii) Review the existing Cost Audit Report Rules and formats prescribed therein, and recommend appropriate modifications to make them more relevant to the needs of different stakeholders including company management, shareholders, regulators, etc;

(iii) Review the existing system with a view to make suggestions for addressing the concerns of the industry with regard to confidentiality of company cost data and cost of compliance;

(iv) Review and, if required, give suggestions for redrafting the existing Cost Accounting Standards in the Indian context in light of international best practices, and to align them with the international cost accounting standards issued by International Federation of Accountants (IFAC).

GENERAL ISSUES:

- Corporate governance, investor protection, global competition, competitiveness, efficiency in resource management, transparency in corporate functioning, liberalized but regulatory framework, etc. are the key issues today. All these issues require strengthening the role of regulatory bodies, independent directors, financial auditors, cost auditors, etc. and enhancing transparency in the corporate functioning.

- Basic doctrine of the entire Companies Act is to enhance transparency in the corporate functioning so as to ensure that the controlling members and managers work as true trustees of public funds and the interests of various stakeholders are protected. Provisions for cost records and cost audit should support this doctrine.

- All companies, whether public or private, are having majority participation of public funds, either directly or through Banks, FIs, MFs, etc., and whether in the form of shareholding or through loans, debentures, PNs, Bonds, etc. Funds invested by fragmented small shareholders (investors) remain at the stake of minority shareholders and managers. Hence, all companies should ensure efficient utilization of national resources and various factors of production.

- All commercial enterprises have responsibility towards social and environmental concerns of the society at large. Therefore, a balance between the input and output, as would be normally expected in any business environment, as also compliance towards the social and environmental concerns of the society should be ensured.
- In the competitive arena, market forces play a significant role. Even in a free but regulated economy, there is need to ensure relationship between cost and price to curb consumer exploitation through unwarranted profiteering and over-pricing. Therefore, cost components need disclosure. International experience is evidence. For example, as a policy reaction to the post-Asian crisis of 1998, the Korean Government required financial institutions and large conglomerates to maintain detailed cost accounting systems that are accessible to the auditors. Similarly, the Securities & Exchange Commission of USA has prescribed various formats for furnishing detailed cost information by all corporates. More recently, a stiff regulatory mechanism is being re-introduced in the financial markets in USA after the sub-prime lending crises.
- No organisation, Public or Private, can survive without reducing costs and making profits. However, profit should be attained through controls exercised over value (turnover), costs (efficiency), quantity (volume) and quality (effectiveness). Therefore, “Cost Audit” should be rightly captioned either as “Management Audit” or as “Efficiency Audit”. The objective should be gradually changed from “what has been” to “what could have been” and then to “what should have been”.
- In this context, March 2008 IFAC Report on *Financial Reporting Supply Chain – Current Perspectives and Directions* becomes pertinent. It states that *“The auditor’s report is a disclaimer than an opinion…. And their report hardly means anything.”* It further opines that many respondents of the survey indicate need for improvement in financial communication by reporting to users the internal information used to run the business.
- Absence of cost accounting and cost audit system would naturally lead to non-reliability of cost records/cost data; non-availability of essential cost details in uniform manner to the Government and Regulators; difficulty in getting key information from the industries; etc. Thus, the cost to the entire economy of not having such mechanism would be much higher.
- There have been concerns as to how to incorporate/inculcate the advantages of advanced cost/management accounting & efficiency tools, in the today’s IT environment, in various departmental undertakings (e.g. ordnance factories, railway engine/coaches manufacturing units, etc.), public service organisations, public utilities, municipal boards/corporations, etc. Similarly, how such a mechanism (i.e. efficient

cost based operations) is brought in social sectors such as healthcare, education, etc.

COST ACCOUNTING RECORD RULES:

Section 209 (1) *Every company shall keep at its registered office proper books of account with respect to -*

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

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

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

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

- Since 1965, under section 209(1)(d) of the Companies Act, Government of India, Ministry of Corporate Affairs have framed and notified separate Cost Accounting Record Rules for each industry/product. So far 44 industries have been covered. This list contains items used as agriculture inputs, mass consumption products, industrial products, etc. Most of these industries are engaged in the production, processing, manufacturing or mining activities. Later, Government prescribed Cost Accounting Record Rules for companies engaged in various other activities such as, exploration & processing of crude oil, growth & processing of plantation products, services like generation, transmission & distribution of electricity, all range of telecommunication services, etc. and also for certain trading activities like bulk purchase/sale of electricity.

- All the 44 Cost Accounting Record Rules (CARR) carry almost identical information (except for some industry specific minor variations). Each CARR has three parts, viz.

  a) Part-I is the main rule itself showing applicability clause, directions to maintain cost records and the penalty clause.

  b) Part-II is the main schedule carrying 26 paras giving narrative explanation of various elements of cost and their treatment in cost records. Since the cost accounting principles remain same for all industries, these paras are almost identical in all the rules.

  c) Part-III contains various proforma. These proforma are also largely common for utilities, process materials, intermediates, cost of production, cost of sales and reconciliation with financial records.

- Presently, the existing CARRs do not apply to a company, -

  (a) The aggregate value of machinery and plant installed wherein, as on the last date of the preceding financial year, does not exceed limit as specified for a small scale industrial undertaking under the provisions of Industries (Development and Regulation) Act, 1951; and

(b) The aggregate value of the turnover made by the company from sale or supply of all its products during the preceding financial year does not exceed ten crores of rupees.

- Historically, the “class of companies” as contained in Section 209(1)(d) has been construed to mean companies engaged in the manufacture of a particular product or those belonging to a specified industry. It is, however, debatable whether the class means only a particular product or an industry, more so in the present economic scenario where large numbers of companies are engaged in multi-product activities.
- Further, in the present economic scenario where Indian economy is characterized by increasingly open markets, presence of national and international competition and the gradual withdrawal of administrative prices, corporate decisions are guided by the competitive situation determined by economic liberalization, globalization and privatization. The present competitive economic environment has made all the organizations more conscious about the need to bring efficiency and economy in their operations. Maintenance of cost records in a systematic manner is essential for all the companies. Large number of companies and manufacturers keep necessary cost data even where no Rules as such are prescribed. Therefore, it is considered necessary to review the existing provisions of cost accounting and cost audit under the Companies Act, 1956 and to make it more beneficial to various regulators, Government departments/bodies to protect the interest of consumers and investors and to protect the industry from unfair trade practices (like anti-dumping, subsidies & counter-veiling measure, cartels, etc.) under WTO agreements.
- In the case of financial reporting, condensed information in the form of Balance Sheet and Profit and Loss Account is presented, with suitable schedules and supplementary information. The basic underlying principle is “substance over form”. The standards to be followed in preparing these statements and the accounting treatment of various components of the statements are provided in the Accounting Standards prepared by ICAI and issued under the Companies Act. The format of the books to be kept is left to the practice internally followed by the business entities with the certifying professionals ensuring that the accounting and reporting is being done as per established standards and principles.
- The cost accounting and reporting system can also follow a similar methodology. One of the views expressed under cost audit framework is that to prepare the cost statements in the prescribed format as per Records/Report Rules, the information has to be culled from the internal costing system followed by the company and fitted into the cost statements to satisfy the requirement of Records/Report Rules. Instead, the final product or service cost sheet (akin to P & L Account) can be prescribed under report rules and the Cost Accounting

Standards issued by ICWAI may be recommended to the companies and certifying professionals.

- The existing mechanism can be considered as the prescriptive methodology rather than a principle based approach. The Expert Group is of the view that there is need to shift from present practice of rule-based to principle-based accounting. Revised mechanism should address issues like deregulation, changing dynamics of economy, regulatory framework, WTO requirements, unfair trade practices, etc. and above all, cost competitiveness of India Inc. and global benchmarking. Thus, this mechanism should result in value addition to the industry.
- Section 209 of the Companies Act, 1956 primarily relate to maintenance of books of accounts by the companies that includes cost records as well. While financial accounting/reporting is supported by the principle based accounting standards approved by NACAS, a differential treatment has been accorded to cost accounting by prescribing separate rules/formats causing an extra burden of additional records. Therefore, separate Rules (CARR) prescribing formats only for cost records or two sets of accounting formats are not required. As such, necessary cost data should emanate from the same set of primary accounting data/records.
- A view emerged that companies should be left free to maintain requisite accounting records and to follow relevant method of cost management depending upon their size, scale & type of operations. However, for sake of uniformity, such records should adhere to the generally accepted cost accounting principles and cost accounting standards.
- Scope of section 209 (1) (d) of the Companies Act, 1956 regarding maintenance of cost records may be widened to cover all class of companies. This would also remove the present anomaly of maintaining a separate set of cost records only for a particular “product” (as prescribed under the extant rules) of a multi-product company and not doing so for the rest of the products.

COST AUDIT REPORT RULES:

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

- As per existing provisions, cost audit orders are issued on individual companies. Appointment of Cost Auditor is done by the Board of Directors after obtaining prior approval from the central Government. Cost audit report is filed with the Government, with a copy to the company.

- Government of India, Ministry of Corporate Affairs under section 233B read with section 642(I) of Companies Act, 1956 has notified Cost Audit Report Rules. These Rules were originally notified in 1968, which were later amended in 1996 and again in 2001. A summarized Form-I was also introduced in 2006 after introduction of online filing of Cost Audit Reports through MCA-21.

- Following features of present practice of cost audit may be noted:

  a) Within the 44 industries/products covered by Cost Accounting Record Rules, Cost Audit orders have been issued in about 2500 cases, covering about 2000 companies. It has been observed that for a particular industry/product covered under the scheme, cost audit orders have not been issued for all the companies.

  b) It is also observed that in case of multi-product companies, more than one Cost Accounting Record Rules become applicable to the company. Consequently in few companies, more than one Cost Audit Orders have been issued for different products.

  c) Similarly, all products of a multi-product company may not be covered by the existing set of Cost Accounting Record Rules. Hence, no cost audit orders can be issued for such non-covered products.

  d) Further, in case of companies which are presently covered under section 209 (1) (d) but not so far covered under section 233B, a compliance certificate is given by the Financial Auditors under CARO, without any responsibility for accuracy and completeness.

- In terms of utility of cost audit report, besides the company management, these reports and the cost data is of immense use to the Regulators and various agencies of Government in areas like, subsidy determination; administered pricing; detection of cases of evasion of direct & indirect taxes; determination of goods for inclusion under free trade agreements; transfer pricing for related party transactions; predatory pricing under Competition Commission; to check cases of unfair trade practices such as price-rigging, cartelization, over-charging, discriminatory pricing, profiteering, siphoning of funds, etc; valuation of goods under antidumping & other agreements under WTO; valuation of goods for captive consumption under the Excise Act; valuation of imports under the Customs Act; valuation of assets and also for IPR; etc. As in case of various advanced countries, cost data is very useful for defence contacts where large potential exists. Similarly, Government has been emphasizing for determination of cost-based user charges.

- Cost audit data could also be used by various other stakeholders like banks & financial institutions (to make performance analysis, inter-firm comparison and monitoring), lenders & creditors, shareholders, employees, consumers, etc. Similarly, such data can also be of immense use for undertaking economic analysis, competitiveness studies and bench-marking studies by various academic institutions, research bodies, management schools, etc. Cost related issues are also relevant in determination of fair price and in various Accounting Standards such as AS2, AS10, AS17, and AS18.

- With regard to cost audit, various industry associations are of the view that the cost audit methodology as structured originally under Section 233B and the existing Cost Audit Report Rules needs re-look. What needs to be done is to redefine the audit objectives without losing the legal backup and the mandatory force it gives for compliance. Instead of the attestation perspective, which was emphasized earlier for price control, the efficiency review aspect should be blown in full force to enable better corporate governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness. There is need to revisit the current methodologies of cost auditing and reporting frameworks. Present formats of Cost Audit Report need to be restructured.

- A view has also been expressed that in a liberalized but regulatory framework operating under global competition, there is need to align the revised structure of Cost Audit Report with the IFRS issued by the International Accounting Standards Board so as to achieve complete harmony in the reporting framework.

- The views that emerged in the Expert Group are:

  a) The term “class of companies” should be removed from section 209(1)(d) and included in section 233B for the purpose of coverage of companies for cost audit. For this, the Group may suggest minimum threshold limit based on size of capital base, annual turnover, etc. The feasibility of exempting certain specific category of companies such as SME companies, section-25 companies, companies limited by guarantee and associations not for profit, etc. from the ambit of cost audit may also be examined.

  b) Existing Cost Audit Report Rules and the formats prescribed therein may be reviewed. In place, a simple abridged form of cost statement requiring minimum but important disclosures may be prescribed. In addition, guidelines for undertaking detailed cost data analysis may also be suggested for the benefit of company management.

  c) Only the abridged cost statement alongwith the cost auditor’s report may be filed with the Government i.e. MCA. In addition, any Government organisation or the Regulators may directly seek such additional cost details from the relevant companies as may be prescribed by them. For example, presently TRAI has prescribed their own formats seeking detailed (audited) cost data from the telecom service providers. Similarly, filing of cost audit report with the taxation authorities.

  d) No part of cost details may be circulated to the shareholders. However, possibility of circulating only the cost auditor’s report together with important efficiency parameters and also the suggestions made, if any, to the shareholders may be examined.

e) Cost auditors may continue to be appointed by the Board of Directors. However, the existing provision of seeking prior approval of Central Government may be dispensed with.

- Existing mechanism of e-filing of cost audit reports on MCA-21 portal together with the steps taken by MCA for limited access of such reports and also the audit trail mechanism under MCA-21 has already ensured complete confidentiality of cost details of the companies.

COST ACCOUNTING STANDARDS:

- ICWAI has so far issued Cost Accounting Standards (CAS) on the following areas:
  - CAS-1 on classification of costs
  - CAS-2 on capacity determination
  - CAS-3 on overheads
  - CAS-4 on cost of production for captive consumption
  - CAS-5 on determination of average (equalized) cost of transportation
- While the first three standards are primarily on the basic principles of cost accounting, the subsequent two deal with the application areas. CAS-6 on arm’s length price has already been finalized and is in the advanced stage of its release for adherence. Drafts of six more CAS are ready.
- These CAS have been designed to achieve uniformity and consistency in measurement, assignment and allocation of costs in arriving at the cost of production so as to facilitate determination of fair price by the manufacturers as well as by various Government authorities and regulators. CAS-1 to 4 have already been approved and notified by the Central Board of Excise & Customs.
- All the CAS are principle based that keep in focus the generally accepted cost accounting principles and codify them so that with the passage of time, CASB can evolve an accepted framework of generally accepted cost accounting principles that can be adopted by all users of the standards like industry, professionals & other stakeholders.
- Cost Accounting Standards Board (CASB) of ICWAI has adopted modified methodology/framework for the development of Cost Accounting Standards. The revised framework is fully aligned with similar guidelines issued by the International Federation of Accountants (IFAC) and also with the best-practices followed in various developed/developing countries.
- CASB has identified 39 areas for developing the Cost Accounting Standards. Of these, 21 areas relate to components of cost and the balance 18 would be on cost accounting methodologies and

procedures. Further, separate CASs are also being developed for the service sector areas (excluding common areas already covered in the list of 39).

- With regards the international scenario, the US Federal Government has constituted a Cost Accounting Standards Board under the Office of Federal Procurement Policy, which is an independent legislatively-established board. The Board has the exclusive authority to make, promulgate, and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts with the United States. The standards are mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating and reporting costs in connection with pricing and administration of and settlement of disputes concerning all negotiated prime contract and subcontract procurement with the United States in excess of US $5 million. CASB, USA has so far issued 19 Cost Accounting Standards.
- Similar Cost & Management Accounting Standards are in-vogue in Canada, Japan, UK and other EU countries that are being enforced for various Government and non-Government activities. Adherence to a plan of legally prescribed cost accounting standards has been considered in Japan as a sort of social discipline by the corporate sector.

OTHER RELATED SECTORS:

- The Expert Group is of the opinion that in view of the growing share of services/social sectors in the GDP of the economy, there is need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors such as healthcare, education, banking, insurance, financial services, public utilities such as municipalities, electricity, water supply, city transportation, etc.
- The Group also argued in favour of extending this framework to various Government projects/schemes, departmental undertakings (such as ordnance factories, railway locomotive/coaches manufacturing units), etc. so as to infuse a sense of efficiency and effective spending of public money and the cost-benefit analysis of each project/scheme/unit is clearly made known to the public at-large through each Ministry/Department's outcome budgets.
- Similarly, such a mechanism would facilitate determination of cost-based user charges for various services provided by different agencies of the Government.

QUESTIONS

1. Cost Accounting Record Rules

1.1. Do you agree with the Expert Group to shift maintenance of cost records from existing rule/format-based to principle-based having universal application?

1.2. If yes, do you propose repeal of all the existing Cost Accounting Record Rules and in place, Government may prescribe maintenance of cost records based on generally accepted cost accounting principles and cost accounting standards?

1.3. Do you agree that under the principle-based accounting system, all companies should maintain cost records as an integral part of books of accounts, but to be left free to follow relevant method of cost management?

1.4. Maintenance of cost data/records, as an integral part of the books of accounts, does not normally entail any additional cost to the companies. However, do you agree that the above mechanism of moving away from rule/format based to principle based maintenance of cost data/records will provide due flexibility to the companies and reduce compliance cost, if any, further?

2. Cost Audit Report Rules

2.1. Do you agree with the revised structure of cost audit broadly proposed by the Expert Group?

2.2. Do you agree that there should be a threshold limit for exemption from cost audit? If yes, what threshold limit would you like to suggest? Should the exemption limit be equal to:

2.2.1. Annual turnover of Rs.10/20/25/50 crores; or

2.2.2. Paid-up capital or Net Worth or Investment in Fixed Assets of Rs.5/10 crores; or

2.2.3. 10%/20%/50% level of public participation (including through Banks/FIs/MFs) in share capital as well as loans; or

2.2.4. A combination of above?

2.3. Would you recommend e-filing a combined cost audit report with the Government (i.e. MCA) containing only a simple abridged cost statement?

2.4. Do you agree that any Government organisation or the Regulators may be left free to directly seek copy of the detailed cost audit report and such additional cost details from the relevant companies as may be prescribed by them?

2.5. Internationally accepted basic dictum of any audit is, it should be "independent". In view of this, how would you suggest the mechanism to appoint the cost auditors?

2.5.1. Should the existing mechanism of appointment of cost auditor be continued i.e. the Board of Directors (BOD) will appoint with the prior approval of the Central Government; or

2.5.2. The Board of Director may appoint without any approval of the Central Government; or

2.5.3. The shareholders in AGM should appoint the cost auditors?

2.6. Further, do you suggest that in case of exempted companies, the power to get the cost records audited be vested with the 10% shareholders by making a request to the Government?

2.7. Similarly, would you also suggest that in such companies, a right be vested in secured creditors with stakes more than 50% of net worth to seek a special audit of the cost records of the company?

2.8. As proposed by CII, would you suggest circulation of any part of cost management trends to the shareholders?

2.9. What should be the periodicity of cost audit? Should it be annual or half-yearly or quarterly linked with the corporate governance and segmental reporting (atleast in case of listed companies)?

2.10. Do you agree that the above mechanism would provide complete confidentiality and fuller utility of sensitive cost data?

3. Cost Accounting Standards

3.1. Do you agree that for ensuring a complete shift from the existing rule-based to principle-based cost accounting & audit mechanism and also for the sake of uniformity in preparing accepted cost statements under WTO and other Statutes, there is an urgent need for the country to have Cost Accounting Standards based on generally accepted cost accounting principles?

3.2. If yes, would you agree that all companies should be asked to comply with such cost accounting standards?

3.3. If yes, do you also agree that ICWAI should assign topmost priority for issue of cost accounting standards in consultation with all stakeholders?

3.4. Would you suggest that all cost accounting standards should be aligned with the cost accounting standards issued by other developed countries, international best practices, IFRS, and other IFAC guidelines?

4. Other Related Sectors

4.1. Do you agree with the Expert Group views that there is need to extend the existing principles & practices of cost accounting and cost audit to the services and other social sectors such as healthcare, education, banking, insurance, financial services, public utilities such as municipalities, electricity, water supply, city transportation, etc?

4.2. Similarly, do you also agree extending this framework to various Government projects/schemes, departmental undertakings, such as ordnance factories, railway locomotive/coaches manufacturing units, etc?

4.3. Presently, fees charged by various public service organisations do not show any correlation with the costs. In light of this, do you agree that all Government agencies should determine user charges based on most efficient costs?

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ANNEXURE-XII

LIST OF RESPONDENTS TO THE EXPERT GROUP QUESTIONNAIRE

Company	Category	Sector	City
Anti-Dumping Authority	Regulator		New Delhi
Central Board of Excise & Customs	Regulator		New Delhi
Central Electricity Regulatory Commission	Regulator		New Delhi
Chief Adviser Cost, Ministry of Finance	Regulator		New Delhi
Competition Commission of India	Regulator		New Delhi
Comptroller & Auditor General of India	Regulator		New Delhi
Fertilizer Industry Coordination Committee	Regulator		New Delhi
Insurance Regulatory Development Authority	Regulator		Hyderabad
National Pharmaceutical Pricing Authority	Regulator		New Delhi
Petroleum & Natural Gas Regulatory Board	Regulator		New Delhi
Reserve Bank of India	Regulator		Mumbai
Securities & Exchange Board of India	Regulator		Mumbai
Tariff Commission	Regulator		New Delhi
Tea Board	Regulator		Kolkata
Telecom Regulatory Authority of India	Regulator		New Delhi
Institute of Company Secretaries of India	Academic		New Delhi
Institute of Cost & Works Accountants of India	Academic		Kolkata
Prof. G. Raghuram, Indian Institute of Management	Academic		Ahmedabad
Prof. M.K. Anand, Indian Institute of Management	Academic		Lucknow
Prof. Sanjay Kallapur, Indian School of Business	Academic		Hyderabad
Athreya Management Systems	Management Consultants		New Delhi
Deloitte Touche Tohmatsu India Pvt. Limited	Management Consultants		Bangalore
Confederation on Indian Industry	Association		New Delhi
Crop Care Federation of India	Association		New Delhi
Indian Banks' Association	Association		Mumbai
Indian Paper Manufacturers Association	Association		New Delhi
Abhishek Industries Limited	Company	Private	Ludhiana
Alstom Industrial Products Limited	Company	Private	Kolkata
Ashok Leyland Limited	Company	Private	Chennai
Asian Paints Limited	Company	Private	Mumbai
Athreya Investment Services Limited	Company	Private	Chennai
Aurobindo Pharma Limited	Company	Private	Hyderabad
Bajaj Auto Limited	Company	Private	Pune
Bajaj Hindustan Limited	Company	Private	Noida
Balasore Alloys Limited	Company	Private	Kolkata
Birla Corporation Limited	Company	Private	Kolkata
BPL Mobile Communications Limited	Company	Private	Mumbai
Brakes India Limited	Company	Private	Chennai
Cadila Healthcare Limilted	Company	Private	New Delhi
Chambal Fertilizers & Chemicals Limited	Company	Private	New Delhi
Dabur India Limited	Company	Private	Ghaziabad
East India Commercial Co. Limited	Company	Private	Eluru
Emcure Pharmaceuticals Limited	Company	Private	Pune
FENA (P) Limited	Company	Private	New Delhi
Finolex Cables Limited	Company	Private	Pune
Ford India Private Limited	Company	Private	Chengalpattu
HBL NIFE Power Systems Limited	Company	Private	Hyderabad
Hindustan Motors Limited	Company	Private	Kolkata
Hindustan Unilever Limited	Company	Private	Mumbai
ITC Limited (Foods Division)	Company	Private	Bangalore
ITC Limited (ITD)	Company	Private	Kolkata
ITC Limited (PPB)	Company	Private	Chennai
J.K. Lakshmi Cement Limited	Company	Private	New Delhi
Jayadarsini Housing Pvt. Limited	Company	Private	Hyderabad
Jindal Stainless Limited	Company	Private	Hisar
JOCIL Limited	Company	Private	Guntur
K.G.Khosla Compressors Limited	Company	Private	Pune
Kamino International Logistics Pvt. Limited	Company	Private	New Delhi

ANNEXURE-XII

LIST OF RESPONDENTS TO THE EXPERT GROUP QUESTIONNAIRE

Company	**Category**	**Sector**	**City**
Keerthi Industries Ltd.	Company	Private	Hyderabad
Kirloskar Brothers Limited	Company	Private	Pune
Lakshmi Machine Works Limited	Company	Private	Coimbatore
Mahindra & Mahindra Limited	Company	Private	Mumbai
Mangalore Chemicals & Fertilizers Limited	Company	Private	Bangalore
Marathon Electric Motors (India) Limited	Company	Private	Kolkata
Maruti Suzuki India Limited	Company	Private	Gurgaon
MRF Limited	Company	Private	Chennai
MRO-TEK Limited	Company	Private	Bangalore
Naturol Bioenergy Limited	Company	Private	Hyderabad
Nava Bharat Ventures Limited	Company	Private	Hyderabad
Nestle India Ltd.	Company	Private	Gurgaon
North Delhi Power Limited	Company	Private	New Delhi
Paramount Quality Systems	Company	Private	Coimbatore
Ranbaxy Laboratories Limited	Company	Private	Gurgaon
Reliance Industries Limited	Company	Private	Mumbai
Ruia Group of Companies	Company	Private	Kolkata
Serum Institute of (I) Limited	Company	Private	New Delhi
Simpson & Company Limited	Company	Private	Chennai
Southern Petrochemical Industries Corpn. Limited	Company	Private	Tuticorin
Sree Akkamamba Textiles Limited	Company	Private	Tanuku
Sree Satyanarayana Spinning Mills Limited	Company	Private	Tanuku
ST-CMS Electric Co. Pvt. Limited	Company	Private	Chennai
Subros Limited	Company	Private	Noida
Sudarshan Chemical Industries Limited	Company	Private	Pune
Sundaram Fasteners Limited	Company	Private	Chennai
Sundaram Finance Limited	Company	Private	Chennai
Swaraj Mazda Limited	Company	Private	Chandigarh
The Andhra Petrochemicals Limited	Company	Private	Vishakapatnam
The Andhra Sugars Limited	Company	Private	Tanuku
The Durgapur Projects Limited	Company	Private	Durgapur
The KCP Limited	Company	Private	Chennai
The Tata Power Company Limited	Company	Private	Mumbai
Tractor & Farm Equipments Limited	Company	Private	Chennai
TVS Electronics Limited	Company	Private	Chennai
TVS Investments Limited	Company	Private	Chennai
TVS Motor Company Limited	Company	Private	Hosur
W.S. Industries (India) Limited	Company	Private	Chennai
Wheels India Limited	Company	Private	Chennai
Airports Authority of India	Company	Public	New Delhi
AP State Financial Corporation	Company	Public	Hyderabad
Bharat Earth Movers Limited	Company	Public	Bangalore
Bharat Electronics Limited	Company	Public	Bangalore
Bharat Heavy Electricals Limited	Company	Public	New Delhi
Bharat Petroleum Corporation Limited	Company	Public	Mumbai
Brahmaputra Valley Fertilisers Limited	Company	Public	Noida
Central Electronics Limited	Company	Public	Ghaziabad
CESC Limited	Company	Public	Kolkata
Coal India Limited	Company	Public	Kolkata
GAIL (India) Limited	Company	Public	New Delhi
Gujarat Alkalies & Chemicals Limited	Company	Public	Gujarat
Hindustan Antibiotics Limited	Company	Public	Pune
Hindustan Insecticides Limited	Company	Public	New Delhi
Hindustan Petroleum Corporation Limited	Company	Public	Mumbai
Indian Oil Corporation Limited	Company	Public	New Delhi
Karnataka Soaps & Detergents Limited	Company	Public	Bangalore
Mahanagar Telephone Nigam Limited	Company	Public	New Delhi
Narmada Hydroelectric Dev. Corp. Limited	Company	Public	Bhopal
National Aluminium Company Limited	Company	Public	Bhubaneswar
National Fertilizers Limited	Company	Public	Noida
National Hydro-Electric Power Corpn. Limited	Company	Public	Faridabad

ANNEXURE-XII

LIST OF RESPONDENTS TO THE EXPERT GROUP QUESTIONNAIRE

Company	Category	Sector	City
National Mineral Development Corporation Limited	Company	Public	Hyderabad
National Small Industries Corpn. Limited	Company	Public	New Delhi
National Textile Corporation Limited	Company	Public	New Delhi
National Thermal Power Corporation Limited	Company	Public	New Delhi
Neyveli Lignite Corpn. Limited	Company	Public	Tamilnadu
Oil & Natural Gas Corporation Limited	Company	Public	New Delhi
ONGC Videsh Limited	Company	Public	New Delhi
Power Grid Corporation Limited	Company	Public	Gurgaon
Rashtriya Ispat Nigam Limited	Company	Public	Visakhapatnam
Scooters India Limited	Company	Public	Lucknow
Steel Authority of India Limited	Company	Public	New Delhi
Tamilnadu News Prints & Papers Limited	Company	Public	Chennai
Transmission Corp. of Andhra Pradesh Limited	Company	Public	Hyderabad
Uttar Gujarat Vij Co. Limited	Company	Public	Mehsana
IFFCO Limited	Cooperative		New Delhi
National Dairy Development Board	Cooperative		Anand
Shri A.V.Ramana Rao	Past President, ICWAI		Chennai
Shri Amal Kumar Das	Past President, ICWAI		Kolkata
Shri D. V. Joshi	Past President, ICWAI		Pune
Shri N. P. Sukumaran	Past President, ICWAI		Thiruvananthapuram
Shri P. D. Parkhi	Past President, ICWAI		Pune
Shri P. D. Phadke	Past President, ICWAI		Mumbai
Shri P. S. Nadkarni	Past President, ICWAI		Mumbai
Shri V. Kalyanaraman	Past President, ICWAI		Chennai
Shri V. R. Iyer	Past President, ICWAI		Mumbai
Shri B. M. Sharma	CCM, ICWAI		Pune
Shri S. C. Mohanty	CCM, ICWAI		Bhubaneswar
Shri Sanjiban Bandyopadhyay	CCM, ICWAI		Kolkata
Shri Somnath Mukherjee	CCM, ICWAI		Dt. Hooghly
Shri V. C. Kothari	CCM, ICWAI		Mumbai
Dr. D. Jagannathan	Cost Accountants		New Delhi
Hyderabad Chapter of Cost Accountants	Cost Accountants		Hyderabad
S.S.Zanwar & Associates	Cost Accountants		Hyderabad
Sagar & Associates	Cost Accountants		Hyderabad
Shri A. R. Ramanathan	Cost Accountants		New Delhi
Shri Arun K. Chatterjee, E. V. Mani & Co.	Cost Accountants		Kolkata
Shri Dantu Mitra	Cost Accountants		Hyderabad
Shri H.S.Arora	Cost Accountants		Patiala
Shri K. Narasimha Murthy	Cost Accountants		Hyderabad
Shri K.S.Sathyanarayana	Cost Accountants		Bangalore
Shri K.S.Subramanian	Cost Accountants		Hyderabad
Shri K.V.H.R.S. Sarma	Cost Accountants		Hyderabad
Shri N.S.Acharya	Cost Accountants		Mumbai
Shri P.Parankusam	Cost Accountants		Hyderabad
Shri Rohit J. Vora	Cost Accountants		Mumbai
Shri S.Srinivasan, Geeyes & Co.	Cost Accountants		Chennai
Shri V. R. Kedia	Cost Accountants		Mumbai
Shri V.Balasubramaniyan	Cost Accountants		Coimbatore
Shri Veer Raghvan Iyenger	Cost Accountants		Mumbai
Thrissur Chapter of Cost Accountants	Cost Accountants		Thrissur

Confederation of Indian Industry
Total Cost Management Division

TCM Maturity Model

Draft Version 1.0

December 2007

CONTENTS

Executive Summary

As a novel approach for cost management in industry, the CII-TCM division has designed and conceptualized the concept of TCM Maturity model to evaluate, assess and rate the cost and cost management systems of the companies across the spectrum of both manufacturing and service industry. The purpose of developing the model has been to evolve a certification process to be administered by CII to make a company more objective, scientific, and efficient and ultimately a leader in the cost management as it navigates across the stated levels of the maturity model. A committee of CII through a network of management consultants facilitates rating and also rates the companies across the levels in the maturity model.

The CII-TCM is proposing to present a draft version in the ‘Cost congress’ to be conducted in mid-December 07.

Further to seeking a consensus on the broad approach and design from the industry, a pilot study is proposed in select companies to evaluate and assess them based on the model

Consequently, the model would be fine tuned based on the initial inputs taken from the pilot study and upgraded version of the model would be launched thereafter

The snapshot of the maturity model is as follows;

Level-1-MINIMAL –
Feature – Financial driven –
This level forms the first step in the evolution of the five stage model. It is predominantly finance driven module. Has ‘Cost centers’ in place for collection of cost information

Level – 2 – FUNCTIONAL –
Feature – System based data support – Product / Service Direct costs (such as material cost in manufacturing / Time costs in service industry) are in place and cost measurement is done through system driven data collection.

Level – 3 – OPERATIONAL –
Feature – Operational focused – The net working is in place, the cost systems are integrated with other information systems. Appropriate costing systems like Activity based cost systems, decision making support systems are in place through cost information system. Enhanced view of profitability of product and customer is available.

Level – 4 – TCM ENABLED –
Feature – Continuous improvements of cost management systems – Support for strategic decision is in place. Cost measurements and feedback systems are integrated. Various tools of cost management are put to use

Level – 5 – Exemplary –
Feature – Systems and procedures followed become a trend to other companies - Companies falling under this category are iconic companies setting a trend in many aspects and leaving a trail for other companies to follow.

Introduction

In Indian economic scenario, the year 1991-92 can be said as a very important mile stone achieved. Indian economy was opened up to the outside world for the first time ever (excepting certain sensitive industries like defense, insurance, pharmaceuticals etc.) which all the while was subjected to protectionism by the government of India.

The closed economy had infused a sense of complacency to the Indian industrial entrepreneurs and had a tremendous impact on the pricing mechanism on the products manufactured within the borders of India. All the costs incurred by the manufacturers were accumulated and an indiscrete margin was added and abnormal price was charged to the customer. Since there was very minimal choice to the customer, the acceptance was almost taken for granted by the manufacturer / service provider.

But, with the changed scenario consumer has a choice both in terms of product and price. Enormous pressure was put on the pricing mechanism of the products made by Indian entrepreneurs. The prices of products / services in the contemporary business world are designed to be dictated by market forces – demand and supply – and the business organization are forced to look inwards into their pricing structures and into all possibilities of cost reduction to both sustain and increase their market share in the industry.

Facing these new challenges, industries are now faced with an uphill task of absorbing these costs (market is no more prepared to absorb any extra cost) and information needed to make management decisions.

Many new tools and techniques of costs were propounded during the mid 80’s and 90’s and eventually adopted by many of the Indian industries. Any new technique brought in like Activity based costing. Target costing et al had an immense impact on reduction of costs and keeping the quality of the product / service intact.

The contemporary Indian industry has come a long way in their outlook of treating costs, cost information systems and feedback systems to the management.

It is almost accepted fact that, the industrial scenario has two most powerful concepts:

- accurate measurement of costs
- reduction of costs by continuous improvements

that enable the finance function to shift from being the passive reporter of the past to a proactive influencer of the future.

Unfortunately, in India there is no one single code of collection, measurement and control of costs, leading to logical reporting system. Every company and industry has its own perceptions and priorities on costs and formed its own format for tracking and treating costs. In fact, many of the modern tools for evaluation of costing are confused as substitutes rather than complements.

Many questions on cost information and cost culture in an organization remain unanswered:

- Is there any universal methodology of cost system universally applicable to diversified industry in India?
- Does the cost system formatted is compatible with the existing finance system of the organization?
- Is the cost system integrated with all other departments existing in the organization?
- Does the cost system is supported by IT (Information Technology) and there by derive the benefits of speed and accuracy?
- Is the cost information accessible to all levels and cost awareness percolates at all levels of employees?
- Is the decision making of the management (both operational and strategic) supported by cost information?
- Is the cost of product / service absorption based on its cause and effect?
- Is the available and operating cost structural of the organization – the best in the industry?
- What is the level of insulation designed by the organizations from the cost system as a cover against market risk, customer risk and product risk?
- Is cost information used for continuous improvements across the operations in an organization?

The above questions lead to evaluation perspective on costs and cost systems operating in the organizations, which is currently unavailable as a system in the world. CII is making an attempt in that direction to put in place a TCM maturity model which is designed to evaluate and rate cost competitiveness of the companies across the spectrum of both manufacturing and service industry. The purpose is to evolve a certification process to be administered to make a company more objective and sequentially lead it a highest level of TCM Company in its industry.

Evolution of any system has its own formative stages like fundamental and baseline to matured and evolved stage and features associated with it. Similarly, TCM maturity model has a 5 stage model and an organization is rated based on the parameters associated with each level of the model.

The evolving levels of the model range from Level – 1 – with companies having cost systems that are inadequate even for financial reporting systems to Level – 5 – with matured companies having lowest cost structural comparable in the industry and their extra ordinary capability to predict the oncoming risks associated with product, market and customer using cost information.

As the companies evolve from Level – 1 to the next level, they ought to have more matured systems of costing in terms of collection, assignment of costs to products / services, management information systems and feed back systems and essentially document the progress so as to institutionalize these evolutionary changes so as to make them system dependent rather than person dependant.

Features

As an innovative step the Maturity model is conceptualized, designed and developed for the purpose of certifying process to be administered to assess and evaluate a company on its strength and capabilities in Total cost management

A company would be evaluated based on stipulated parameters available in each of the levels. There are certain check points for each parameter on which a company's cost information and evaluation system would be assessed

These check points again are in two categories:

a) Check points with single point answers
b) Check points which seek certain clarifications

The five levels featured in the TCM maturity model are detailed below as a snapshot

Level – 1

Name of the level – **MINIMAL**
Feature – Financial report driven

The evolution of any model begins at its first step and hence is aptly name as 'Minimal'. For the last few decades cost systems have had its roots in organization's finance department and any cost system dependent on finance are this level. But then this level is inadequate for managerial reporting and control. The manufacturing costs are tracked and compiled but the material cost is still elusive for measurement and evaluation.

1) Cost awareness only at senior management levels,
2) Collection of costs at 'COST CENTERS'
3) Assignment of only manufacturing expenses/operational expenses to products/services
4) Delayed feed back to management
5) Unreliable cost data
6) Product cost not based on standard practices
7) More informal decisions sans robust cost analysis
8) Non-financial information has sub-optimal role
9) Cost data not aligned to 'Value chain analysis'
10) Product specific material consumption not adequate

Level – 2

Name of the level - **Functional**
Feature – System driven data support

The material cost / time cost is in place for evaluation and compilation, product wise / customer wise with built in wastages. The powerful capabilities of information technology is introduced and customized and cost measurement systems are in place.

1. Adequate measurement of direct and indirect costs related to product / service
2. Cost measurement not driving cost improvement initiatives
3. Cost information more supportive of operational decision making & less for strategic
4. Inter department sharing not in place
5. Non-financial information availability through stand alone systems of various Modules

Level – 3

Name of the level - **Operational**
Feature – Operationally focused

The net worked and client server systems are in place – the processing of available information systems into specialized managerial accounting system is attempted here. Activity based cost systems, operational feed back systems to promote efficiency and protocols for accessing the operational information for operational decision making are in place at this level. Also cost information for budgetary support exists at this level to provide a base for scientific evaluation.

1. Synchronization of financial accounting and cost accounting
2. Both Material costing and process costing based on acceptable cost accounting standards
3. Effective utilization of cost data for improvements (such as Kaizen)
4. Operational support for budgeting process
5. All the systems interlinked

Level – 4

Name of the level – **TCM Enabled**
Feature – Continuous improvements

The support for strategic decision making is in place. Cost measurements and feed back systems are integrated. Various tools of cost management are in vogue.

1. Integrated cost system in place
2. Customer focused cost measurement & management
   (Target costing & Value engineering)
3. Operational excellence reinforced continuously through cost management
4. Cost management link with business strategy explicitly articulated
5. Total cost management support for strategic formulation and its implementation
6. ERP System providing total solution for cost management requirement

Level – 5

Name of the level – **Exemplary**
Feature – Systems and procedures followed become a trend to other companies

The companies falling under this category are iconic companies and these companies create a trail on which other companies follow suit. The trail is in terms of methods and procedures, cost structures and other approaches made in the cost systems and have reaped benefits from the ventures made.

1. TCM effectively linked to enterprise risk management – ability of the organizations to anticipate the impact of risks arising from Product specific risk, customer risk, environmental risk (climate change) and market risk

2. Drive cost structural in a particular industrial sector - Achieve cost leadership in formulating cost structural and eventually be a trend setter

3. The internal system is designed to minimize and absorb both national and global uncertainties

4. achieve an edge in having a cost advantage in external value chain

Importance / Relevance of Maturity model

The fast changing business and economic scenario globally has changed the dynamics of costs structure, cost information, performance measurement and management systems viewed across the spectrum of industry. Business models are constantly being reviewed for sustained competitiveness which has also injected a new dynamism into cost management.

The basis and assumptions used in the traditional costing are constantly being challenged resulting in pressure for evolving the organizations into higher maturity levels.

The challenges, the business organizations are facing today are becoming more intense and are in the form of both internal and external. Some of them are detailed below

1) Fierce competition
2) Rising input costs
3) Pressure on bottom lines
4) Mismatch of rising top line and bottom line growth
5) Wide product / service range
6) Improved technology
7) Shifting customer loyalties

For an organization to thoughtfully and cautiously face the above challenges it is of paramount importance that, management has to necessarily have a tab on utilization of resources. There cannot be a process which consumes resources and does not add value to the stake holders

The standard regime of a scientific costing system begins with systematic collection of cost information across the spectrum of organization’s value chain and assigning and analyzing from various perspectives, required in terms of obtaining right

- Process costs
- Cost drivers
- Product / Service costs
- MIS
- Performance measurement systems

By and large cost systems available and operating with many companies across the corporate world are customized to their requirements, dictated on the day of installation. These again are articulated by the current management practices. They may or may not get upgraded in response to the needs of the changing dynamics of economic and market scenario resulting in minimal functionality.

The development of the costing system in certain organizations is more by hindsight rather than on foresight.

The status quo of the existing cost systems in India could be as stated below:

- The cost awareness in many organizations and industries is slowly catching up
- There is no government mandate to make the cost information of an industry accessible in the public domain. While this may be acceptable it may be healthy trend to inform the advancement in cost management trends to stakeholders
- Many organizations are not aware of the level of advancement of cost systems which can benefit the stake holders
- Low level of awareness in the Indian industry on the ramifications of impending WTO and FTA (Free Trade Agreements)
- Even the available approach to cost management in many organizations may be ad hoc and may not be in a scientific manner which may have negative implications on quality of service rendered.
- Awareness across the industry, that, there are various levels that exist in the cost systems (with better features) which can be reached by the industry. These levels help the organizations to achieve preparedness to face enormous challenges ahead.

Hence it is imperative to design and operate an evaluation system on costs and costing systems which does two important tasks or functions:

1. Identifies the level the organization currently occupies in the maturity model
2. Procedure available to move from one level to another level in the maturity model

The above two functions acquire high importance due to both current and upcoming challenges to be faced by the Indian industry in terms of rising costs and reducing bottom lines.

Some of the important benefits for an organization to have a maturity model rating are detailed below. Some of stated benefits external in nature and some are internal in nature.

External

1. OEM – For organizations who are the component suppliers to OEM (Original Equipment Manufacturer), the rating could acquire tremendous credentials in terms of authenticity, precision and importance for the pricing structure of the products.

2. Mergers & Acquisitions (M&A) – As globalization is in progress, the impact is on wide span of industries and countries. The rating from the maturity model could add high value to the transaction made (both buy and sell)

3. By incorporating the need for calibrated cost management systems in FTA much desired transparency can be achieved by the concerned governments.

4. Transfer pricing – During a transaction made between multi-divisions either intra or inter organization, grading by the maturity model could provide better perspective for the valuation of the product / service being transferred.

5. Preparation of quotations – During the preparation of quotations for a product / service, the grading through maturity model would inform a company more about itself. The level of scientific methodologies adopted for cost analysis, available potential for further progress and level at which the company is equipped to make a quote. Better clarity is available for the organization with grading of maturity model.

Internal

(A) Strategic

1. The financial success of business model need to be constantly evaluated with a reliable and appropriate data base. This can lead to either change in the business model or strategy itself. The cost management system at higher levels of maturity can fulfill this need.

2. Multi – product / service – An organization with multi-product / service, has an onerous task of holding best assessment methodology to evaluate the cost of its individual product / service. The presence of cross-subsidy would cannibalize either into their own product range or into their competitor's product range.

3. Customer profitability: Customer should not only bring top line growth but also add to profits. Hence customer profitability review is the key element of current management process. Cost management systems at higher levels of maturity enable this value.

4. Competition – During intense competition, the rating by the model could facilitate the organization to review its cost structure and draw a road map to enable a metamorphosise into next level to have better outlook and control on its costs being incurred.

5. Capital projects – If the existing companies are in expansion mode, it requires authentic data as inputs for project evaluation on its economic feasibility and submission. The grading in the maturity model would equip the project working with scientific basis and thereby provide a better viability picture for the project working

6. New product development – An organization working towards new products and services requires simulation of existing process data at various stages like at the drawing board, pilot project stage and actual manufacturing and selling. At all the stages if the companies are graded under the maturity model, the assessment and assignment of costs to the products would be accurate and scientific.

(B) Operational

7) Measurement of quality is an important aspect of Quality management systems. A good cost management system would integrate Quality management system and highlight cost of quality

8) Cost leadership strategies require a strip down focus on process waste caused by non-value added activities. Mature cost management systems would provide visibility to such issues through appropriate measures

9) A continuous improvement environment focusing on operational efficiencies will always result in breakthroughs at a threshold limit. Such breakthroughs will warrant investment which can be measured against benefits through appropriate cost management systems.

Approach for Implementation of the model

The design, application and success of the TCM maturity model would depend largely on the industry participation. The interaction with the industry largely required in the following phases

1) Concept development
2) Pilot study of the application of the model in an industry
3) Final development of the model

1) Concept development

Once the base model was framed, the concept was discussed and debated on 30th April in TCM committee meeting, represented by finance heads of major companies to seek their views and opinions

2) Pilot study of the application of the model in an industry

Year – 2007: The model with the development of version 1.0 is proposed to be applied in select companies to perform a preliminary assessment and provide a rating to the companies based on the feed back from the pilot study.

Year – 2008: Based on the results of the pilot study and inputs received from the industry the model is proposed to be upgraded and have a pilot study in select companies and version 2.0 which would be a improvised model used for grading the companies would be released.

Year – 2009: The maturity model is proposed to use extensively in many companies across all the sectors (both manufacturing and service) and further upgrade based on the inputs received from the industries.

3) Awareness and promotion

CII also seeks the participation of the industries and other professional bodies to create awareness of the TCM maturity model amongst its members and provide a platform to promote the model through literature (of booklets and case studies) and application of the model

Professional Accountants in Business Committee

Exposure Draft
June 2008
Comments are requested by September 23, 2008

International Good Practice Guidance

Evaluating and Improving Governance in Organizations

International Federation of Accountants

REQUEST FOR COMMENTS

The Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC) approved this exposure draft, Evaluating and Improving Governance in Organizations, for publication in June 2008.

As part of a pilot project to further encourage user-involvement in the development of these International Good Practice Guidance documents, all those interested are invited to provide their comments via an online survey which can be accessed through this link: http://www.ifac.org/governanceED.

All written comments will be considered a matter of public record (unless otherwise requested) and will ultimately be posted on the IFAC website, with a summary of the survey results.

Please submit your comments, preferably by email, so that they will be received by September 23, 2008. Comments should be addressed to:

Technical Manager
Professional Accountants in Business Committee
International Federation of Accountants
545 Fifth Avenue, 14th Floor.
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

Copies of this exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org/PAIB.

INVITATION TO COMMENT

Guide for Commentators

This International Good Practice Guidance (IGPG) on Evaluating and Improving Governance in Organizations complements the 2007 IGPG on *Defining and Developing an Effective Code of Conduct for Organizations* [web link]. Its aim is to establish a benchmark for good practice in establishing effective governance, and in particular to help organizations create a balance between performance and conformance, as described in the framework in section 2 of the document. The IGPG emphasizes the need for organizations to spend enough time and resources both on the performance and conformance perspectives of governance.

In encapsulating good practice in a framework and twelve fundamental principles, the emphasis of this IGPG, as is the case with the IFAC PAIB Committee's other IGPGs, is to support professional accountants in business in a flexible way. That is helping them think about how to apply good practice rather than instructing on how actually to apply specific governance topics.

IFAC's PAIB Committee would like to receive comments on all matters addressed in this proposed IGPG. Anyone offering comments should refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for proposed changes to wording. The PAIB Committee is particularly interested in comments on the matters set out below:

The terminology

1. Does the term "governance" fit in the context of this IGPG, or should it be replaced by another or more refined term, like "enterprise governance" or "corporate governance"?

The framework and the principles

2. Do the framework and the principles cover all the fundamental areas in evaluating and improving governance in organizations, and especially in creating a balance between performance and conformance?

The guidance

3. Is the application guidance for each principle adequate to guide good practice?
4. Are there other examples of organizational values/principles or other resources on governance not already mentioned in appendices A and B that should be considered?

We also welcome feedback on further topic selection for PAIB Committee publications as International Good Practice Guidance in the area of governance.

IFAC PAIB COMMITTEE INTERNATIONAL GOOD PRACTICE GUIDANCE

CONTENTS

Evaluating and Improving Governance in Organizations

1. Why the Topic is Important

1.1 This International Good Practice Guidance provides principles-based guidance for the professional accountant in business and their organizations on evaluating and improving governance in organizations. Recognizing that varied organizations and cultures take different approaches to governance, this guidance is based on the premise that certain factors and behaviors can lead to better outcomes and increased stakeholder value across all entities.

1.2 Some form of governance has always been present in organizations, but the attention paid to governance issues has evolved with changes in the business environment. Due to recent corporate failures and regulatory responses, governance has again become a priority. Various governance codes have been proposed and implemented on both national and international levels; see Appendix B for some examples.

1.3 Although most organizations have a governance structure in place, it is often focused on conformance with regulations. This conformance is of course necessary, but a governance structure should also support an organization's efforts to improve performance. The intention of this paper is to create a balance between performance and conformance, as described in the framework below.

1.4 Successful organizations adhere to governance principles, and periodically evaluate results to ensure the continuing effectiveness of their governance systems. Furthermore, governance procedures and practices should be benchmarked against those of successful organizations and the principles outlined in this guidance document. As organizations and their environments change, the governance system must adapt to future opportunities and threats by improving processes and practices.

The Role of the Professional Accountant in Business in Governance

1.5 As reported in IFAC's 2005 information paper, *The Roles and Domain of the Professional Accountant in Business* [web link], the domain of the professional accountant in business includes – among other things – the following activities:

1. Providing, analyzing and interpreting information to management for formulation of strategy, planning, decision-making and control.
2. Measuring performance, recording financial transactions - typically under national or international generally accepted accounting principles - and communicating the results to board and stakeholders.
3. Managing risk, and providing internal control and business assurance.
4. Generating or creating value through the effective use of resources (financial or otherwise) through (a) understanding the drivers of value to stakeholders (which may

include shareholders, customers, employees, suppliers, communities, and government), and (b) organizational innovation.

1.6 These activities, in which the professional accountant in business is engaged, are strongly aligned with the activities included in the definition of governance (see below): (1) providing strategic direction, (2) ensuring objectives are achieved, (3) ascertaining that risks are managed, and (4) verifying the responsible use of resources. The professional accountant in business has a responsibility in all of these activities to ensure that the organization engages in effective and efficient practices. The professional accountant in business has a responsibility to provide objective and valid information and analyses to support all of these activities and, in some cases, may have overall responsibility in areas such as risk management and resource allocation.

2. Definitions, Framework, and Key Principles That are Widely Accepted Features of Good Practice

Governance Definitions in the Context of this IGPG

2.1 **Governance:** “the set of responsibilities and practices exercised by the board and executive management (“the governing body”) with the goal of (a) providing strategic direction, (b) ensuring that objectives are achieved, (c) ascertaining that risks are managed appropriately, and (d) verifying that the organization’s resources are used responsibly.”[1] This definition reflects both the performance and conformance aspects of governance.

2.2 **Conformance**: compliance with laws and regulations, best practice governance codes, accountability, and the provision of assurances to stakeholders in general. The term can refer to (a) internal factors defined by the officers, shareholders, or constitution of an organization, as well as (b) external forces such as consumer groups, clients, and regulators.

2.3 **Performance**: policies and procedures that (a) focus on opportunities and risks, strategy, value creation, and resource utilization, and (b) guide an organization’s decision-making.

2.4 **Stakeholder:** any person, group, or entity that has an interest in an organization’s attention, its resources, or output (or that is affected by that output). Stakeholders include regulators, shareholders, debt holders, employees, customers, suppliers, advocacy groups, and society as a whole.

2.5 **Shareholder** (stockholder): a holder or owner of shares in a company or corporation. The shareholder plays a formal role in the governance of an organization, and is generally entitled to vote on a variety of issues and to share in the financial results.

2.6 **Stakeholder value**: organizational value that is generated for stakeholders by creating, implementing, and managing effective strategies, processes, activities, assets, etc.

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[1] IT Governance Institute, Board Briefing on IT Governance, 2nd Edition, USA, 2003

Sustainable value creation for stakeholders occurs when the benefits to them are greater than the resources that are expended on a consistent and ongoing basis. Value is generally measured in financial terms (as in the case of shareholders), but can also be measured as social or environmental benefit or organizational reputation (as in the case of both shareholders and other stakeholders).

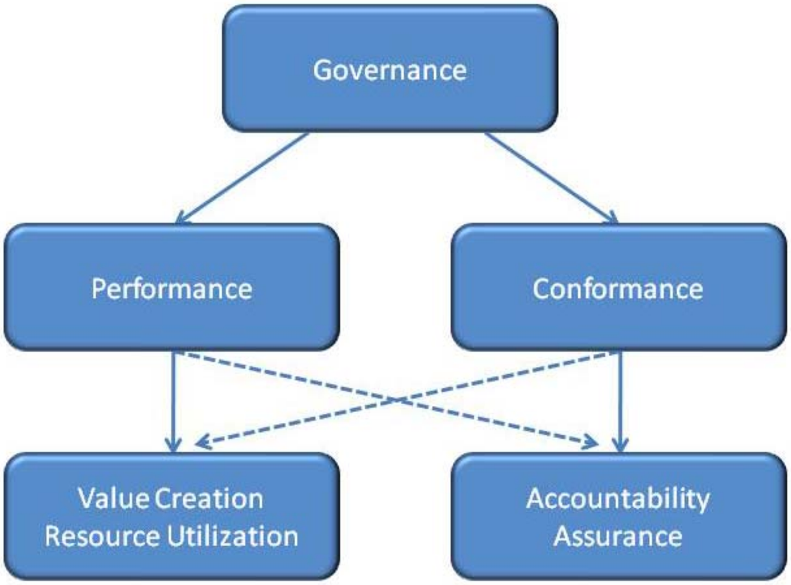
2.7 **Enterprise risk management**: the process of planning, organizing, leading, executing, and controlling the activities of an organization to maximize value and minimize the risk of events that diminish value. Enterprise risk management covers all kinds of risks, including risks associated with accidental losses, as well as financial, strategic, operational, and reputational risks.

2.8 **Governing body**: the person(s) or organization(s) (e.g., a board of directors) with primary responsibility for overseeing (a) the strategic direction of the entity and (b) the accountability of the entity. This includes overseeing the financial reporting process. The governing body can consist of various committees, such as the audit committee, the remuneration committee, and the ethics committee. In some entities in some jurisdictions, the governing body may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. In some cases, the governing body is responsible for approving the entity's financial statements (in other cases management has this responsibility). For a discussion of the diversity of governance structures, see Appendix C, The Diversity of Governance Structures. In most large organizations, there can be multiple organizational levels, each with specific authority and responsibility for governance. This paper uses the term governing body in both respects, that is, the governing body at the top (board of directors or board of trustees), and the lower level governing bodies.

2.10 **Business model**: how an organization takes resource inputs and generates value for stakeholders. It represents how an organization undertakes its business. It consists of an organization's objectives and revenue streams, its strategy, operations, and its various other functions.

Governance Framework

2.11 The governance framework is composed of two dimensions: the performance dimension and the conformance dimension, which together represent the entire value creation, resource utilization, and accountability framework of an organization.



Governance Framework

2.12 In general, the conformance dimension tends to take a historic view, while the performance dimension is more forward-looking.

2.13 Conformance responsibilities focus on providing assurances to stakeholders:

- Concerning the effectiveness of the identification, prioritization, management, control, mitigation, and reporting of strategic and operational risks.
- That the organization is working effectively and efficiently to achieve its strategic and operational goals.
- That the systems generating financial and non-financial information are working within prescribed standards of accuracy and reliability, and that such information reflects the true performance of the organization.
- That management's fiduciary responsibilities are being met.
- That the organization is able to prevent and detect criminal activities such as fraud, money laundering, theft, and misappropriation.

2.14 Performance responsibilities focus on strategy, value creation, and resource utilization, and include:

- Establishment of a robust decision-making process, including the determination of risk appetite (the amount of risk the organization is willing to take in pursuit of its objectives).
- Oversight of strategy implementation and evaluation of the strategy's ongoing relevance and success.
- Alignment of business operations and resource utilization with strategic direction and the organization's levels of risk appetite.
- Identification of the critical points at which an organization needs to make decisions in response to changing conditions.

2.15 Performance and conformance dimensions enhance each other and the organization as a whole, as represented by the dotted line relationships in the above diagram.

2.16 Concern that company attention is dominated by compliance at the expense of strategy and performance was confirmed by an independent survey commissioned by IFAC. The report, *Financial Reporting Supply Chain Survey—Current Perspectives and Directions* [web link], issued in 2008, reveals that many respondents believed that organizations focus too much on compliance, and do not focus enough on matters such as strategy and building a business. The respondents also observed a checklist mentality, leading to governance in name and not in spirit. Respondents recommended a move from compliance governance to business governance.

2.17 Also, 27 case studies undertaken as part of an IFAC/CIMA research project on governance, published in 2004 in the report *Enterprise Governance: Getting the Balance Right*[2] [web link], showed that although compliance is necessary to avoid failure, it is not sufficient to ensure success. This demonstrates the need for organizations to ensure that they spend enough time and resources on (strategic) performance.

The Key Principles of Evaluating and Improving Governance in Organizations

2.18 In developing principles to represent good practice for evaluating and improving governance, the PAIB Committee referred to the findings from the case studies presented in *Enterprise Governance: Getting the Balance Right* [web link], and confirmed by the *Financial Reporting Supply Chain Survey* [web link]:.

A. The creation and optimization of stakeholder value should be the objective of governance.

B. Good governance should appropriately balance the interests of stakeholders to optimize value.

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[2] This guidance paper uses the term "governance" instead of "enterprise governance" among other reasons to emphasize that the key governance principles apply to a wider circle of organizations than (only) enterprises.

C. The conformance and performance dimensions of governance are both important to optimize stakeholder value.

D. Good governance should be fully integrated into the organization.

E. The governing body should be properly constituted and structured to achieve an appropriate balance between performance and conformance.

F. The governing body should establish a set of fundamental values by which the organization operates. All those participating in governance should embrace these fundamental values.

G. The governing body should understand the organization’s business model, its operating environment, and how stakeholder value is created and optimized.

H. The governing body should provide strategic direction and oversight in both the conformance and performance dimensions.

I. Effective and efficient enterprise risk management should form an integral part of an organization’s governance system.

J. Resource utilization should align with strategic direction.

K. The governing body should periodically measure and evaluate the organization’s strategic direction and business operations, and follow up with appropriate actions to ensure appropriate progress and continued alignment with goals.

L. The governing body should ensure that reasonable demands from stakeholders for information are met on a timely basis, and that the information provided is relevant, understandable, and reliable.

3. Practical Guidance on Implementing the Principles

PRINCIPLE A

The creation and optimization of stakeholder value should be the objective of governance.

A.1 Governing bodies in all types of organizations have the (fiduciary) responsibility to create and optimize value for their stakeholders. Governing bodies should know who the stakeholders are and understand their needs.

A.2 In for-profit organizations, the primary focus is generally on increasing shareholder value, which generally entails finding the optimal balance between revenue, cost, and risk. However, those organizations should also take into account the needs of other stakeholders. Public sector and not-for-profit organizations may satisfy stakeholder needs by enhancing the environment in which they operate, or by giving back to the community.

A.3 The professional accountant in business should help the governing body to identify and understand groups of stakeholders, by providing appropriate information and sharing knowledge.

PRINCIPLE B

Good governance should appropriately balance the interests of stakeholders to optimize value.

B.1 Stakeholder groups have differing, and sometimes conflicting, interests; processes should be established to identify and understand these interests. When making important decisions, the interests of all stakeholders should be appropriately balanced. To balance interests is not necessarily to make them equal.

B.2 Stakeholders should be encouraged to express their legitimate interests and concerns. Where they express unpopular positions, the organization should ensure that their rights are also taken into account.

B.3 The key stakeholder in the for-profit organization is the shareholder. Basic shareholder rights generally include the right to (a) obtain relevant materials and information on the organization on a timely and regular basis, (b) participate and vote in general meetings, and (c) elect and remove the board of directors. Shareholders, as their name implies, also rightly expect to share in the results of the organization.

B.4 Although various interests might seem to be in conflict in the short-term, they could be aligned in the longer term. For example, the interests of environmental groups may conflict with the short-term shareholder interests to maximize profits. However, in the long-term it benefits all to balance the various stakeholder interests.

PRINCIPLE C

The conformance and performance dimensions of governance are both important to optimize stakeholder value.

C.1 Governance affects the entire value creation, resource utilization, accountability, and assurance framework of the organization. The two dimensions of the governance framework, conformance and performance, should be appropriately balanced.

C.2 Historically, the conformance aspect of the framework has tended to receive dedicated attention, and generally well-established mechanisms ensure that good governance processes are directed to conformance, e.g., that the risk management function, internal controls, and audit committees, are effective.

C.3 Many organizations early in their life cycle focus primarily on the performance dimension. These organizations should also pay attention to the conformance dimension before this imbalance yields adverse outcomes.

C.4 The performance dimension, focusing on strategy and value creation, does not lend itself as easily to a regime of standards and audit. Unlike the conformance dimension, the absence of dedicated oversight mechanisms can cause a significant “oversight gap.” Therefore, it is desirable for organizations to develop a range of tools and techniques that can be used to ensure that appropriate attention is paid to the performance dimension, e.g., by using a strategic scorecard or appointing a strategic oversight committee.

C.5 The professional accountant in business participates in both performance and conformance activities. For conformance, professional accountants in business are often responsible for meeting regulatory and reporting requirements, and developing control processes. With regard to the performance dimension, professional accountants in business are generally responsible for providing, analyzing, and interpreting information to management for formulation of strategy, planning, decision-making, and control.

PRINCIPLE D

Good governance should be fully integrated into the organization.

D.1 Fostering good governance is more than a compliance exercise; governance should permeate all facets of the organization. The governance principles should be taken into account both in setting the organization’s objectives (planning), and in all subsequent actions (implementation and review). Governance should be part of the DNA of the organization.

D.2 The organization as a whole, as well as every individual in it, is responsible for achieving its objectives; everyone has a role in steering the organization toward those objectives.

PRINCIPLE E

The governing body should be properly constituted and structured to achieve an appropriate balance between performance and conformance.

E.1 The key issues in establishing the composition of a governing body are: (a) ensuring a suitable percentage of outside, non-executive members who are independent of the organization, (b) the objectivity of members, (c) the appointment and performance evaluation process, (d) the alignment of members' interests with stakeholder interests, and (e) the existence of appropriate governance functions like audit and remuneration committees.

E.2 Good practice calls for a suitable balance between (a) those members of the governing body who have direct responsibility for the operations and success of the organization (inside, executive, staff), and (b) those who are responsible only to the stakeholders and are not involved in operations (outside, non-executive members).

E.3 The majority of the non-executive (outside) members of the governing body should also be independent of management, and free from any business or other relationship that could materially interfere with the exercise of impartial judgment. Non-executive members should not have any conflicts of interest that could influence their objectivity, such as realizing financial benefit from decisions made by the governing body.

E.4 To strengthen the structural checks and balances, the roles of chairman of the governing body and chief executive should be separated; ideally, the chairman should be an independent, non-executive member.

E.5 The governing body as a whole, and all individual members, executive or non-executive, dependent or independent, (a) should take into account and balance all stakeholders' interests, and (b) should therefore exercise objectivity in all their decisions. Non-executive, independent members help to ensure a balance between the various stakeholder interests.

E.6 The governing body is responsible for ensuring the appropriate mix of its members, ensuring the sufficient representation of both conformance and performance competencies. This can be accomplished by (a) clearly defining the required roles and responsibilities, e.g., chair, audit committee chair, etc., and (b) implementing rigorous appointment and evaluation processes based on required competencies, experience (like sector knowledge and operational, financial, and/or legal competency), and on performance.

E.7 Measures should be taken to ensure that the interests of the members of the governing body are (and stay) aligned with stakeholder interests. On the one hand, this means that members should be aware of their governance leadership role ("tone at the top") and all the related responsibilities, as described elsewhere in this guidance document. On the other hand, it means that incentives that might endanger the member's objectivity should be avoided. Periodically, the governing body should reconfirm its adherence to the organization's values, and evaluate the possible existence of incentives that prejudice alignment with stakeholder interests (see also principle J on resource utilization and incentives).

E.8 The governing body should take explicit responsibility and devote sufficient resources to specific governance functions in the organization, such as (a) overseeing the external reporting and auditing process, (b) selecting and evaluating the performance of the CEO, and (c) remunerating the organization's management. The establishment of specific committees for these functions could be helpful. Committees of the governing body with oversight responsibilities, such as an audit committee, should be predominately composed of independent, non-executive members to ensure objectivity. In recent years, there has been a move in some jurisdictions toward adding a strategy committee, to improve strategic direction and oversight in the performance dimension. In many cases, this committee is a preparatory committee for the entire governing body, and not a decision-making committee.

E.9 As important as a proper governance structure is, it should be complemented by appropriate governance processes that ensure that the right people do the right things.

PRINCIPLE F

The governing body should establish a set of fundamental values by which the organization operates. All those participating in governance should embrace these fundamental values.

F.1 The governing body must set the "tone at the top" by (a) defining the organizational values, (b) developing and implementing a code of conduct, and (c) adhering to these principles as an example of appropriate behavior. A practical approach for doing so can be found in IFAC PAIB Committee International Good Practice Guidance: *Defining and Developing an Effective Code of Conduct for Organizations* [web link]. Some examples of organizational values are given in Appendix A.

F.2 The governing body should clearly communicate the organization's values to all (internal) stakeholders, and ensure that the values are understood, accepted, put into practice, and upheld.

F.3 The organization's values should be respected by all those involved in its decisions and actions. It is the responsibility of the governing body to make that happen.

F.4 Participants in governance should be driven by their conscience and organizational values to "do the right thing". Incentives could act as an additional motivator. However, incentives can produce both good and bad results. The organization should therefore ensure that incentives and remuneration are and remain aligned with (changes in) strategic direction.

F.5 Stakeholders, including employees, should be able to freely communicate their concerns about illegal or unethical practices to the governing body; their interests should not be compromised by doing this.

PRINCIPLE G

The governing body should understand the organization's business model, its operating environment, and how stakeholder value is created and optimized.

G.1 The governing body should assume a central role in governance, as its primary duty is to manage the organization in the long-term interest of all stakeholders. It is therefore essential that the governing body understands how the organization operates, and the opportunities and risks inherent in the environment in which it operates. Further, the governing body should understand how the organization creates and optimizes stakeholder value, to evaluate whether or not the needs of stakeholders are being met. A number of actions can be taken to facilitate this understanding; these include (a) a rigorous appointment process that ensures appropriate knowledge and experience, orientation, and training of new members of the governing body, and (b) a performance evaluation process that measures competence and achievements in critical areas.

G.2 As professional accountants in business are at the center of the information management process, they play an essential role in ensuring that the governing body can meet governance requirements.

PRINCIPLE H

The governing body should provide strategic direction and oversight in both the conformance and performance dimensions.

H.1 Conformance oversight has traditionally been a responsibility of the governing body, often assisted by an audit committee. These responsibilities have not been diminished by adding the performance dimension of governance to the conformance dimension; however, good practice indicates that balanced attention needs to be paid to the value-creating activities of strategy formulation and implementation.

H.2 Good practice indicates that the governing body might challenge various strategic activities, such as environmental scans and competitive analyses. In some circumstances, the governing body should engage external resources to gather further information. It is essential, however, that the governing body implements processes and procedures to provide both conformance and performance oversight.

PRINCIPLE I

Effective and efficient enterprise risk management should form an integral part of an organization's governance system.

I.1 Central to the requirements of governance in organizations is a clear relationship between managing risk and fulfilling organizational objectives. Enterprise risk management integrates risk management and internal control into decision-making and all subsequent activities at all levels, taking into account strengths and opportunities (performance), as well as weaknesses and threats. It also assures the governing body and external stakeholders that the organization understands its risks and is actively managing them. Good practice in risk management is intrinsic to organizational success, and better governance should facilitate change rather than safeguard a position.

I.2 Historically, risk management and internal controls have (a) focused on the prevention of physical and financial loss at an operational level and (b) been far removed from the decision-making process. Many organizations now recognize that the current environment, characterized by an ever-increasing pace of change, necessitates a more performance-focused approach to risk management and internal control that actually helps decision-makers take more risk. Successful organizations now seek to integrate risk management and internal control into all activities, through a framework of risk identification, risk assessment, and risk mitigation.

I.3 Risk is often presented as something that is negative and that should be avoided. However, risk essentially flows from opportunities, and all organizations must react positively to opportunities if they are to survive and to be successful. Since risk is inherent in taking advantage of opportunities, risk should be managed, not eliminated.

I.4 As part of its overall strategy formulation, the governing body should define and maintain the organization’s risk appetite (the amount of risk the organization is willing to take in pursuit of its objectives) and risk capacity (the amount the organization is capable of losing before it endangers its own sustainability).

PRINCIPLE J

Resource utilization should align with strategic direction.

J.1 Part of the fiduciary responsibility of the governing body, management, and all other staff is to manage the resources of the organization. This includes both safeguarding these resources (conformance) and ensuring that they are utilized in a manner that enhances stakeholder value (performance).

J.2 Although the governing body and senior management have historically done a good job in safeguarding an organization’s physical assets, safeguarding intangibles such as intellectual assets has often been given insufficient attention.

J.3 The governing body should implement processes to review resource allocation periodically, to ensure that the activities that create the greatest stakeholder value are given sufficient resources to be successful. The strategic planning process should include resource planning for new projects, so that when projects are approved, that approval includes the associated resource acquisition and allocation.

PRINCIPLE K

The governing body should periodically measure and evaluate the organization's strategic direction and business operations, and follow up with appropriate actions to ensure appropriate progress and continued alignment with goals.

K.1 What gets measured gets done. Therefore, it is important for the governing body to develop, implement, and maintain a comprehensive performance measurement scheme that evaluates progress against objectives. When setting strategy, decision points and milestones (along with critical success factors) should be identified, so that the governing body can periodically measure performance objectively.

K.2 Performance measurement tools should be developed that reasonably depict an organization's strategic position and progress. Evaluation against objectives should also include an environmental update, to ensure that the conditions (risks and opportunities) present during the planning process have not changed significantly. As mentioned above, the professional accountant in business plays a important role in measuring performance. See also paragraph L.10 below.

K.3 An organization's system of enterprise risk management and internal controls should be regularly evaluated, and corrective action taken if necessary.

K.4 The governing body should also periodically evaluate the organization's governance structure and performance to (a) ensure its effectiveness, and (b) strive for continuous improvement.

PRINCIPLE L

The governing body should ensure that reasonable demands from stakeholders for information are met on a timely basis, and that the information provided is relevant, understandable, and reliable.

L.1 Good governance requires the governing body to oversee an organization's disclosures, including financial and non-financial reporting, to ensure that stakeholders receive relevant, understandable, and reliable information. This reporting should include both (a) a historical perspective of the entity's performance for the period covered by the report, and also (b) information that would allow stakeholders to assess the entity's future performance.

L.2 This responsibility for reporting oversight should include assurances that the governing body has reviewed the enterprise risk management and internal control systems to ensure their effectiveness. This type of oversight is usually guided by the audit committee.

L.3 Non-financial reports also provide management and the governing body with the opportunity to present their perspective to readers on the underlying potential and prospects for the organization – its long term sustainability and the quality of its earnings.

The report can include information on how effective the organization has been in meeting its strategic objectives, and how it has managed its resources. (Although the report may include information about markets, risks, and competitive positions of the organization, it should not include details of how the organization plans to build on its competitive position and mitigate associated risks.)

L.4 Reports presented to stakeholders should only include material information. Items are material if they would affect stakeholder decisions. Caution should be exercised to ensure that the reader is not overwhelmed with details that are more appropriate for management decisions.

L.5 There must be consistency between financial and non-financial information, as well as between internal and external information, presented in a given period. These four elements should be included in one integrated document that links past performance with future expectations.

L.6 The information from one reporting period should be consistent with information from the next, especially for those items that can materially affect performance at the strategic level, to the extent that they continue to be relevant to an organization's success.

L.7 The presentation style of stakeholder reports should be sensitive to the fact that not all stakeholders will be financial professionals. Complex issues should be explained so that they can be easily understood by all interested readers, and not just by those with technical expertise in accounting.

L.8 Financial and non-financial reports are unique to each organization. Care must however be taken to ensure that such reports do not become marketing tools. These reports must be written in an even-handed, balanced way – negative results should be included, rather than just glossed over. Care must be taken to ensure disclosure of all relevant information.

L.9 The governing body is responsible for (a) reviewing and questioning the procedures and practices that are involved with providing external stakeholder information, and (b) ensuring that the principles of integrity, accountability, and transparency govern these processes.

L.10 Professional accountants in business play an important role in providing, analyzing, and interpreting information to management for formulation of strategy, planning, decision-making, and control. They also participate in performance measurement and communication to the governing body and stakeholders. This includes the financial recording of transactions and subsequent reporting to stakeholders under national or international generally accepted accounting principles.

Appendix A

Examples of Organizational Values/Principles

In the private sector, the fundamental values/principles can be defined as:

- Integrity: straightforward dealing and completeness.
- Accountability: responsibility to shareholders.
- Transparency (openness): disclosure of information, within the limits set by competitive position, is seen as the basis for the confidence that needs to exist between a business and all those who have a stake in its success.

In the public sector, the fundamental values/principles can be defined as:

- Integrity: comprises both straightforward dealing and completeness. It is based on (a) honesty and objectivity, and (b) high standards of propriety and probity in the stewardship of public funds and resources, and management of an entity's affairs. It depends on the effectiveness of the control framework, and on the personal standards and professionalism of the individuals within the entity. It is reflected both in the entity's decision-making procedures, and in the quality of its financial and performance reporting.
- Accountability: the process whereby public sector entities, and the individuals within them (a) are responsible for their decisions and actions, including their stewardship of public funds and all aspects of performance, and (b) submit themselves to appropriate external scrutiny. It is achieved with a clear understanding by all parties of those responsibilities, and with clearly defined roles and through a robust structure. In effect, accountability is the obligation to answer for a responsibility.
- Transparency (openness): is required to ensure that stakeholders can have confidence in (a) the decision-making processes and actions of public sector entities, (b) the management of their activities, and (c) the individuals within them. Openness through meaningful consultation with stakeholders and communication of full, accurate, and clear information leads to effective and timely action, and stands up to necessary scrutiny.

The UK-based standing Committee on Standards in Public Life set out seven principles of public life: Selflessness, Integrity, Objectivity, Accountability, Openness, Honesty, and Leadership, commonly known as the Nolan Principles. See IFAC's IGPG on *Defining and Developing an Effective Code of Conduct for Organizations* [web link] for an example.

The fundamental principles in IFAC's *Code of Ethics for Professional Accountants* [web link] are: integrity, objectivity, professional competence and due care, confidentiality, and professional behavior. They are focused on professionals, and specifically on professional accountants (performing a professional service) and their organizations.

Appendix B

Resources

This list of resources is not intended to be exhaustive. Use the IFAC KnowledgeNet at www.ifacnet.com to search IFAC and many of its member body websites.

- IFACnet is the global, multilingual search engine developed by the International Federation of Accountants (IFAC) and its members to provide accountants and others with access to global resources and information. IFACnet can be accessed free-of-charge at http://www.ifacnet.com [web link]
- To provide professional accountants in business with greater access to global resources and information, IFAC launched a "relevant links" page where users can share links to websites and documents on topics of interest. Users can post links, "tag" them to multiple categories, and include a description. These links can be sorted by topic, name, or most recently posted. This free resource is available at http://www.ifac.org/PAIB/relevant_links.php [web link]
- IT Governance Institute, *Board Briefing on IT Governance*, 2nd Edition, USA, 2003
- The IFAC report *Enterprise Governance: Getting the Balance Right* (IFAC/CIMA 2004) [web link] specifically focused on governance failures and what must be done to ensure that things go right.
- In November 2005, IFAC published *The Roles and Domain of the Professional Accountant in Business* [web link]. The purpose of this paper is to define the term “Professional Accountant in Business” and to provide an understanding of the roles and responsibilities that professionals in these positions occupy in business.
- The Organisation for Economic Co-operation and Development (OECD) published the *OECD Principles of Corporate Governance: 2004* [web link]. The purpose of this guidance is to assist the preparers of enterprise reporting to produce disclosures on corporate governance that will address the major concerns of investors and other stakeholders.
- The United Nations Conference on Trade and Development (UNCTAD) issued the *Guidance on Good Practices in Corporate Governance Disclosure* [web link]. The purpose of the guidance is to help those responsible for preparing company reports to produce disclosures on corporate governance that address the major concerns of investors and other stakeholders.
- Through the following website, the European Corporate Governance Institute is making available the full texts of corporate governance codes, principles of corporate governance, and corporate governance reforms, both in Europe and elsewhere. http://www.ecgi.org/codes/all_codes.php [web link]
- In 2006, the Professional Accountants in Business Committee of IFAC published *Internal Controls - A Review of Current Developments* [web link]. This information paper reviews

current developments and some of the latest thinking in the area of internal control. See also: http://ifac.org/Store/ [web link]

- In 2007, IFAC published an international good practice guidance *Defining and Developing an Effective Code of Conduct for Organizations* [web link]. This IGPG helps organizations to encourage an ethics-based culture, and to define and develop a code of conduct. It also refers to the most significant resources in this area. See also: http://ifac.org/Store/ [web link]
- In 2008, IFAC member body, the Institute of Chartered Accountants of Scotland (ICAS) issued guidance on the principles of governance and how these may be applied in the private company as it develops: *Avoiding the pitfalls in running a private company: A practical guide for Directors* [web link]

Appendix C

The Diversity of Governance Structures

Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:

- In some jurisdictions, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a “two-tier board” structure). In other jurisdictions, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a “one-tier board” structure).
- In some entities, the governing body includes positions that are an integral part of the entity’s legal structure, for example, company directors. In others, for example some government entities, a body that is not part of the entity is charged with governance.
- In some cases, some or all of the members of the governing body are involved in managing the entity. In others, the governing body and management have different memberships.

In most entities, governance is the collective responsibility of the governing body. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee (or even an individual) may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

It is important (a) that all functions covered by the expression ‘governance’ be exercised by an appropriate person or body, (b) that there is clarity on governance matters for all in the organization and its stakeholders, and (c) that undue concentrations of influence are avoided.

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Professional Accountants in Business Committee

Exposure Draft
June 2008
Comments are requested by September 23, 2008

International Good Practice Guidance

Costing to Drive Organizational Performance

International Federation of Accountants

REQUEST FOR COMMENTS

The Professional Accountants in Business Committee of the International Federation of Accountants (IFAC) approved this exposure draft, *Costing to Drive Organizational Performance*, for publication in June 2008.

Please submit your comments, preferably by email, so that they will be received by September 23, 2008. All comments will be considered a matter of public record (unless otherwise requested). Comments should be addressed to:

Technical Manager
Professional Accountants in Business Committee
International Federation of Accountants
545 Fifth Avenue, 14th Floor.
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

Copies of this exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org/PAIB.

INVITATION TO COMMENT

Guide for commentators

This International Good Practice Guidance (IGPG) follows recent guidance on Project Appraisal Using Discounted Cash Flow and Defining and Developing an Effective Code of Conduct for Organizations (web link), and also complements proposed guidance on Evaluating and Improving Governance. Its aim is to establish a benchmark for good practice in costing, and in particular to help the provision of useful cost information to support decision-making in organizations. A performance-based view of costing helps to ensure costing information supports both forward looking strategic and tactical decisions as well as providing feedback on historical performance.

In encapsulating good practice in eight fundamental principles, the emphasis of this International Good Practice Guidance, as is the case with the Committee's other IGPG, is to support professional accountants in business in a flexible way, therefore helping them to think about how to apply good practice rather than instructing on how actually to use specific costing methods. The principles, guidance supporting the application of the principles, and the associated definitions and summary of typical costing methods, are intended to sit above the myriad of costing terms used in organizations, academe and by consultants and to help professional accountants in business to differentiate between them.

The PAIB Committee would like to receive comments on all matters addressed in this proposed IGPG. Anyone offering comments should refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for proposed changes to wording. The PAIB Committee is particularly interested in comments on the matters set out below:

The principles

1. Do the principles cover all the fundamental areas in thinking about costing and how it drives organizational performance?

The guidance

2. Is the application guidance for each principle adequate to guide good practice?
3. Is there national guidance on costing not already mentioned in appendix D that should be considered?

We also welcome feedback on further topic selection for PAIB Committee publications as International Good Practice Guidance in the area of costing and performance management.

IFAC PAIB COMMITTEE INTERNATIONAL GOOD PRACTICE GUIDANCE

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Costing to Drive Organizational Performance

1. Why the Topic is Important

1.1 The creation, operation, alteration, and cessation of every action and function in an organization, whether within the private, public, or voluntary sector – all incur costs. Costing – the accumulating and assigning of costs to the organization's various activities – enables the organization's cost structure to be understood, explained and improved. Costing is therefore an important tool in assessing organizational performance in terms of shareholder and stakeholder value. It informs how profits and value are created, and how efficiently and effectively operational processes transform input into output. It includes product, process, and resource-related information covering the organization and its value chain. Costing information can be used to provide feedback on past performance, and should be used effectively to motivate future performance. It is most useful if it communicates not only what the costs are, but also how and why they are incurred.

1.2 This view of costing supplants the traditional view that led many organizations to use costing exclusively as a tool to value inventories and determine profit. Many organizations now use cost information to support a wide variety of decisions, which has led to the development and evolution of costing methods such as activity-based costing. The many costing methods and approaches to measuring costs often lead to confusion over (a) which costing methods might be useful in supporting decision-making in an organization, (b) in which contexts they are best implemented, and (c) how they are implemented. Too often, such costing methods and approaches are perceived as solutions to business problems, whereas their principal value is diagnostic. However, alternative costing approaches should not be seen as competing with each other, and elements of each can be effectively combined. For example, both activity-based costing and standard costing can be applied to job-order or process costing systems. This International Good Practice Guidance (IGPG) establishes eight fundamental costing principles that will help professional accountants in business and their organizations evaluate and improve their approach to costing, and to *benchmark* good practice in applying costing systems and methods and using costing information.

1.3 Good practice in costing involves improving costing systems and costing information to provide relevant cost and performance information with an objective of enabling organizations to deliver increased value to customers. Costing should therefore support a range of both regular and non-routine decisions when designing products and services to (a) meet customer expectations and profitability targets, (b) assist in continuous improvement, and (c) guide product mix and investment decisions.

1.4 To better support decision-making, costing establishes and interprets relationships between financial, operational, and other data. Therefore, selecting the most appropriate approach for costing information and analysis, and using their output, requires the exercise of careful professional judgment and sound logic. Costing is not an exact science, but the selected costing approach should be rigorously applied. The eight principles have been developed in a way that allows professional accountants in business to be flexible in developing costing systems and methods best suited to decisions to be made in their organizations. Professional accountants in business should find this IGPG useful in explaining the role and purpose of costing to non-accounting colleagues.

The Role of the Professional Accountant in Business

1.5 Professional accountants in business draw on a broad base of capabilities in undertaking a variety of roles. They can be in a front-line business management role as a decision-taker or in a decision support role supporting the consumers of costing and operational information. Regardless of their perspective, professional accountants in business have important roles to play in (a) ensuring that cost data is ‘fit for purpose’, (b) clarifying decision requirements, and (c) deciding how best to present information and analysis (including method of delivery, e.g., paper, web-based portal, etc). Performing such roles usually requires the professional perspectives and skills of other disciplines, such as industrial engineers, operational managers, economists, and systems analysts who provide valuable insights.

1.6 In a decision support role, it is important to carefully identify who uses information and what decisions are based on it, in order to meet users’ requirements. For example, to take a relatively simple situation at a local level, a plant manager is the customer of a particular piece of cost analysis developed by a plant controller to help the plant management team make decisions. In other situations, however, meeting users’ requirements can become more complex when considering a range of internal customers with differing needs. For example, the customers of a financial forecast of a typical multinational, multi-operational company are the board, the corporate management team, and the operational management team – all with different levels of information requirement in terms of timeliness, accuracy, and precision.

1.7 In determining costs and cost drivers, professional accountants in business can be involved in designing, developing, improving, and using costing systems and techniques. The supplier of costing information should have a strong connection to preparing, analyzing, and interpreting cost information for users. Although the roles of information supply and design/implementation of costing systems can be separated, one cannot be done well without appropriate knowledge of the other. Users require advice on (a) identifying needed decisions, (b) what assumptions should apply to the inclusion/ exclusion of specific costs, and (c) how costs behave i.e. vary (or not) with activity. Supplying cost information involves both routine calculation of the cost of products, services, and other cost objects, and the supply of information that supports non-routine decisions such as “make or buy”. Many professional accountants in business also undertake broader roles at a planning and performance evaluation level, where costing information supports the preparation of plans and budgets and the accomplishment of strategic objectives, and provides a benchmark for evaluating performance.

1.8 As both suppliers and consumers of costing information, many professional accountants in business now advise other parts of an organization on interpreting and analyzing relevant information for making decisions. This includes considering the relevance of revenue and cost information, and the range of factors and issues relevant to a particular decision. Decisions can range from selecting which products to produce, where to produce them, and how to deliver them to market.

2. Key Principles That are Widely Accepted Features of Good Practice

The definitions at Appendix B help to explain the concepts used in all costing systems. They help to promote use of a consistent and reliable costing terminology to minimize confusion among professional accountants in business, and their organizations. Other cost definitions exist, some of which are included in references in the resources section at Appendix A. The elements of a basic costing system are set out in appendix C. Typical costing methods and approaches include:

2.1 **ABC**: is both a product costing method and a resource consumption model that can provide information useful in making decisions concerning product and process improvements. An ABC system typically involves four stages: (1) identifying activities performed to produce outputs, (2) assigning or mapping resources to the activities using resource drivers, (3) identifying outputs for which the activities are performed, and (4) assigning activity costs to the outputs. The sophistication of ABC systems varies between organizations. For example, greater sophistication can be associated with:

- A higher number of cost pools to better capture resource consumption by different products/services;
- A variety of cost drivers to more accurately measure resources consumed by cost objects;
- Directly assigning costs to cost pools or using a cause-and-effect resource drivers; and
- The extent to which transaction and duration drivers are used in the second stage allocation process (a transaction driver, like the number of setups, assumes the same quantity of resources is used every time an activity is performed, whereas a duration driver, like setup hours, represents the amount of time to perform an activity).

2.2 **Grenzplankostenrechnung (GPK)**: a costing method focused on marginal costing that is helpful to support short-term decisions, for example a production decision (a decision to accept or reject an additional order based on contribution margin information) or a pricing decision. GPK varies in complexity depending on an organization’s history, culture, and requirements (which in turn are determined by the complexity of products and processes). In most instances, GPK combines both resource and activity analysis, and assigns resource costs to cost objects based on causality (as is the case in ABC systems).

2.3 **Lean accounting**: Lean accounting reports and methods support a lean organization or transformation to a lean organization. The financial and nonfinancial reporting in a lean accounting method reflects the overall value stream flow, not individual products, jobs, or processes. Implementing a lean approach, as exemplified by the Toyota Production System, focuses on delivering customer value without waste and this involves identifying value streams. Cost and profitability reporting is done using value stream costing, a summary of direct costing of value streams. Lean accounting principles ensure that lean thinking is applied to efforts to reduce waste created during transaction processing, during report creation, and during other accounting steps in the organization. Lean accounting principles ensure that lean thinking is applied to waste reduction from the transaction processes, reports, and accounting methods throughout the organization. This recognizes that in a lean organization information required to control operations arises in the flow of work (rather than from outside accounting and production controls such as standard cost-variance budget reports), thus empowering those at the front-line to manage daily operations.

2.4 **Lifecycle costing**: Life-cycle costing involves estimating and accumulating costs over a product's or service's lifetime. The purpose of life-cycle costing, which is typically used during the product's planning phase, is to allow planners to anticipate a product's costs over each phase of its lifetime. The helps to avoid underestimating a product's total costs that is often the main cause of unprofitability. Life-cycle costing identifies and estimates the costs in all phases of the product/service life-cycle including planning and development, introduction and growth, maturity, decline and abandonment or renewal. It is particularly useful for products that create significant cost burdens at discrete points that need to be captured, such as significant planning and development costs and decommissioning costs. Therefore, it is often used to better understand the environmental performance of products and services, and to support sustainable development initiatives. Lifecycle costing is often used to support life cycle assessments to evaluate the environmental burdens associated with a product, process, or activity by identifying and quantifying energy and materials used and wastes released to the environment and to identify and evaluate opportunities to improve environmental performance. Lifecycle costing can also be used with other costing methods. For example, during the planning phase, target costing is used to drive the product and process design so that, at a given market price, the product will be profitable.

2.5 **Job order costing**: used to cost a distinct product or service and to help organizations calculate the total cost to produce a specific project. The cost object is a unit or multiple units of a distinct product or service called a job. Costs are traced to individual jobs to the extent economically feasible. A common approach (a) identifies direct costs of the job, then (b) determines a basis for allocating indirect costs, then (c) identifies indirect costs associated with each cost allocation base.

2.6 **Kaizen (continuous improvement) costing**: a cost management tool focusing on reducing the cost of an existing production process. Unlike target costing, which is a planning tool, Kaizen costing focuses on improving the existing production and performance of related activities to achieve target cost reductions.

2.7 **Process costing systems**: calculate the unit cost of a product or service by assigning total costs to many identical or similar products/services. Such systems separate costs into cost categories, according to when costs begin to be incurred in a process. Process costing is appropriate for production of products or services with the following characteristics: (a) the production involves a regular process pattern, (b) its output consists of homogeneous units, and (c) all units are produced through the same or a similar process.

2.8 **Resource Consumption Accounting (RCA)**: a recent addition to cost management terminology used to promote the integration of cost management methods that have often been applied in isolation. Generally implemented at the same time as an Enterprise Resource Planning system, RCA is based on three pillars: (a) how resources are viewed, (b) the nature of cost, and (c) a quantity-based approach to cost modeling. Its resource focus ensures the capture of cost information at a low level, and involves identifying resource pools that include all resources, including costs that serve resources.

2.9 **Standard costing**: standard costs are constructed or predetermined costs that can be applied to activities, services, or products on a per unit basis. Standard costing supports a control technique that reports variances by comparing actual costs to pre-set cost standards (so actual information is compared with estimated standard rates). It (a) traces direct costs to output by multiplying the standard prices or rates by the standard quantities of inputs allowed for actual outputs produced, and (b) allocates overhead costs on the basis of the standard overhead-cost rates multiplied by the standard quantities allocated to produce the actual outputs.

2.10 **Target costing**: a demand-pull approach of cost management because of its focus on customer requirements for quality, cost, and time. It is often referred to as a strategic planning tool, because it attempts to link cost management to the value perceptions and requirements of customers. It therefore uses prospective and estimated cost information, starting when products/services and processes are designed. Its usefulness depends on involving all disciplines in bringing a product/service to market to ensure an appropriate gap between (a) the target cost, and (b) the estimate of the cost to build the product based on current processes, suppliers, productivity levels and materials.

The Key Principles in Costing to Drive Organizational Performance

2.11 The key principles underlying widely accepted good practice are:

A. The ability to measure, account for, analyze, interpret, and present costs is necessary for an informed understanding of the drivers of profit and value, and is therefore an essential part of good financial management and decision-making.

B. Cost information should be collected and analyzed systematically and consistently, whether in a routine information system, or for a specific application and/or purpose.

C. Costing systems and methods should be designed and maintained to reflect an organization's chosen strategy and business model, taking account of its structure, culture and competitive environment.

D. Cost information used to support strategic and operational decisions, performance management, or reporting should be appropriate for the specific purpose, context, and legal requirements.

E. The professional judgment used to (a) determine costing methods, and (b) specifically select cost information to support decision-making, including any limitations on its applicability, should be transparent, rational, and understandable by the user.

F. Definitions and sources of cost data, and the methods of calculation of costs, should be recorded and capable of review, risk analysis, and assurance.[1]

G. Cost information and costing assumptions should be periodically reviewed for their relevance, robustness, and susceptibility to change.

H. The design, implementation, and continuous improvement of costing methods, data collection, and systems should reflect a balance between the required level of accuracy and cost.

2.12 The principles apply to all organizations. In jurisdictions where special requirements relating to costing are laid down by law, compliance with them is a necessary part of local good practice, even if not specifically mentioned in this IGPG. Examples of specific arrangements are at appendix D.

3. Application Guidance on Implementing the Principles

PRINCIPLE A

The ability to measure, account for, analyze, interpret, and present costs is necessary for an informed understanding of the drivers of profit and value, and is therefore an essential part of good financial management and decision-making.

A.1 The first principle in IFAC's International Good Practice Guidance on *Evaluating and Improving Governance in Organizations* is The creation and optimization of stakeholder value should be the objective of governance (web link). Governing bodies of all organizations have a fiduciary responsibility to create and preserve stakeholder value. All organizations should take into account and may need to address the needs of a wide range of stakeholders. Companies, however, generally focus on increasing/maximizing shareholder value. In all organizations, enhancing value, whether it is for shareholders and/or a wider range of stakeholders, entails finding the optimal balance between revenue, cost, and risk.

A.2 Costing, and the many costing methodologies applied in organizations, measure the consumption of economic resources and support the accountability of business performance. Cost information helps users to determine relevant costs of specific activities, goods and services, and the cost of doing business and changes over time. It permits tracing of production costs to output. It can highlight issues of operational efficiency,

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[1] The word "assurance" in this principle may be read to include "audit" in those jurisdictions in which cost audits are required (see appendix D).

pinpoint areas requiring management attention, and assist in measuring and rewarding performance.

A.3 Analysis and presentation of costs is best accomplished within a financial management system that (a) delivers both cost information and operational feedback for planning, budgeting, cost, and financial accounting purposes, and for operational improvement, (b) helps to ensure the fulfillment of external reporting and other compliance requirements, and (c) presents information clearly in a way that helps manage an organization. Appropriate understanding and analysis of costs is essential to operational management, increased efficiency, and productivity, understanding the impact of investment decisions, and evaluating pricing decisions and the profitability of products, services, and customers. Therefore, although costing has historically provided awareness of the cost of operations (what, when, and where), which allows an organization to manage costs, its greater value lies in its forward-looking perspective (how and why), to help planning and better-informed decision-making at a strategic and operational level.

A.4 The principle of cause-and-effect is vital to a rigorous approach to understanding the drivers of profit and value. A costing system should be designed so that it is complete in that it accounts for all costs, and it should be systematic so that it attributes a direct cost to the cost object that created the direct cost, and in that it allocates an indirect cost to a cost object in a way that reasonably reflects the cause and effect relationship between the cost object and the indirect cost. Therefore, identifying how products/services consume resources that create indirect costs requires an understanding of a cause-and-effect relationship between production and resource use. In supporting the process of organizational improvement, it is also necessary to identify cause-and-effect relationships between measures of process performance (such as product quality and customer service) and measures of performance on primary objectives (such as profits).

A.5 Because costing can support both regular reporting for accountability purposes and specific analyses in support of strategy, planning and general business decisions, the way it is presented can be as influential as the actual data. Care needs to be exercised in the selection of data and the way it is shown, in line with the normal principles of presentation such as relevance, completeness, inclusion of appropriate comparators and related non-financial information, and the use of charts, tables and commentary.

PRINCIPLE B

Cost information should be collected and analyzed systematically and consistently, whether in a routine information system, or for a specific application and/or purpose.

B.1 Costing systems provide a systematic process for accumulating and assigning costs to objects, either continuously or periodically as desired, so that cost information is available for decision-making on the acquisition, use, and consumption of an organization's resources. Continuous reporting of costs will help users determine the ongoing costs of providing specific products, programs, projects, or activities, and the impact of changes in the composition of these costs. Alternatively, some organizations may (a) choose to accumulate and report costs through periodic, ad hoc and targeted cost studies, and (b) use cost-finding tools, such as job order and process costing and cost allocation techniques, to determine the cost of producing costs and services. Whichever approach is adopted should be consistent, systematic, rigorously applied, and accessible.

B.2 Larger and more complex organizations (in terms of employee numbers, product and service lines, geographical spread, and complexity of processes) usually aim for a single costing system to develop reliable costing information to support both performance and conformance (against legal and regulatory requirements) decisions at both operational and strategic levels. Organizations with a single costing system typically derive cost data from a common data source to support the needs of both external users (investors, regulators, and tax authorities) and internal managers and employees. In manufacturing businesses, such an integrated system will allow (a) relevant costing and operational performance information to be provided to internal users, as well as (b) the valuation of inventory and measurement of cost of goods sold for financial reporting purposes. 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.

B.3 An integrated information system is not necessarily a single, closed information system for cost measurement, and performance improvement. Operational feedback systems could source data from outside the costing system, but the information presented needs to be integrated where appropriate to support operational performance, because it promotes employee learning and improvement in activities and processes. Integrating databases and information systems can help to provide useful costing information more efficiently as well as reducing source data manipulation. A comprehensive enterprise information system typically (a) tracks daily expenses by account code, activity, and business process, and (b) measures performance information that supports feedback to operations, such as the cost of resource consumption, defects, throughput, and quality, in addition to cost information associated with products, customers, and activities.

B.4 The sophistication of the costing systems execution will need to take into account, and may be limited by:

- The degree of precision required from each of the system’s outputs to effectively support decisions;
- The minimum frequency at which information is needed to support reliable decisions (frequency matters where special data collection methods outside routine reporting systems are required);
- The practicability of collecting or estimating the data required for specific cost computations; and
- The organization’s overall information technology strategy, the extent of existing information systems, and the availability of funds to develop new ones.

B.5 In many cases costing systems rely on using non-financial information, which is likely to be originated by non-accountants. Where the reliability of costing outputs is dependent on such information, the aim should be as far as possible to apply expectations of consistent preparation and reliability to the non-financial information similar to that applied to financial sources of data. Practical considerations may cause the quality of important data to vary. Where this is the case, or where estimates have to be used, the effect on costing outputs should be evaluated and disclosed to users.

B.6 Dedicated supplementary cost studies may be required to support specific, one-off decisions. For example, costing information may be required when making non-routine decisions, such as whether to outsource, to build a new plant, to make or buy a product or component, to discontinue a product or service, to purchase a new machine, or to re-engineer a product/service or process. Investigating aspects of an organization's strategy and business environment may also require costing information. Non-routine decision analysis should include all relevant items such as:

(a) The value of all the incremental *revenue* effects of the decision over all the time periods affected by the decision; and

(b) The value of all the incremental *cost* effects of the decision over all the time periods affected by the decision.

In this kind of analysis, it may be appropriate to consider whether costs are avoidable. For example, reducing labor requirements through closing a production line could be affected by labor agreements or legislation protecting employment.

B.7 Small and/or less complex organizations will need cost information to manage their business operations. However, their requirements may involve costing systems with less formal procedures and methods, and these are likely to develop as a natural consequence of needing costing information. Such organizations should periodically consider the need for processes to report relevant and routine cost and operational information for management purposes. This will typically require a costing system and appropriate procedures to ensure that the necessary cost information is collected, measured, analyzed, and effectively communicated.

PRINCIPLE C

Costing systems and methods should be designed and maintained to reflect an organization's chosen strategy and business model, taking account of its structure, culture and competitive environment.

C.1 Costing systems should focus on helping an organization achieve its strategic objectives, and take into account the nature of an organization, its business model, its culture, structure and competitive environment. No one costing system is therefore appropriate for all organizations, and costing methods will vary from organization to organization. Costing systems should be designed to meet individual organizational needs, characteristics, and cost structure.

C.2 Costing system design will be driven by the specific use to which the resulting cost information will be put, which in turn will govern the choices to be made on four key interrelated elements, namely:

- What objects it measures;
- How the costing system measures the chosen objects;
- How it manipulates or aggregates the recorded measurements; and
- How it reports to decision-makers.

The design and scope of a costing system will generally depend on:

- The organization's business model – its sources of income, its supply chain(s), and ways of creating value;
- How the organization structures itself and holds its managers accountable;
- How an organization measures itself, taking into account its regulatory and/or market context, the jurisdiction(s) and industry(ies) in which it operates, and what its competitors and equivalent organizations do; and
- The specific requirements of the organization's managers for the purposes of organizational control and the exercise of informed judgment in making strategic and operational decisions (What questions is the system required to answer? Why are we doing this?);

C.3 When an organization designs a costing system, it is helpful to start by building one or more cost models. This will reflect the judgments made on matters in paragraph C.5, and should describe the organization and its cost and income flows and relationships as faithfully as possible, subject to materiality and affordability. The model(s) should be widely discussed and challenged, so that they are understood and agreed to be reasonable and suitable by those who will rely on their outputs. This will include agreeing on areas where relatively less precision is required, where estimates may be made, and where existing data sources may need to be improved or supplemented.

C.4 It is important to review and understand the underlying business model and its economic drivers when designing costing systems and allocating costs. For example, where products are being delivered via a network infrastructure, such is typically the case with transport and communications networks, it is advisable to ensure that costs reflect the primary products/services delivered on the network. This could involve investigating whether an apparently joint or common cost is truly attributable to all the products/services that share it. This is especially the case where a premium product which carries priority by its nature, or by strategic decision, causes cost (due to its priority status – for example the need for a new operating unit or shift) even when apparently incurred on or shared with a lower priority product/service. The underlying rationale could lead to the creation of a cost driver to assign process setup costs and premium surcharges to the priority output.

C.5 How costing systems support organizations, and how cost information is communicated and used to support decisions can vary widely. These variations usually relate to the 'management control' perspective adopted by an organization. Organizations with traditional management control systems often use a responsibility accounting system, where costs are usually accumulated by responsibility centers, revenue centers, or by revenues and costs in profit centers. The managers in these centers are accountable for specified activities (thereby supporting the notion that managers should only be accountable for those costs/revenues in their span of control), which might cover a number of products and services.

C.6 An organization converting to a new costing system and/or management control system should consider whether its strategy and culture supports a new approach, and whether a cost-benefit review might ensure a subsequent strategic benefit. For example, existing costing systems and organizational structures can act as a barrier in organizations undertaking a lean transformation. All organizational aspects (structure, culture, management philosophy, reward strategies, etc.) could require review, as could the way costing information will be supplied and used in support of the new approach may be radically different. Applying a lean philosophy often does not translate well into a command-and-control hierarchical environment. This should be considered in any effort to apply lean accounting to support a lean transformation.

C.7 The structuring of responsibility centers depends on their lines of responsibility and accountability, their outputs, and their funding sources. Responsibility centers could include a department, division, geographic territory, machine group, or operational process. Such segmentation often supports (a) organizational budgetary reporting, and (b) performance measurement where performance goals or targets are set for each center. However, a system designed around responsibility areas may make it hard to identify the underlying cause of costs that lie outside a manager's responsibility. It may be necessary to compare the organizational design with the business model to check for any non-alignment.

C.8 Increased information requirements driven by increasingly competitive markets and increased product diversity have led many organizations to refine their costing systems. Some organizations adapt their variance reporting system (a) to report on variables that are particularly important in their context, and (b) by replacing volume-based cost drivers with cost drivers that better reflect the causes of resource consumption. Another approach is to move to a costing system based on an ABC methodology, particularly where an organization's costs are not associated with direct labor and direct materials. ABC systems focus on activities and processes. They trace the direct and indirect costs of using resources (for example in a responsibility segment) to cost objects (pools), and tend to use a broader set of cost drivers to reflect variety and complexity in assigning activity costs to cost objects. An ABC system can calculate actual (historical) cost driver rates based on last period expenses for resources actually supplied and realized. It can also be used to estimate the costs of activities to be performed in the current period, and in future ones. In focusing on the drivers of activities and costs, ABC has the potential to foster a deeper understanding of cost causation.

PRINCIPLE D

Cost information used to support strategic and operational decisions, performance management, or reporting should be appropriate for the specific purpose, context, and legal requirements.

D.1 Analyzing and interpreting costing information underpins decision-making in organizations by supporting operational management and control, planning and budgeting, and a range of management decisions required to meet organization’s goals, to manage an organization, and to provide value to customers. Cost information can help to address strategic challenges, such as how many and what products to produce, how many and what customers to supply, what will be the most effective supply chain, and how best to structure the organization. Forecasting costs supports both operational and strategic planning. Operational planning uses financial cost and operational information to help manage resources, including specific initiatives to determine product margins. Professional accountants in business who design, use, or collect cost information will typically work with other parts of an organization to analyze and interpret this information for decision-making. In most cases, they will need to delve below the level of detail recorded in the financial ledgers and required for financial reporting.

D.2 Organizations need to view their operations from different perspectives for these different purposes. An organization can be seen as a set of products, a group of facilities and departments, a collection of processes, etc. To support these different views, costs need to be measured, analyzed, and reported in various ways, and may only have meaning in the context of a specific intended purpose. For example, product costs are the sum of the costs assigned to a product for a specific purpose, and different measures of product cost will be required for different decisions. Pricing and product-mix decisions provide information on profitability of different products, and assign the costs incurred throughout the value chain to different products.

D.3 Professional accountants in business not only need to master these differences, but also to be able to explain how the use of different accounting bases, different measurement and recognition methods, and sources of data affect costing information. Crucially, a professional accountant in business therefore needs to understand the organization in terms of the cause-and-effect relationships that convert its inputs into outputs (see para A.3). In responsibility accounting, standard costing systems are popularly used in setting budgets, because standard costs of operations and products can be readily built up into total costs for any budgeted volume and product mix. The management control in responsibility accounting typically uses variance analysis to determine where, and by how much, an operation’s costs deviate from standard. However, standard costs can mask the cause-and-effect relationships essential to the effective use of costing to support business decisions. It is inadvisable, therefore, to rely on those costs for that purpose, except in organizations whose activities consist of a series of repetitive operations with limited change, and who have only one or similar types of product or service.

D.4 The selection of cost objects will significantly affect subsequent decisions that can be made. A cost object is anything that is separately measured, whether it is a product, service, department, activity, or customer. Different costs can be assigned to the same cost object, depending on the purpose. For example, costs from all parts of the value chain could be assigned to a product for pricing decisions (although this information is not necessarily required for external financial reporting). Note also that the direct cost of one cost object might be the indirect cost of another cost object.

D.5 The materiality of a particular cost is important in classifying costs. The less significant a cost, the less likely will it need to be traced to a cost object. Cost-effective design of costing solutions will focus on understanding where most money is spent, and for many decisions, it may be adequate to estimate less significant costs. Irrespective of size, however, it is necessary to understand in greater detail any area of cost whose treatment may lead to a different decision.

D.6 The choice of costing methods determines how costs are assigned and measured. Most period costing methods involve assigning cost (expense data) sourced from transaction systems (such as payroll, purchasing, etc). Most costing methods trace consumption of expenses to a destination (usually a cost object). The difference in cost assignment is usually based on (a) the selected cost object, and (b) the assumptions on how to assign costs of expenditures. A costing method that arbitrarily allocates costs to cost objects (rather than on a direct or cause-and-effect basis) could possibly result in a less than adequate association of costs with a cost object, thus compromising costing accuracy.

D.7 A costing system should make appropriate classifications of costs as direct or indirect, because misclassifications can have significant implications. For example, when a direct cost is misclassified as indirect, the consequence can be to (a) undercost the cost object to which the direct cost rightfully belongs, and (b) overcost the cost objects that are improperly allocated some of this cost. Similarly, when an indirect cost is misclassified as a direct cost of some cost object, the resulting cost reported for that cost object can be overstated, and the cost of the other cost objects that use the resource (to which the indirect cost rightfully belongs) will be understated. The consequence of misclassifying costs is to taint the decisions made using those costs. Implications of classifying direct costs as indirect include:

(a) Products that are unprofitable appearing to be profitable, resulting in decisions to keep producing a product that should be abandoned;

(b) Failure to recover full costs in cost-based contracting;

(c) A cost-based transfer price that is set too low, resulting in a misallocation of taxes payable between the tax jurisdictions involved in the transfer of goods; and

(d) Failure to recover the full value of goods in insurance claims.

All of these errors can have significant economic impact and often lead to disputes over the adequacy of the costing system in computing costs.

D.8 These difficulties are less likely to be encountered, and challenges more easy to refute, where a costing system is based on well-researched cost models that reflect the underlying reality of the way the organization works, as closely as materiality and affordability allow. For example, a costing system that uses broad averaging for allocating the cost of resources to cost objects uniformly would not reflect the underlying reality if the products consumed resources unevenly, and would give misleading results. Costing methods that provide information on the activities that lead to costs, such as ABC, can therefore provide better information to support decision-making.

D.9 Developing costing and information systems to support managers in running an organization requires an understanding of managerial purposes and the types of decisions managers will make. This understanding will then drive the information required from a costing system. Decision-makers have a range of requirements and preferences for consuming cost information. Understanding the information requirements and financial data usage of managers and employees requires a dialogue on what aspects of costing reports they currently find useful, and then determining their information gaps. Discussions with users could be based on understanding (a) the kind of decisions they make, (b) how costing information supports decisions, and (c) how to improve cost data and presentation.

D.10 Outside of manufacturing, cost relationships may be more complex or less obvious, especially where the sources of income may not directly relate to specific cost objects (products, services, activities, etc). In some organizations, the analysis of costing for pricing may have a political dimension, for example in taxation-funded services and regulated monopoly utilities. In such cases, (a) the use of economic rather than accounting cost concepts may be needed (for example long-run marginal or incremental costs), and (b) the advice of economists on system design will be essential and may be required by government policy, mandate, or regulation.

PRINCIPLE E

The professional judgment used to (a) determine costing methods, and (b) specifically select cost information to support decision-making, including any limitations on its applicability, should be transparent, rational, and understandable by the user.

E.1 A costing system should have *integrity*, that is it should be complete, systematic, logical, consistent both internally and with other management information, and fairly and faithfully represent the underlying reality of the organization.

E.2 Costing information can be presented in a range of formats, all of which should be reconcilable to each other. For example, historical general purpose financial reports should be consistent with cost information reported to managers. A reconciliation between values generated from by a financial accounting system and a costing system can help to avoid confusion and provide costing information greater credibility. Therefore, a professional accountant in business should be able to interpret and explain the significance of the costing information provided for decisions, and its limitations, and to explain the reasons for differences from the data used for legal purposes.

E.3 Applying costing systems and methodologies and measuring costs requires professional judgment. In turn, this requires transparency in (a) how decisions on selection of costing systems and methods are made, (b) how costs are defined, classified, and allocated, (c) how these choices are considered appropriate for users, and (d) any limitations of the costing information. Transparency can also help organizations better rationalize decisions, for example, choices of costing methods and how their application has been refined to suit particular circumstances and contexts.

E.4 Costing involves different methods and definitions, and some users may find this confusing, or hard to understand. Professional accountants in business can play a central role in educating users, including advising, for example, on the selection of costing methods, cost measurement, classification, allocation, and behavior. Professional accountants in business are also able to explain the different purposes and outputs of costing methods. For example, they might need to clarify that standard product costs reported for costs of goods sold and inventory valuation may differ from ABC-calculated product costs. Professional accountants in business might also (a) show why variance analysis based on the difference between budgeted and actual data may provide a view of efficiency that differs from operational performance information coming from a separate system, and (b) then go on to recommend how usefully to integrate these information sets.

E.5 Professional accountants in business should be aware that it is not necessary to choose one single costing method over others to support (a) achievement of an organization’s strategic objectives, and (b) all decision-making on planning, operational control, and reporting activities. Costing methods do not necessarily compete with each other. They can often be usefully combined, so long as the differences and relationships between them are made clear. For example, both ABC and standard costing can be applied to job-order or process costing systems. Also, many organizations will refine their costing systems and methods over time to support specific decision-making. Different types of decisions will require different cost information, and different considerations and adjustments to costing systems and methods. What considerations and adjustments may be necessary depend on a range of issues, such as cost behavior (fixed versus variable), level of data aggregation, precision versus accuracy, historic versus future data orientation, frequency of calculation, and planning horizons. In practice, for example, many variants of product costing may suit different decision requirements in areas such as inventory control, pricing, and make/buy/sell decisions.

E.6 Different costing methods could also produce different costs for the same item, activity, or entity, and this should be considered when reporting to users. For example, different inventory valuation methods will result in different net income calculations. It can be important to inform users of different choices in measuring, assigning, and allocating costs, and how they can be reconciled with previous methods. Where different methods are possible, and give different results, the professional accountant in business should offer advice on the most appropriate one and encourage its consistent application.

E.7 Cost recognition and an understanding of cost behavior underlies all decisions that rely on cost information, and provides critical insights into forecasting costs during budgeting and estimating cash flow. Estimating costs, including assessing the accuracy and reliability of underlying data, requires professional judgment. Recognizing costs based on estimates can be reliable and fit for purpose if based on a rational and systematic method. Methods to estimate behavior underlying costs include the high-low method, the visual fit method, and the regression method. All require the application of professional judgment, although usually in differing measures. The chosen method should reflect the application of judgment relating to the sensitivity of the decision to the cost estimate. The more sensitive the decision is to the cost estimate, and the greater the risk and size of the potential loss from using an inappropriate cost estimate, the greater the value of using a formalized tool to estimate costs. Any tool that relies on recorded costs to estimate cost behavior is susceptible to errors arising from inaccurate cost recording. However, cost estimation is more important than no cost recognition at all, and in conjunction with principle F, is capable of review, risk analysis, and assurance.

E.8 Cost information should be accompanied by advice on the limitations of its accuracy and applicability, especially where statistical approaches and estimates have been applied. An ABC model can be forward-looking if it uses budgeted rather than historical expenses. Where forecasts of economic and market variables are used, the period of their validity will likely be limited – this should be made clear to users. And where forecast activity levels are used, it is important to consider the capacity of resources to support those levels. Advising on applicability could also include advising on cost behavior patterns, particularly where (a) correctly defining fixed and variable costs is crucial for deciding how to use (or whether to eliminate) capacity, and (b) individual costs could be reclassified as either variable or fixed. Advising on the potential outcomes and likely behaviors that result from choosing a costing approach could also be necessary. For example, the choice of activity cost drivers can send a particular message that influences subsequent employee behaviors.

PRINCIPLE F

Definitions and sources of cost data, and the methods of calculation of costs, should be recorded and capable of review, risk analysis, and assurance.

F.1 Costing systems that have been computerized may quickly take on the status of a “black box”, in that computations are invisible and the system can lead to criticism as users change. Even a thoroughly researched and widely agreed-upon cost model can lose its legitimacy and general acceptance over time, unless the owners (those accountable) of the system and its users are kept regularly informed about the model(s) underlying the system and any changes made to them.

F.2 Organizations should critically review their costing systems and methods periodically. Reviews require accurate and comprehensive records of earlier decisions. Decisions on (a) selection and design of costing systems and methods, and (b) cost measurement and allocation, require professional judgment and subsequent justification, review, and assurance that could benefit from regularly maintained records. As an organization evolves, it is difficult to trace back to earlier events without a record of both decisions and the logic and reasoning that supported them.

F.3 Part of the value of costing information depends on consistent calculation over time. Therefore, changes to cost assignment methods, cost drivers, etc., need to be applied consistently from the date of change, and at the point of change figures need to be produced on both the old and improved bases. Any material discontinuity in a pattern of costs resulting from such a change will need to be recorded and appropriately disclosed.

F.4 Documentation can cover the selection of a costing system and costing methodology, as well as all costing activities, processes, and procedures. Documentation could take the form of a manual or handbook, which should be reviewed periodically. Such a reference helps to clarify the scope of a costing system and method, including applicable processes and activities, and provides a centralized record on earlier decisions, for example on data definitions. It can provide appropriate instruction, and include where necessary the reasoning and logic behind (a) costing system and methodology selection, (b) design and measurement, (c) cost allocation, and (d) accountabilities. A manual could also include the list of cost accounts and subsidiary accounts related to the standard general ledger.

PRINCIPLE G

Cost information and costing assumptions should be periodically reviewed for their relevance, robustness, and susceptibility to change.

G.1 Organizations should critically review costing methodologies and techniques periodically, to ensure that they are fit for purpose. The purpose of periodic review should also be to support continuous improvement in the costing approach, and to allow the identification and implementation of change.

G.2 All assumptions formulated in preparing costing information should be periodically reviewed and updated. Ideally, a wider post-decision review should compare the actual resources consumed with earlier forecasts.

G.3 Using a standard costing system could require a frequent review and update of the standard costs to ensure that their use encourages improvements in efficiency and are attainable.

PRINCIPLE H

The design, implementation, and continuous improvement of costing methods, data collection, and systems should reflect a balance between the required level of accuracy and cost.

H.1 Designing and implementing costing methodologies and systems, and collecting data, can be costly. Cost information supplied to internal or external users should be reliable and useful, but avoid unnecessary detail and spurious precision.

H.2 The professional accountant in business should ensure that the board or other body charged with the governance of an organization is satisfied with any trade-offs made between (a) system cost and complexity, and (b) the potential accuracy of information to be produced.

H.3 Some cost data can be expensive to produce, because it involves collecting data from outside the accounting system. In such cases, the frequency of reporting is a key part of fitness for purpose. Not all cost information is required with the same regularity that is needed for budgetary control. Cost information needs only to be sufficiently current for the type of decision to be made. For example, if a service organization (for market, regulatory, or policy reasons) only adjusts its prices to consumers annually, monthly reporting of costs required to support pricing decisions may be an unnecessary expense.

H.4 The design, implementation, and continuous improvement of costing methodologies, data collection, and systems should be economically feasible and subject to cost-benefit analysis. For example, the economic feasibility of cost tracing and assignment methods requires a judgment on whether the benefits (i.e., producing information of value to users) of applying a costing method outweigh its costs.

H.5 Such an analysis should consider how closely a costing system needs to depict the underlying reality to support good quality decisions. Asking questions like: ‘Is it reasonable, relevant, and practical?’ can help the analysis. Allocating costs should be conducted on a reasonable and consistent basis. Testing reasonableness should take into account the purpose of the cost information and the economic feasibility of collecting it. Directly tracing costs might be a preferred approach when economically feasible, as this helps to ensure a greater accuracy in assigning costs, especially if it involves tracing all direct costs to various activities or outputs. Assigning costs on a cause-and-effect basis should be considered for costs that cannot be directly traced to outputs. However, a judgment needs to be made on the point when such cost allocation methods outweigh the benefits of the increased accuracy. It can be costly to assign supporting costs (such as general management and support costs) on a direct or cause-and-effect basis; such costs can be arbitrarily allocated using a common denominator such as number of employees. However, this kind of cost allocation can reduce costing accuracy and reliability. For those items that account for a substantial cost of an output, it is usually preferable to base cost allocation on a direct or cause-and-effect basis. Using either of these methods can greatly improve cost accuracy.

H.6 A cost-benefit test and analysis of a costing system to judge its usefulness for decisions on requirements for input measurement, inventory valuation method, cost accumulation, and cost assignment, will impact the cost of designing, implementing, and maintaining the system. This test and analysis can be applied at several levels, including when a new costing system and/or costing method is being implemented, or during a redesign or review of the existing system. For example, a costing system could be refined to improve product cost information. Rather than using "predetermined" costs, using actual costs might be considered. However, in this example an organization could usefully assess whether the improvement in the quality of the decisions based on that information is worth the additional cost. The additional cost of operating a system that uses actual costs is not always necessary, and costing systems that use budgeted data can be relatively economical.

H.7 A costing method can be redesigned in different ways. For example, a costing method can be refined to make it easier to implement and maintain, especially where absolute accuracy of cost information for internal decisions is perhaps not necessary. The trade-off between the cost of implementing and maintaining a costing system and the accuracy required of product costs should be considered. A simpler approach to establishing an ABC system, for example, could entail (a) defining a more limited range of activities (and hence cost drivers), or (b) combining smaller activities into larger ones, to avoid complexity. Using good estimates and cost drivers (e.g., the number of setups), which are more easily defined (but consume the same quantity of resources every time an activity is performed), can also help to reduce system complexity. However, if the amount of resources required to perform an activity varies considerably across products, more accurate (intensity- and duration-based) cost drivers could be required.

H.8 A cost-benefit analysis should factor in the full range of advantages and disadvantages of a particular approach. For example, the use of ABC in an overarching ABM approach can bring organization-wide benefits to the way an organization is managed. It does this by separating value-adding activities from non value-adding activities, resulting in greater strategic control. The result can be improved management of an organization, and delivery of greater value to customers. In a smaller organization, implementing a budgeting system can (a) help employees plan ahead, and (b) provide information for operational control, thereby allowing an organization to take timely corrective action. The implementation costs include initial investments in physical assets and training employees, and all the costs of ongoing operations. However, all the related benefits, including positive behavioral impacts, of changing to a new way of working should be factored into a cost-benefit analysis where possible.

H.9 The complexity of a costing system will depend on both (a) the nature of decisions and the demand from users, and (b) the required level of information detail. The perceived benefits of information transparency can be outweighed by the administrative costs of obtaining the information. A cost-benefit analysis might usefully refer to the level of complexity implicit in a particular costing system, and define this complexity in relation to several factors, including:

- The nature of an organization’s operations;
- The precision and accuracy required and needed by users;
- Practicability of data collection and processing (and availability of information systems); and
- The cost of implementing and maintaining the costing system.

H.10 Some organizations may not require a sophisticated costing system to report costs regularly for external and internal purposes, but might use special cost studies to analyze costs and their causes at a particular time to support specific decision-making. This might involve using costing methods or cost accounting processes on a one-off rather than recurring basis. A cost study should also be subjected to a cost-benefit analysis to ensure that the cost of planning, implementing, and using the cost study does not outweigh the potential benefit to the organization.

Appendix A

Resources

This list of resources is not intended to be exhaustive. Use the IFAC KnowledgeNet at www.ifacnet.com to search IFAC and many of its member body websites.

Cooper R and Kaplan R S (1998), Cost and Effect: Using Integrated Cost Systems to Drive Profitability and Performance, Harvard Business School Press ISBN-13: 9780875847887

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Krumwiede K R and Charles S L (2006), Finding the Right Mix: How to Match Strategy and Management Practices to Enhance Firm Performance, Strategic Finance, Institute of Management Accountants [web link]

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Appendix B

Definitions

- **(Full) Absorption costing**: method of inventory costing in which all variable and fixed manufacturing costs are included as inventoriable costs so that all manufacturing costs are capitalized in the inventory and therefore become assets.

- **Accounting system**: refers to the ledgers and the collection of financial information for financial reporting, supplemented by information needed for budgetary control. Costing systems draw on the same data, but require the additional ability to break particular ledger code outputs into smaller sums, usually by applying a factor derived from other ledger codes (for example, product revenues), payroll data (for example, timesheets), work study outputs, and sampling schemes, etc.

- **Activity**: an event, task, or unit of work with a specified purpose, such as designing products, preparing machines, operating machines, and distributing products.

- **Activity-based Management (ABM)**:
  - Operational ABM: actions, based on analysis of driver activity, that increase efficiency.
  - Strategic ABM: actions, based on activity-based cost analysis, that aim to change the demand for activities that improve profitability.

- **Actual costing**: traces direct costs to a cost object by multiplying the actual direct-cost rates by the actual quantities of the direct-cost inputs. Indirect costs are allocated based on multiplying the actual indirect-cost rates by the actual quantities of the cost allocation bases. Normal costing, although similar to actual costing, uses predetermined (budgeted) indirect-cost rates to estimate costs during a year.

- **Allocation method**: is used when the cost to trace costs to cost objects is greater than the benefits derived. Costs are allocated based on a common denominator such as direct labor hours. Absorption costing typically allocates costs to products on the basis of a production volume related measurement.

- **Avoidable cost**: the specific cost of an activity or sector of an organization that would be avoided if the activity or sector did not exist.

- **Batch costing**: form of specific order costing where costs are attributed to batches of product.

- **Business model**: describes how an organization takes resource inputs and generates value for stakeholders. It represents the way an organization undertakes it business. It consists of an organization’s objectives and revenue streams, its strategy, operations and its various other functions.

- **Cost**: the monetary value of resources used or sacrificed or liabilities incurred to achieve an objective, such as acquiring or producing a good or performing an activity or service.

- **Cost accounting**: the process (enabled by costing systems) of accumulating, measuring, analyzing, interpreting, and reporting cost information to both internal and external users. Cost accounting provides information for management accounting and financial accounting, although organizations typically use these terms interchangeably.

- **Cost allocation**: assigning a whole item of cost or revenue to a single cost unit, center, account, or time period.

- **Cost assignment**: encompasses (a) tracing accumulated costs that have a direct relationship to a cost object, and (b) allocating accumulated costs that have an indirect relationship to a cost object.

- **Cost behavior**: determining how input costs vary with activity. Cost may increase proportionately with increasing activity (the usual assumption with variable cost), or it may not change (a fixed cost). Some costs that have variable and fixed elements are called semi-variable.

- **Cost driver**: any factor that causes a change in the cost of an activity or output resulting in the activity consuming fewer or greater amounts of resources.

- **Cost finding**: a process of developing cost information used to aid decision-making.

- **Cost method**: costing methods such as job and process costing, standard costing, ABC, Grenzplankostenrechnung, are (period costing) methods of assigning costs (cost assignment). Life cycle costing and target costing are non-period costing methods. Defining the appropriate measurement, assignment, and allocation of cost for a given purpose and decision involves selecting the appropriate costing method(s).

- **Cost model**: the description of sources, drivers, classification, and organization of costs and the relationships between them, and the relationship between costs and income. The cost model therefore (a) explains an organization in dynamic financial terms, and (b) aggregates cost and contribution reports for an organization and its subdivisions (geographical, product, process, etc). A cost model can be used to design a technological solution that supports a costing system.

- **Cost object**: an activity, output, or item whose cost is to be measured, for example, an organizational division, a function, task, product, service, or customer.

- **Cost pool**: a grouping of individual cost items. It is often referred to as a grouping of costs relating to a particular activity in an ABC system.

- **Cost study**: is often used to refer to the development of cost information independently of (or in conjunction with) cost and accounting systems using cost estimates or cost projections.

- **Cost structure**: the pattern how costs are incurred and relate to each other in processes and locations to define an organization's expenditure in financial terms. This pattern, in combination with and relationship to its sources of income, can build a business model in financial terms of the way it works to deliver value.

- **Direct costs of a cost object**: costs that can be specifically identified with an output. Indirect (overhead) costs of a cost object are costs of resources that are jointly or commonly used to produce two or more types of outputs, but cannot be specifically identified with any of the outputs or traced to a given cost object in an economically feasible way.

- **Full Economic Costing**: is a methodology for determining the full costs of undertaking a project or activity. It normally involves calculating directly incurred costs, directly allocated costs and indirect costs, and therefore enabling opportunity costs to be fully considered.

- **Incremental cost**: the increase or decrease in total costs that would result from a decision to increase or decrease output level, to add a service or task, or to change any portion of operations.

- **Joint and common costs**: are the costs of a production process that yields multiple products simultaneously. For example, the distillation of coal, which yields coke, natural gas, and other products. The cost of the distillation is a joint cost. Joint costs are fundamentally allocated by (a) an allocation based on a measure of the number of units, weight, or volume of the joint product, or (b) an allocation based on the values attributed to the joint products. A common cost is a cost of operating a facility, activity, or like cost object that is shared by two or more users. The common cost is lower than the individual cost to each user. Common costs are usually allocated to each user in an equitable way on the basis of the individual costs of the cost object. Common costs provide a general capacity without committing the capacity to a particular product or mix of products. For example, a piece of fiber optic cable allows its owner to provide various services to customers while not committing the owner to provide a specific set of services.

- **Lean philosophy and management**: a management control system in which organizational learning is emphasized over control. This enables lean organizations, such as Toyota, to focus on eliminating waste and creating capacity to satisfy customer demand. The cultural shift in lean organizations extends to improving the consumption and use of costing information usually by integrating it with operational information to better serve operations. This approach typically emphasizes more real-time non-financial operational feedback performance information targeted at both front-line employees and managers. Operational performance information usually includes data on the cost of quality, throughput, defects, cycle time, and yields.

- **Marginal costing**: the segregation of costs between those that are fixed, and those that vary directly with volume. Therefore, only those costs that are a consequence of production of the product are assigned to a product.

- **Non-period costing**: the period for which costs are accumulated that are unique to the cost object, whether a specific product, service, customer, or delivery channel.

- **Opportunity cost**: the value of the benefit sacrificed when one course of action is chosen over an alternative. The opportunity cost is represented by the foregone potential benefit from the best rejected course of action that has a similar relevant risk profile. [*This is the definition used in IFAC PAIB Committee's IGPG on Project Appraisal Using Discounted Cash Flow* [web link].

- **Output**: any specific product or service generated from the consumption of resources.

- **Period costing**: the period for which costs are accumulated. These are fixed time intervals, such as a week, month, or year.

- **Responsibility accounting**: collection, summarization, and reporting of financial information about various decision responsibility centers.

- **Responsibility center**: an organizational unit responsible for its activities.

- **Strategic control**: tracking and responding to progress against strategic goals.

- **Value stream**: all the processes required to create value for the customer.

- **Variable costing**: a method of inventory costing in which all variable manufacturing costs are included as inventoriable costs. All fixed manufacturing costs are excluded, and are treated as costs of the period in which they were incurred.

Appendix C

Basic Costing System Elements

CMA Canada's Cost Concepts and Classification Strategic Management Accounting: Standard 2100, an extract

A costing system accumulates costs in cost pools. There are three types of cost pools – primary, intermediate, and final.

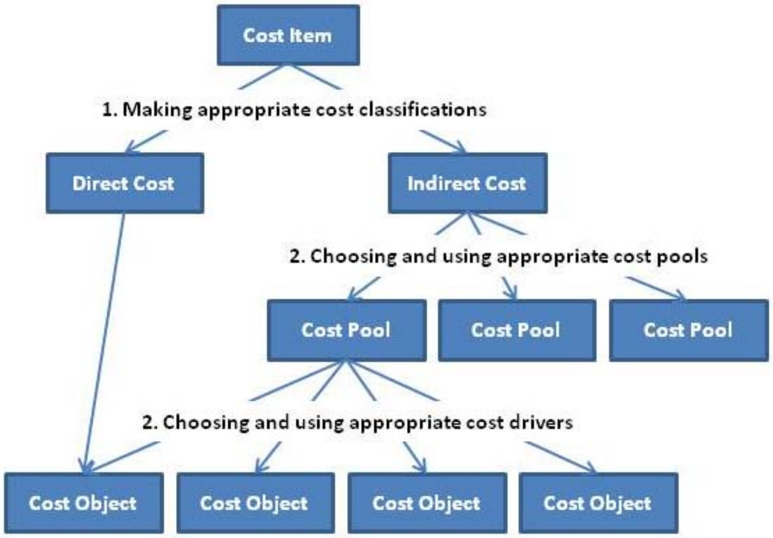
A primary cost pool is the initial account to which the cost is assigned. This account will usually correspond to an account in the financial accounting system's general ledger. For example, the wage paid to a worker whose job is factory maintenance might be assigned to the account "Wages – Factory Maintenance."

An intermediate cost pool accumulates costs pending their final disposition. An example of an intermediate cost pool is the cost of a particular activity, such as quality testing.

A final cost pool corresponds to the cost object. A cost pool that is final for one decision might be an intermediate cost pool in another decision. For example, in a "make or buy" decision, a decision-maker might consider the entire cost of a division. Therefore, the cost pool accumulating all the costs of the division is the final cost pool in that decision. However, in a decision that requires the cost of one of the division's products, the cost pools accumulating the costs of the division would be intermediate cost pools.

There are two characteristics that define the adequacy and potential accuracy of any costing system. Figure 2100-4 summarizes these characteristics.

Figure 2100-4



The two characteristics are:

- **A proper classification of every cost as direct or indirect.**
- **Proper handling of the cost, once classified.**

When the cost is classified as direct, the cost should be attributed to the cost pool associated with the cost object to which the cost belongs.

When the cost is classified as indirect, the cost should be assigned to an appropriate intermediate cost pool to accumulate that indirect cost. In general, the cost pools used to accumulate indirect costs should be designed so that they only accumulate costs with the same cost driver.

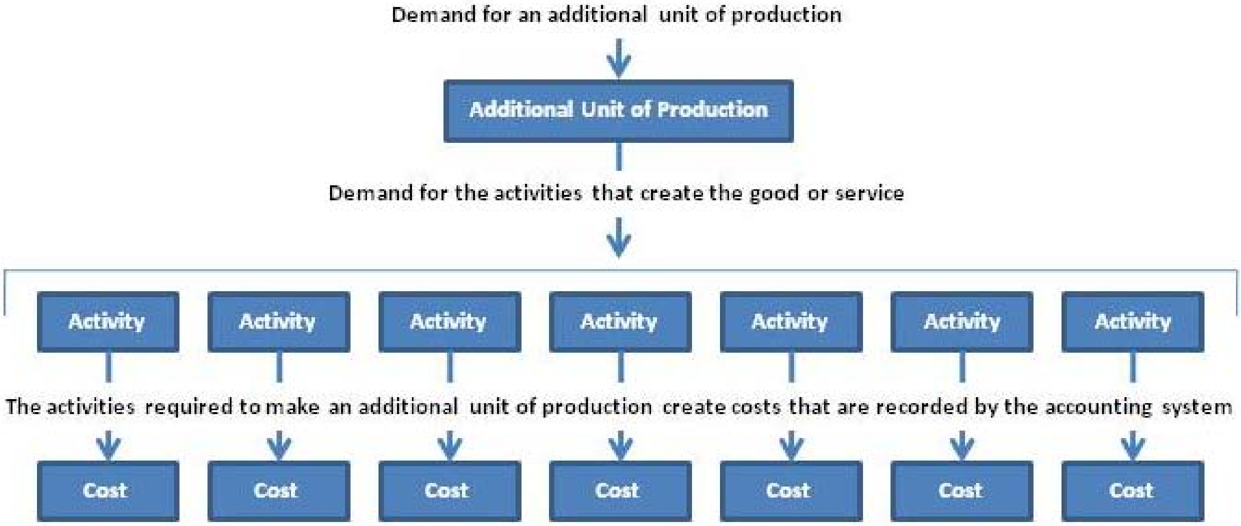
When costs are allocated from the intermediate cost pools to the final cost objects, the cost allocation basis should be the cost driver for that cost pool.

Broad Costing Principles

The appropriate principle for attributing or allocating costs to cost objects is cause-and-effect. That is a cost should be allocated to the cost object that caused the cost to be incurred. Figure 2100-1 depicts the cause-and-effect relationship between the demand for a good or service, the activities that are needed to make that good or service, and the costs that undertaking those activities create. The principle underlying Figure 2100-1 is that producing a good or service requires that the organization undertake certain activities. These activities consume resources. The organization incurs costs to acquire these resources, completing the cause-and-effect chain between the cost object (in this case a unit of production) and the cost. Therefore, the role of a costing system is to:

1. Identify the type and number of activities consumed by the cost object;
2. Develop an estimate of the cost of completing each of the identified activities; and
3. Assign a cost to the cost object by accumulating all the costs of all the activities consumed by the cost object.

Figure 2100-1



Appendix D

Specific Arrangements in Some Jurisdictions

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

- A number of South Asian countries, including India (since 1965), Pakistan (since 1990) and Bangladesh (since 1994) require a *cost audit*, which involves the audit of the cost accounts of many industries. In Sri Lanka and Nepal, a cost audit is not mandatory. Cost audits help to ascertain whether an organization's cost accounting records are so maintained as to give a true and fair view of the cost of production, processing, manufacturing, and mining of a product. Therefore, cost audits can be used in these countries to the benefit of management, consumers and shareholders by (a) helping to identify weaknesses in cost accounting systems, and (b) to help drive down costs by detecting wastage and inefficiencies. Cost audits are also of assistance to governments in helping to formulate tariff and taxation policies.
- Japan: while there are no legal requirements on costing in Japan, the Japanese Ministry of the Environment has produced guidelines on Environmental Accounting that define environmental protection/conservation costs and benefits. More than 800 companies in Japan have voluntarily introduced environmental accounting based on these guidelines, and disclose the results in environmental or sustainability reports.

The extent to which cost accounting is used within governments varies from country to country. In 2000, IFAC published *Perspectives on Cost Accounting for Governments, an International Public Sector Study* [web link]. This provided useful governmental perspectives on cost accounting.

In a public sector context it is important to note that using full cost information along with non-financial information on program outputs and outcomes can aid governments, managers, and other stakeholders to make decisions on service delivery. The full costing of public service programs (or the output of a responsibility center) generally involves compiling the sum of direct and indirect costs that contribute to the program or output. This compilation also includes the full costs of intermediate activities, processes, projects, or programs that need to be measured to calculate the full costs of their outputs. This can enable better evaluation of the merits of a public service policy or program (although program outcomes may require separate measurement). Examples of government requirements and guidelines for costing include:

- USA: The Chief Financial Officers (CFO) Act of 1990 was designed to improve federal management and accountability by gaining financial control of government operations. It required (a) the development of cost information, and (b) agency CFOs to develop and maintain accounting and financial management systems that report cost information. To support CFOs, the Federal Accounting Standards Advisory Board (FASAB) issued Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*. This standard recognized the importance of information on full costs of programs and activities to allow proper evaluation of programs' outputs and outcomes.

- UK: for significant project proposals, the UK Government expects the use of Full Economic Costing as a more accurate way of helping to determine whether an activity or a project is worthwhile and sustainable. The UK Treasury's *Green Book, Appraisal and Evaluation in Central Government* [web link], applies to government departments although full economic costing is required in other public sector/non-for profit organizations such as in the University sector (from 1 September 2005 Research Councils pay 80 per cent of the Full Economic Costs of research in Higher Education Institutions). The Green Book states that for substantial proposals, relevant costs are likely to equate to the full economic cost of providing the associated goods and services. The Full Economic Cost should be calculated net of any expected revenues for each option.

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PREFACE

The objective of the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) is to develop programs aimed at improving public sector financial management and accountability. To that end, the IFAC PSC issues Standards, Guidelines, Studies and Occasional Papers. Studies are undertaken by the Committee to provide information that contributes to public sector financial reporting, accounting or auditing knowledge, and to stimulate discussion.

The objectives of government are determined by the political process, and cost accounting is one of a number of tools that may be used to achieve those objectives. Although in some situations cost accounting may not be as central to achieving a particular government's objectives as it is generally for private sector entities, it nevertheless almost always provides important information to help improve the functions of government.

This Study is intended to aid government financial officers and other government accountants in their efforts to develop and implement cost accounting. It provides governmental perspectives on cost accounting not available elsewhere, but it is not an in-depth exposition of the subject of cost accounting. Government accountants who do not have basic knowledge of cost accounting can acquire it from existing literature or training programs, and they can bring into their organizations consultants or others who have experience with cost accounting.

Cost accounting is one aspect of financial management and management control, and should be used by program managers and others as a managerial tool in day-to-day operating activities and by senior managers in their supervisory and evaluative roles. Although this Study will be informative for non-accountant managers, they may find it beneficial to also refer to other literature with a managerial perspective, such as the publications of IFAC's Financial and Management Accounting Committee (FMAC), including *Management Accounting Concepts* (1998) which provides useful background, and *Management Control of Projects* (1991) and *The Capital Expenditure Decision* (1989), which deal with the cost accounting aspects of particular managerial issues and decisions.

Cost accounting for governments is continuously evolving. Since this Study was first released for comment in December 1998 there has been considerable progress in implementing cost accounting, new approaches and techniques have been developed and other countries not cited in the Study have prepared descriptions of their approaches, e.g. Spain's Contabilidad Analítica Normalizada para Organismos Autónomos (C.A.N.O.A.) project. This Study has been revised for comments received where revisions were deemed essential for reader understanding.

In-depth studies are needed on how cost accounting can contribute to decisions and issues that are peculiarly governmental, such as decisions to privatize government-owned enterprises and issues relating to government performance measurement and program evaluation. These special governmental decisions and issues are beyond the scope of this Study.

Chapter 1 describes the scope, need and purpose of this Study.

Chapter 2 of this Study describes the governmental uses of cost accounting, the extent of its use and recent growth, and the prospects for future growth. This Chapter gives readers a perspective to consider their own situation in comparison with the potential uses of cost accounting and with the progress being made in other countries. It suggests that progressive implementation of cost accounting may be appropriate in a number of situations.

Chapter 3 explains the cost concepts that are relevant to various different management objectives. It also explains the fundamental processes that should be used in the cost accounting exercise. Alternative ways to develop cost information are mentioned. This Chapter provides a theoretical grounding on cost accounting issues with which governments will need to deal. Practical aspects and more specifics are provided in following chapters.

Chapter 4 discusses accounting standards issues where the resolution may affect the values used in the cost accounting exercise. The Chapter uses the International Accounting Standards Committee (IASC) private sector standards for inventories and other property as a baseline for discussing those issues. This Chapter provides government standard setters and policymakers with a cost accounting perspective that might be considered in making choices among accounting standards.

Chapter 5 shows how the concepts and processes discussed in Chapter 3 might be applied in designing and implementing a cost accounting system. The various kinds of requirements for a system are discussed. Issues related to integrating cost accounting with other information systems are explained and the basic types of systems are reviewed. Finally, available types of cost accounting software are discussed, as are some of the relevant features of modern computer equipment.

Chapter 6 relates cost reports to systems requirements and illustrates a variety of cost reports based on different ideas of management needs. Reports recommended for use in the United States by the U.S. General Accounting Office and those in use in Malaysia and New Zealand are described and illustrations are provided. Generalizations are drawn about how regular management cost reports should be designed. The Chapter also discusses how systems requirements can satisfy special information needs.

Chapter 7 discusses the major issues of importance to senior management. It points out that senior management should be involved in their resolution in order to ensure the successful implementation of cost accounting in government. It goes on to outline various approaches that might be taken in resolving those issues.

The Appendix is provided to define the technical terms used in this Study. This is a necessary reference because some countries attach different meanings to these terms.

The Bibliography lists only the government-related literature used in the preparation of this Study. There is a wealth of additional literature dealing with cost accounting which is not cited, that cover its function in commercial-type activities. Other literature covers more fully the integration of cost accounting with the broader, related issues of management accounting and control, system applications and technology infrastructure. The IFAC FMAC and Information Technology Committee may be able to assist those readers of this Study who wish to obtain additional literature on these subjects.

Perspectives on Cost Accounting for Governments

CONTENTS

CONTENTS

- continued -

CHAPTER 1: INTRODUCTION

SCOPE OF THIS STUDY

.001 In the past, cost accounting was viewed as a method of accounting that used various techniques to assign costs to particular cost objectives, e.g., the cost to perform an activity, produce a product or render a service. Under that view, cost accounting served to implement the accrual basis of accounting, which determined the values that cost accounting then assigned to cost objectives. Cost accounting was viewed as a relatively simple mechanical process and was almost always the sole domain of the accountant. Today, not only have the techniques improved, but cost accounting itself is viewed as more of a management exercise where accountants play important, but no longer dominant, roles.

.002 Cost accounting is now viewed as an activity that provides information on costs and related data to satisfy a variety of management needs for decision-relevant information. It is concerned with how cost information is used in the management process and with the values generated by the financial accounting system to the extent that they may affect the quality of cost information.

.003 Cost accounting also encompasses the design of information systems that may be needed to generate a great variety of cost-related information. It is also concerned with the design of cost reports tailored to management needs and preferences. Because of its significance to efficient and effective management and to communications with those outside the entity, senior government management now has an important role in the development and implementation of cost accounting.

.004 This contemporary view of cost accounting has been adopted as the basis for this Study. However, the Study’s scope is limited to governmental perspectives. Other published sources on cost accounting in the private sector provide useful information and guidance that can be applied to cost accounting in connection with the commercial activities of government. Other sources also provide information about the integration of cost accounting with the broader issues of financial management and information technology. Complete coverage of these broader issues is beyond the scope of this Study.

NEED FOR THIS STUDY

.005 Although great similarities exist between the public and private sectors, a number of governmental cost accounting issues have not yet been dealt with comprehensively in existing literature. One study of value that covers some of these aspects is published by the International Monetary Fund, titled *Effective Government Accounting* (1995).

.006 The need to overcome this gap in the literature and provide governmental perspectives is accentuated by today’s pressures on governments to deal with shrinking budgets and meet demands for improved services. Governments must cut costs wisely and take cost-related steps to improve services. To do that they need applicable reference material on cost accounting. Furthermore, governments do not yet make full use of cost accounting in those government agencies which provide goods and services to the public without charge. As a result, many government managers have little understanding of how to use cost accounting to improve their operations. This accentuates the need for good reference material.

.007 Even though cost accounting is today more of a management than an accounting exercise, the PSC believes that government financial officers and accountants have important leadership roles to play. They can provide much of the stimulus and knowledge needed to develop and implement cost accounting. They can provide “hands on” help to those in operating management who must participate in development and implementation if this management tool is to be used, and they can help to integrate the work of technical people, such as information systems experts. In addition, they can counsel senior management who must be involved in the resolution of basic issues concerning how cost accounting will be used and developed.

.008 Financial officers and accountants are more likely than others in government to have a basic knowledge of cost accounting and how it can be used. If they lack sufficient knowledge, they are likely to know how to acquire it for themselves and their organizations. This Study aims to provide a governmental perspective to stimulate putting that knowledge to work and to be a resource for financial officers and accountants in helping others in their organizations to learn more about cost accounting in government.

PURPOSE OF THIS STUDY

.009 The basic purpose of this Study is to equip financial officers and accountants with a tool they can use in furthering cost accounting in their countries. This Study provides:

- a description of how cost accounting can be used to assist governmental management processes;
- information about what is happening in various countries and how cost accounting might be adopted progressively and used in other than full accrual environments;
- an understanding of the various cost concepts that can be used to satisfy government information objectives and the related cost accounting processes;
- a discussion of the accrual accounting issues whose resolution may affect the values used in determining full costs;
- guidance on how to develop cost accounting systems, raising major issues that will need resolution;
- a discussion of various options for the design of cost reports for government managers;
- encouragement to involve senior managers in basic cost accounting issues, with suggestions on how that might be done.

CHAPTER 2: THE USES OF COST ACCOUNTING IN GOVERNMENT

.010 In addition to its historical function of determining values in the financial accounting process for inventories or other types of property, cost accounting has a number of primarily management functions, including:

- budgeting;
- cost control and reduction;
- setting prices and fees;
- performance measurement;
- program evaluations; and
- a variety of economic choice decisions.

.011 When cost accounting is used in the commercial activities of governments, its applications in financial accounting and management functions need not be materially different than those in the private sector.

BUDGETING

.012 Budgeting as a planning and control mechanism has a prominent and important role in government. Among the reasons for this is the visibility of the result and the need to allocate resources to a large number of individually important activities whose objectives are complex and often non-profit oriented.

.013 Budgets may be formulated and carried out on a cash basis or on an accrual basis. Where they are on an accrual basis, e.g., in New Zealand, the costs of government programs incurred in the past can be readily used as a basis for preparing budget estimates of future costs. Where they are on a cash basis, e.g., in the United States, using cost information in budget preparation requires crosswalks between the accrual basis used for cost accounting and the cash basis used to prepare the budget.

.014 When accrual-based budgets are adopted, incurred costs can be easily compared with budgets for control purposes. If flexible budgets are used, as they may be in the case of “for profit” government business enterprises, e.g., in Australia, then fixed and variable costs must be determined for budgeting and related control.

COST CONTROL AND REDUCTION

.015 As in the private sector, cost information can be used in cost control and reduction. For example, with appropriate cost information, managers can:

- compare costs with known or assumed benefits of activities, identify value-added and non-value-added activities, and make decisions to reduce resources devoted to activities that are not cost-effective;
- compare cost changes over time, identify their causes and take any appropriate action, e.g., take steps to improve efficiency;
- identify and reduce excess capacity costs; and
- compare costs with similar “benchmark” activities, find the causes for cost differences, and take any appropriate action, e.g., revise and improve business processes.

.016 But governments do not usually have profitability and return on investment objectives for their governmental activities. They lack these economic incentives to manage costs. Government managers must take the initiative to analyze cost behavior and then, after careful consideration of all the consequences, take appropriate action. Unless initiative is taken by government managers to analyze cost behavior, inefficiencies may emerge, continue, and grow for a long time before the need for action becomes obvious.

SETTING PRICES, FEES AND INTER-UNIT REIMBURSEMENTS

.017 Cost is an important element of the decision-making process for setting prices and user fees for government-provided goods and services. Information about costs is relevant even when goods and services are provided at less than cost as a result of government policy decisions, or when prices and user fees are set on the basis of market prices. Cost is also frequently the basis for transfer pricing between government units. A number of governments have specific cost-related requirements for pricing.

.018 When governments are engaged in commercial type activities, private sector concepts of pricing may be relevant and, as a result, market prices may be a more determining factor than cost recovery. For example, in the United States, unless otherwise specified by law, regulations require that prices charged to the public for government goods and services be based on market prices or the full costs incurred by the government. Nevertheless, determining costs remains important in these circumstances.

.019 Canada has an initiative for cost recovery with respect to certain government goods and services provided to external users. This initiative is to give departments the impetus to maximize cost recovery where appropriate and to change attitudes and processes to meet higher cost-recovery expectations. Canada suggests that full cost is a good starting point for determining user fees.

.020 New Zealand has expanded the concept of pricing services to all activities of the government, whether sold, transferred between government units or distributed free to the general public. All outputs are costed and the costs of those distributed free to the public represent the prices Ministers pay departments and agencies for the production of goods and services.

.021 The United Kingdom encourages charging for services supplied between departments unless it is clear that the likely benefits would not justify the cost. The expected benefit from internal charging for support services is improvement in the "value for money" from exercising greater cost discipline upon the suppliers of services and their internal customers.

PERFORMANCE MEASUREMENT

.022 Some governments, such as the United States, are showing increasing interest in performance measures. Other governments, such as the United Kingdom, have established systems for reporting this information. Performance measurement includes both financial and non-financial measures and is generally more effective when these measures are interrelated. But cost itself can be a measure of financial performance.

.023 When cost is combined with an effectiveness measure, it can show cost-effectiveness. Thus, the service efforts and accomplishments of an entity can be evaluated with the following measures:

- Measures of service efforts — these are resource costs and other measures of the inputs used to provide the services.
- Measures of accomplishments — these are outputs (the services provided) and outcomes (the effects of those services).
- Measures that relate efforts to accomplishments — these are, for example, the cost per unit of the various outputs of the entity.

.024 Performance measurement can be viewed as the government equivalent of private sector profitability measurements. However, selecting appropriate measurements is quite difficult and requires the exercise of judgment. While outcomes may be far more difficult to define and measure than either outputs or inputs, outcomes of government programs and activities provide the ultimate measurement of their success. Measuring outcomes is difficult because the effects may be difficult to determine and those that can be observed often represent a blend of effects from government outputs, other interventions (e.g., regulations) and non-government factors.

.025 While it is possible to allocate input costs to outputs, it is very much more difficult, if not impossible, to allocate the cost of outputs to outcomes in a rational way. For example, it is possible to calculate the cost of an output like surgical intervention, but it is not clear how this cost could be assigned to the different outcomes which should result, such as improved quality of life, enhanced longevity, reduced cost of medication. In some cases, the outcome might also not be known for a considerable period of time.

PROGRAM EVALUATIONS

.026 The cost of government programs, when combined with appropriate performance measurements and reported publicly, can help the public and legislators to evaluate the programs.

.027 Whether or not reported publicly, the cost of programs is a factor in making policy decisions related to program authorization, modification and discontinuation. Many countries use information on program costs as a basis for cost-benefit considerations. For example, Canada fosters the use of cost-benefit analysis by individual departments to improve the efficient allocation of resources among competing government programs.

.028 When considering costs in program evaluation, some consideration should be given to any collateral costs of the programs, as well as the government's own incurred costs. National governments may use laws and regulations to require local governments, private sector businesses and other non-governmental entities to take specific actions to further government programs. These actions often result in both pecuniary and non-pecuniary costs to these entities. Also, the programs themselves may have unforeseen costs to the non-government sector which are not reflected in the outcomes or other performance measurements of those programs. Or governments may use "tax expenditures", e.g., reductions in the tax base or the tax itself, to induce taxpayers to take actions to further program objectives. Although difficult to measure, governments should be aware of the possible magnitude of any such collateral costs and give them consideration in program evaluations.

ECONOMIC CHOICE DECISIONS

.029 Making choices among alternative actions, such as whether to do a project internally or contract it out, requires cost comparisons between alternatives. Privatization decisions may involve comparing the incremental net cost or profit of continuing a government activity with the economic and other benefits of placing it in private hands. Cost studies of various types can help to decide whether to accept or reject a proposal for a government capital project, to continue or drop a government product or service, or to contract with a private sector vendor.

HOW WIDELY IS COST ACCOUNTING USED?

.030 The extent to which cost accounting is used within governments varies from country to country. Usage frequently depends upon the objectives of the various types of government organizations. State-owned enterprises organized for profit generally employ some form of cost accounting. Public utilities are an example of this type of organization. Non-profit revolving funds, whose objective is to maintain capital through sales of goods and services, rather than through appropriations, frequently employ cost accounting. Internal inventory and service funds which provide goods and services to general fund organizations are examples of this type of organization.

.031 By comparison, relatively infrequent use of cost accounting systems is found in governmental organizations that provide goods and services to the general public without charge. Of those governmental organizations that have not utilized cost accounting, the requirement for some form of performance evaluation or the recognized need to promote management efficiency and effectiveness often results in the adoption of cost accounting. In countries where these factors are important, there is generally more widespread use of cost accounting within government. Well-managed governments are turning to cost accounting as an essential component of the management of their activities.

.032 Some reasons still cited for not using cost accounting include the following:

- All citizens are served by the government without charge and the goods and services provided are essentially governmental functions.
- Many costs cannot be reliably calculated, e.g., natural resources.
- Criteria for meaningful performance evaluation are lacking even if costs are known.
- Government programs and projects are politically driven and cost is irrelevant or secondary.
- Government budgets are on a cash basis and control of budgetary funds, not costs, is the only or primary interest of legislators.

.033 While these arguments continue to be made, a number of countries are moving to more widespread adoption of cost accounting. This move has been motivated by the need to deal with increasing debt levels and shrinking budgets and by related public criticism of government management. This increasing use of cost accounting is sometimes combined with the adoption of improvements in accrual accounting and the adoption of cost-based budgeting. For example, in Taiwan, the development of cost accounting was linked to better mid-term and long-term budget planning.

.034 In Malaysia, cost accounting is an essential part of its “value for money” concept of government management. The “value for money” concept has been in use for some time in the United Kingdom, but recent steps to adopt cost-based budgeting will likely improve its cost accounting systems.

.035 In Canada, fiscal pressures resulted in an emphasis on “stretching the tax dollar” and led to the issuance of guides on how to deliver services and to “make or buy” in a more economical or efficient manner. Cost accounting on a full-cost basis is recognized by Canada as essential to these initiatives.

.036 In New Zealand, fiscal exigencies led to the adoption of full accrual accounting as the basis for government financial management and also to related initiatives for the development of cost accounting as a management tool. These related initiatives were the adoption of cost recovery or charging policies where goods and services are provided to identified consumers, and the corollary requirement to determine the cost of all government outputs in order to facilitate management control and accountability.

.037 Although improvements in cost accounting have come about as a result of recognition by government managers that improvements in customary accounting and management practices were needed, many times these improvements are led by new laws adopted by the legislature and new policies adopted by the top management of government. The United States is a case in point. Until recently, cost accounting has been limited in use by United States general fund organizations. Despite the fact that the United States continues to budget largely on a cash basis, cost accounting is now beginning to be implemented across the government. This is the result of several pieces of legislation and related actions by the executive branch of government starting with the passage of the United States Chief Financial Officers (CFO) Act in 1990.

.038 In 1995, the United States published the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as recommended by the Federal Accounting Standards Advisory Board. This requires federal entities to accumulate full cost information. The reporting of full costs is required in the SFFAS No. 7, *Accounting for Revenue and Other Financial Sources*.

.039 The Federal Financial Management Improvement Act of 1996 added the force of law to these accounting standards and also to any systems requirements established by the U.S. Joint Financial Management Improvement Program (JFMIP). JFMIP issued cost accounting systems requirements for U.S. government organizations in February 1997.

POSSIBLE CAUSES OF INCREASED USE OF COST ACCOUNTING

.040 Adoption of accrual accounting as the basis for budgeting and management information, following the examples of New Zealand, the United Kingdom and Australia, will obviously trigger increased use of cost accounting and the development of supporting systems. Short of that, recognition of its need in "right sizing", eliminating inefficiencies and privatization will also spur increased use and related systems development. Managers of government programs, if they are informed of the managerial advantages, will likely provide impetus for increased use. Program managers can improve operational performance from three perspectives — quality/productivity, cycle time, and cost. If cost is brought into the managerial decision-making processes along with these other measures in a balanced fashion, then better decisions can be made.

.041 Because government decision-making is subject to a number of political pressures, how reported performance measures are viewed by users of those measures will affect the pace at which cost accounting is adopted. Relating costs and the outputs of government programs is not in principle more difficult than costing products or services in the private sector. This step alone has provided legislators and government officials with decision-relevant information. It has also provided the general public with information about the efficiency of government. However, measuring the outcomes of government programs and establishing the linkage with all costs is significantly more difficult than measuring the government's incurred cost of outputs. While a number of governments are trying to do this, there is still much to be learned. If and when governments succeed in measuring outcomes satisfactorily, cost accounting will become even more important than it is today.

PROGRESSIVE IMPLEMENTATION OF COST ACCOUNTING

.042 Some countries may wish to move relatively quickly to implement an approach to cost accounting which meets all their known needs for cost information. But other countries may wish to move more slowly toward obtaining cost information that satisfies their needs, and they may define their initial needs modestly.

.043 Implementation of cost accounting can be done on a step-by-step basis. The following describes some of the many different situations that may be faced by governments, and some of the possible steps governments might wish to consider in moving progressively to implement cost accounting.

- Governments on the cash basis of accounting can develop useful cash basis information and, at the same time, learn about the processes of cost accounting by using those processes to obtain information about expenditures that their cash basis records do not ordinarily provide. For example, the cost accounting processes described in Chapter 3 can be used to calculate amounts spent indirectly on behalf of the beneficiaries of particular government programs.

- Governments on the cash basis may also develop approximate cost information through cost studies based on the expenditure information in their records and estimates of the effects of asset recognition and consumption. This approach is more likely to be satisfactory when inventories are not significant. Cost studies of this sort may also help cash basis governments learn about the nature and extent of their need for full cost information.

- Governments on the cash basis may also implement a stand-alone cost system while retaining, at least temporarily, a cash basis for financial accounting. Such stand-alone systems assign cost data drawn from operating systems and other reliable sources to cost objectives.

- Governments on a modified accrual basis for financial accounting may find that a stand-alone cost accounting system is relatively easy to implement if they have asset registers that can be used to compute depreciation.

- Governments on a full accrual basis of financial accounting should be able to develop useful managerial cost information through cost analysis of information in accounting records. In a few cases, these governments may decide that their need for regular, periodic cost information is not extensive and, therefore, that no cost system is required. In other cases, these governments may decide to use cost analysis for a period of time while they evaluate the kind of system they want to implement.

- Governments whose accrual accounting financial systems do not reflect all possible elements of full cost, e.g., interest on capital employed, may develop cost systems based on full costs and reconcile the results with the financial accounting records. Alternatively, they may develop a cost system based only on the cost data in their financial accounting records and either try to deal with unrecognized costs in some other fashion or add the missing full-cost elements to their cost system later.

- No matter what the basis of financial accounting, countries that implement a cost system may choose to satisfy a set of limited cost information needs initially and expand the system later as they gain knowledge of their exact requirements and the likely costs of gathering the additional data required for a more comprehensive system. For example, a government might choose to implement a basic cost accounting system for all of its operating units so as to obtain needed government-wide information in a relatively short period of time. After that was accomplished, it might then encourage its individual units to expand and modify the basic government-wide system to satisfy their special needs and circumstances.

.044 Whether to move quickly or progressively to implement cost accounting obviously depends on the particular circumstances of the government.

CONCLUSION

.045 Cost accounting has a number of important uses in the efficient and effective management of government. It is a valuable tool for the management of general fund organizations as well as for commercial type activities. But the measurement difficulties associated with some of its applications should be recognized. The use of cost accounting is likely to become even more widespread than it is today as more successes are reported and the use of accrual accounting spreads. In appraising how to improve the quality of available information, governments should consider the advantages of using cost accounting for management purposes in addition to the advantages of accrual accounting for financial reporting. There are a number of approaches that governments in different circumstances can adopt to move progressively to implement cost accounting.

CHAPTER 3: BASIC COST CONCEPTS AND PROCESSES

.046 Simply put, cost represents the value of resources that have been, or must be, used or sacrificed to attain a particular cost objective. A government's cost objectives are a function of its information objectives and to measure their values a government must define the cost concepts to be used. A government must also apply the processes of cost accounting so that those values are measured with desired accuracy. Because accrual accounting measures periodic values more precisely than cash accounting, cost accounting is normally done in an accrual accounting environment. But, as discussed in Chapter 2, governments on a cash basis of financial accounting can also do cost accounting, make cost studies, or use the processes of cost accounting to measure the achievement of cash objectives.

COST CONCEPTS SHOULD REFLECT INFORMATION OBJECTIVES

.047 The objectives of the cost accounting exercise determine the cost concepts used. The full-cost concept, for example, is appropriate for many of the management objectives discussed below, as well as for the determination of values for inventory and other property in balance sheets prepared under accrual accounting standards. But the other cost concepts mentioned below are appropriate for some of the other management objectives discussed. Still other cost concepts may be appropriate for specific types of management decisions.

.048 It should be noted that the costs which should be considered in many types of management decisions are not the recorded costs, but rather the expected future costs that will differ among the possible alternative courses of action. Much of the data for estimating these relevant costs may be found in a well-constructed full-cost database.

Full Cost

.049 As will be discussed in Chapter 4, the definition of what constitutes full cost can be affected by financial accounting standards and there may be differences among countries on the definition of full cost. Exclusion of certain cost elements from the definition of full cost may adversely affect the utility of full-cost information. While the selection of an appropriate concept is critical, so is the precise definition of the concept. This is particularly true of the full-cost concept.

.050 Full costs can be the basis for budgeting, as in New Zealand and the United Kingdom. The PSC's Occasional Paper 1, *Implementing Accrual Accounting in Government: The New Zealand Experience*, describes how adopting full accrual accounting as part of its major reform of public sector management shifted New Zealand's method of budgeting appropriations from expenditures for inputs to costs of outputs. This, in turn, required the development of management cost accounting information on a full-cost basis.

.051 When used in budget planning, the basic cost information used in the cost accounting exercise is normally derived from the full accrual accounting system. The full-cost information on past outputs is then adjusted for such things as cost trends which are expected to continue, changes in programs, and anticipated inflation to determine budget requests.

.052 If the objective of cost accounting is to provide a basis of cost recovery, then the full costs of outputs is the needed information. Both Canada and the United States have policies, albeit with specific exceptions, which require that full costs be the basis for user fees for government services and for the sale or use of government property or resources. Canada's policies are expressed in the Treasury Board User Fee Policy. U.S. policies are expressed in OMB Circular A-25 on User Charges.

.053 Normally, full costs are used in cost control and cost reduction, but frequently in combination with marginal cost information.

Controllable Costs

.054 Full costs are generally used in connection with performance measurement and program evaluation. However, this is often with the proviso that program managers' performance is evaluated based only on those costs for which they can be held accountable. Canada's position is that full costs should be measured, but this measurement should always provide for separate identification of costs incurred by other responsibility centers.

Marginal Costs

.055 Full costs do not always provide the information needed by management. Marginal costing is one of several other cost concepts that serve different management needs.

.056 A marginal costing concept focuses on variable costs or how the costs of outputs or activities will change if a specific level of activity increases or decreases. For example, this concept may be useful if level–of-service decisions are to be made, excess capacity costs are to be identified, or the costs of extraordinary non-recurring activities are to be billed. It is often useful when providing analysis of cost behavior to provide marginal cost per unit data, i.e., to analyze the effect of variable costs (in total or by element) in terms of their effect on the unit cost of production.

.057 How marginal costs are defined depends on the situation. For example, the relevance of non-cash fixed costs such as depreciation depends primarily on whether the analysis is being performed to determine funding implications or to portray the economic impact of alternatives. Non-cash costs might not be considered in the former case but would normally be considered in the latter.

Differential and Incremental Costs

.058 If the need is to evaluate the cost differentials between alternatives such as in "make or buy" decisions, then all costs that are common to the options being considered are normally ignored. The relevant costs in a make or buy decision are those that would change depending on which option is selected.

.059 This differential costing concept is closely related to an incremental costing concept used in privatization decisions whereby the costs which are avoided and those that are incurred by a change in activities undertaken are measured by cost accounting. This change in costs is then compared with the potential proceeds from the sale. Consideration may also be given to additional "proceeds" represented by the potential future taxes which a buyer might pay. The differential costing concept can also be used to determine the benefit from eliminating what appear to be non-value-added costs or the cost detriment of retaining unused or "excess capacity." Other types of cost/benefit decisions may be made using the differential costing concept.

Opportunity Costs

.060 Opportunity costing is based on the value of what must be given up to obtain a result. Under this concept, unrecoverable "sunk" costs such as depreciation are ignored and cash values are employed. Investment decisions are normally made using an opportunity cost concept. This concept is appropriate when considering replacing or upgrading equipment or property. Opportunity costing essentially compares the present value of the cash costs of making the investment with the risk-adjusted present value of the anticipated net cash benefits to be obtained. Anticipated reductions in costs as a result of making the investment provide some of the data used in estimating net cash benefits.

Contract Costs

.061 When special purpose cost information is required based on the provisions of particular agreements with others, such as cost reimbursement contracts or pricing formulas based on cost, the values considered in cost accounting are derived from the provisions of the contracts or formulas. For example, costs which are recognized by the U.S. government in contracting with suppliers are determined by cost accounting regulations set by the U.S. Government's Cost Accounting Standards Board, and these regulations are included in supplier contracts.

PROCESSES FOR DEFINING COST OBJECTS, CLASSIFYING COSTS, AND ASSIGNING COSTS TO COST OBJECTS

.062 The quality and accuracy of cost information is also affected by how the processes of cost accounting are applied. Great care should be taken in defining the particular cost objects to be valued, in classifying the relevant costs, and in choosing and applying the assignment methods to the classified costs.

Defining Cost Objects

.063 A cost object (also referred to as a cost objective) is an item whose cost is to be measured. For reporting cost information to those outside the reporting entity, the relevant cost objects may be types of inventory or other property accounts. They may also be government programs, or the outputs of various goods and services provided by each of the programs, or benefits paid within the programs. While these cost objects are also relevant to management, additional cost objects may be identified to meet other management information needs such as the costs of activities within programs or the costs of long-term projects. Management cost objects may also include the costs of the various departments or cost centers involved in programs and projects. Such objects may also include costs of outputs by geographic region or by customer type. What the cost objects are, and which should be satisfied by the cost system, requires consideration of the:

- various objectives of cost accounting;
- decisions to be aided by cost information; and
- frequency of the desired information and the cost to provide it.

.064 The definition of cost objects is the shared responsibility of program and department managers and financial officers. Program and department managers have knowledge of the programs and outputs and need their own information about programs, projects, customers, etc. Financial officers should define the cost objects necessary to satisfy these needs and the cost information objectives and needs of senior management.

Classifying Costs

.065 Like the choice of cost objects, the choices made to classify costs should depend on the various objectives of cost accounting. Classifying costs facilitates the assignment to cost objects. Classifications distinguish types of cost. These are some of the cost classifications which are likely to be needed to assign costs systematically:

- fixed vs. variable;
- direct vs. indirect;
- production vs. non-production; and
- controllable vs. non-controllable.

.066 As discussed earlier, it may be useful to determine marginal costs. To do this, costs must be classified as fixed or variable. This can be done by observing the relationship between the behavior of specific costs and changes in production volume.

.067 In order to facilitate assignment of appropriate amounts of costs to cost objects, costs should normally be classified in even more detail than just fixed and variable. These classifications may be based on what factors drive the costs, i.e., cause them to increase or decrease. "Cost drivers" may be determined by observation or by careful analysis of the various activities undertaken in the production process.

.068 A basic classification that is almost always made is that of direct costs and indirect costs. The relationship between the cost and the cost object determines whether a cost is direct or not. Those that have a directly traceable relationship with the cost object are direct costs. Costs of this type include some payroll costs, materials used, etc.

.069 For many costs, it will not be possible to establish a direct tracing to cost objects. These indirect costs are common to more than one cost object. However, common costs may still be assigned to cost objects on the basis of what factors drive them, i.e., their cause and effect. Such costs are assigned to cost objects based on the extent to which they are caused by, and contribute to, the cost object.

.070 Cause and effect is difficult or costly to determine in some cases. Administrative costs are an example of costs where there is a general but non-specific relationship to outputs or some other types of cost objects. Separating these costs from other indirect costs facilitates allocating them to cost objects on a more general but still appropriate basis.

.071 Costs should also be classified according to whether or not they contribute to the cost object. For example, those that do not relate to outputs are non-production costs, such as abnormal costs of various kinds or certain types of administrative costs (such as the cost of high-level officials) that are so remotely related to production that they are considered non-assignable to outputs.

.072 Other types of classification decisions, like those suggested by the previous discussion of cost concepts, may be necessary to accomplish management objectives. Some of these, which relate to departmental cost objects like controllable costs and uncontrollable costs, may be reflected in the cost-accounting system. A number of cost classifications are needed to make a cost system operative. These other classifications are mentioned in Chapter 5.

.073 Other management cost accounting objectives which require information about incremental costs, sunk costs, and opportunity costs also require cost classification. These may be aided by the classifications included in the cost-accounting system, but they are ordinarily done by analysis or study rather than being a product of the cost-accounting system.

.074 The responsibility for cost classification is primarily that of financial management, but classifications should be in accord with the cost concepts adopted by senior management. Program managers should assist in identifying needed classifications and the related cost drivers for those classifications. Both senior management, and department and program managers should be consulted by financial officers when classification alternatives may be critical to satisfying information objectives.

Assigning Costs

.075 Assigning costs is the final step of an interrelated cost accounting process. Choices of cost objects and cost classifications affect how costs are assigned to objects. Cost classifications are a function of cost objects chosen but are also affected by the cost of information gathering and cost assignment practicality.

.076 A well-designed cost-assignment process helps ensure that cost objects are properly specified and that the costs of all of the resources consumed by the cost objects are accurately assigned to them.

.077 In general, the cost-assignment process can be summarized by the equation **C = R x Q**, *where:*

- **C** represents the cost of the resource consumed;
- **R** equals the per unit cost of resource consumption; and
- **Q** represents the quantity of that resource consumed.

The task is, therefore, to assign costs to objects on the basis of resource consumption.

.078 There are various methods of assigning costs to objects. The choice is determined by whether the cost can be assigned, the amount of information available, and the cost of the method itself. The cost-assignment method selected will affect the accuracy of cost information.

.079 The cost assignment in terms of outputs being the cost object will be discussed, but the procedures are also generally applicable to other types of cost objects. Specific outputs produced should be identified and, if practicable, measured in units. The costs of resources that directly or indirectly contribute to the production of outputs should be assigned to outputs through costing methodologies or cost-finding techniques. The assignment of production cost should be performed using the following methods listed in the order of preference wherever feasible and economically practicable:

- tracing direct costs to outputs;
- assigning indirect costs on a cause-and-effect basis; or
- allocating any remaining indirect costs on a reasonable and consistent basis.

.080 There are many methods of direct tracing. They involve using quantities of resources consumed and the actual unit cost of the resource.

.081 They make use of:

- Time recording systems — Where each individual's time is charged to particular outputs.

- Activity review — Such as time and motion studies, activity analysis and time sampling.

- Inventory records and other resource management records — Charging outputs for withdrawn inventory or usage of computers, telephones, etc.

- Output accounting records — Costs assigned to output codes in the general ledger as incurred.

.082 Estimates and judgment, while less accurate, may sometimes be used.

.083 Assigning costs on a cause-and-effect basis will often require two or more stages. Indirect costs incurred outside a production department usually need to be assigned to production departments before they may be assigned to the outputs of those departments. For example, the number of purchase orders issued by the purchasing department for each production department might be used to assign the costs of the purchasing department. The production departments can then directly trace the total of their own costs and the assigned costs of the purchasing department to their own outputs. When inventories are involved, the department responsible for storing and disbursing inventories produced can trace the costs of the inventory disbursed to outputs when shipped. It can assign its own costs to outputs on the basis of the number or value of the items of various kinds shipped.

.084 A third stage is used where accuracy and cost considerations dictate assigning indirect costs of departments which support the production departments to all benefiting departments, including other supporting departments, before assigning them to production departments. This can be complex when reciprocal assignments attempt to capture all interaction between departments. For example, the head count of all other departments can be used as the basis for assigning the costs of the personnel department. Personnel department costs would then be assigned to the purchasing department, and the purchasing department might also assign costs to the personnel department depending on the reciprocal formulas decided upon. Assigning costs can become even more complex and possibly unmanageable if a variety of bases are used. For example, personnel costs may be assigned to some departments on the basis of their head counts and to others on the basis of the number of new hires provided to the departments by the personnel department. Complexities in how the multiple stage process is used and in the selection of more specific cost drivers, while possibly improving accuracy of the cost result, can also result in managers not understanding the significance of the cost information and how to use it.

.085 When costs cannot reasonably be assigned on a cause-and-effect basis, they are allocated on some general basis like the total of directly traced and cause-and-effect assigned costs, or on direct production hours. Allocation bases of this sort were widely used in the past to allocate all indirect costs. The separation of indirect costs into those which can be assigned on a cause-and-effect basis and those which must be allocated, has improved the cost accounting process. Inaccuracies, which can also occur if direct tracing or assigning costs do not properly reflect the equation, are more likely when allocating costs on a general basis.

.086 Financial management has the principal responsibility for determining cost assignments. Choices among assignment methods, like the choices of cost objects and cost classifications, will be affected by the ability to develop needed cost information. If cost systems are employed, choices among assignment alternatives will be affected by the degree of integration of cost and other information systems.

ALTERNATIVE WAYS TO DEVELOP COST INFORMATION

.087 As mentioned in the previous Chapter, cost information may be obtained by using cost systems of varying degrees of complexity, by cost analysis of information in the general accounting system, or by special cost studies based on relevant data gathered or developed for the special purpose of each study.

.088 Cost systems are described in Chapter 5. A system is indicated when cost information is needed on a regular basis for financial reporting as well as for management reports. It is even more advisable if the operations of government are complex and diverse and management wants to use cost accounting in the several ways described in Chapter 2.

.089 Cost analysis of information in the general accounting system can substitute for a system when the requirements for cost information do not include regular reporting, the requirements for detail and precision are less demanding, and cost information is not a fundamental component of the management process. To accomplish this successfully, general ledger accounts and especially the object class expense accounts should provide sufficient data.

.090 Cost studies are often prepared in connection with privatization or investment decisions. They are generally made in conjunction with a cost system, or start with a cost analysis of general accounting information. They may draw upon information in the budget or in management information systems. Cost studies may also be based almost entirely on cost sampling. For example, “should-take” costs may be developed by various kinds of operations analysis such as that used to set standard costs.

.091 No matter whether the cost information is developed systematically, by special analysis, or through cost studies, the basic processes of defining costs, classifying costs, and assigning costs to objects should normally be employed.

USEFUL REFERENCES

.092 Canada’s *Guide to the Costing of Outputs in the Government of Canada* (1989) together with its follow-on guide, *Stretching the Tax Dollar: A Guide to Costing Service Delivery for Service Standards* (1995), present practical step-by-step descriptions of the costing process and how to implement it. The Canadian approach is notable in its explanation of how to bring into consideration any costs that are not recognized in the financial accounting system. Its approach is different from some other countries in its designation of the activities within programs as cost objects to accumulate costs prior to their assignment to outputs.

.093 New Zealand’s *Improving Output Costing: Guidelines and Examples* (1994) is also a useful reference. It is particularly valuable for its conceptual development of the cost-assignment process and for its systems orientation.

.094 The previously mentioned U.S. *Managerial Cost Accounting Concepts and Standards for the Federal Government* sets specific requirements for the cost accounting processes to be used for financial reporting and cost management by all federal government entities. It provides the rationale for the concepts and standards chosen.

CONCLUSION

.095 The cost concepts used in the cost accounting exercise depend upon the objectives of the exercise. Full cost will satisfy several important objectives. Selected components of full cost will satisfy others or provide some of the needed data. The processes used in the cost accounting exercise to implement the cost concepts will determine whether and to what degree the objectives will be achieved. The choices of concepts and processes are interrelated and important judgments must be made by top management and by operating and financial management. These choices are also related to financial accounting choices discussed in Chapter 4 and affect the systems design and reporting choices discussed in Chapters 5 and 6. Chapter 5 elaborates on senior management's role in making these choices.

CHAPTER 4: COST ACCOUNTING AND FINANCIAL ACCOUNTING

.096 Because it is normally efficient to use the same database for both cost accounting and financial accounting, consideration should be given to the impact on cost accounting when government financial accounting standards are set or adopted.

.097 While there are benefits from modeling government financial accounting standards on those of the private sector, sometimes these financial accounting standards may be inconsistent with cost accounting objectives. This Chapter discusses some of the possible inconsistencies by reference to the private sector standards at the international level developed by the International Accounting Standards Committee (IASC).

INFORMATION CONSISTENCY AND INCONSISTENCY

.098 The value of the resources used or sacrificed in relation to any particular cost objective is usually derived from the financial accounting system for two basic reasons:

- the greater understandability of cost data which is consistent with financial accounting data; and
- the cost efficiency of generating the cost data based on or integrated with an existing system of accounting.

.099 When cost information is reported outside the particular governmental entity, it is generally provided on a basis consistent with financial accounting. This is the case, for example, in New Zealand, where departments provide information about the costs of their outputs in their annual financial statements.

.100 Inconsistencies between the values generated by the financial accounting system and those used in cost accounting can be appropriate. For example, in modified accrual systems of some jurisdictions of Canada, depreciation of property, plant, and equipment is added to cost systems that are otherwise based on information in the financial accounting systems.

.101 A full accrual environment also may have inconsistencies. This may be deliberate if the government has different objectives for its cost accounting than it does for its financial reporting. It also may result from failure to coordinate the setting of standards for financial reporting with cost accounting concepts or from failure to give full consideration to alternatives by those in government who adopt particular accounting standards and cost concepts.

NEED FOR RECONCILIATIONS

.102 Where there are inconsistencies between the values generated by the financial accounting system and the cost accounting system, a reconciliation should be provided. In the private sector, the need for reconciliations has been recognized by the IASC in its standard IAS 14, *Reporting Financial Information by Segment*, when segment operating results are computed differently than entity-wide results. The United States government has adopted the concept of reconciliation whenever governmental cost information is reported on different bases. Without reconciliations there are greater possibilities of confusion and misunderstanding and of loss of credibility for the cost information presented.

FINANCIAL ACCOUNTING STANDARDS

.103 Financial accounting standards govern the flow of costs into the operating statement. Although the discussion of IASC standards that follows is in terms of property, plant and equipment (PP&E), inventory and costs related to these assets, other standards also affect the flow of costs.

.104 Under IASC accounting standards, how values for inventory and PP&E are determined can be briefly summarized as follows:

(a) The general basis for the initial valuation of these assets is the historical cost that was incurred by the entity to bring:

   (i) inventories to their present location and condition; and
   (ii) PP&E to working condition for their intended use.

(b) Specific types of costs are excluded from these valuations. Administrative and selling costs, development and preproduction costs, and storage costs are excluded unless they are directly attributable to inventories or PP&E. Abnormal amounts of wasted material and labor and excess capacity costs are also excluded, as are borrowing costs related to these assets except under a permitted alternative where borrowing costs related to the construction of PP&E may be included.

(c) Costs resulting from related party transactions are reflected in inventories and PP&E on the basis of the prices assigned to the transactions.

(d) Historical costs for inventories are reduced to net realizable value and for PP&E are reduced for depreciation and to reflect any lower recoverable value for those assets.

(e) Under an IASC allowed alternative, PP&E may be revalued regularly to fair value.

.105 IASC standards do not deal comprehensively with the costs of deferred maintenance, the capital costs of holding inventory and PP&E, or the values of natural resources.

QUESTIONS ABOUT THE APPLICABILITY OF FINANCIAL ACCOUNTING STANDARDS

.106 The particular circumstances of governmental entities raise questions about whether financial accounting standards for governments should reflect cost accounting considerations. Governments have types of assets and responsibilities which are different from those in the private sector. Concepts of capital maintenance and performance measurement may differ from the private sector. Governments may wish to emphasize the determination of operating costs rather than balance sheet values.

.107 Some of the major questions about the applicability of financial accounting standards for inventory, PP&E and related costs are discussed below.

Fair Value

Why use historical cost rather than fair value?

.108 Countries that wish to use current economic costs for pricing purposes and whose budgeting and funding arrangements are designed to maintain physical capital may find fair value accounting for PP&E (and possibly inventory) a compelling concept. New Zealand entities in the public sector depreciate their PP&E on the basis of fair values re-established every three years, at a minimum, where the entity has elected to depart from historic cost. Many Australian public sector entities adopt a deprival value[1] methodology for the valuation of their non-current assets. At present, public sector bodies in the United Kingdom are required to record tangible assets at their net current cost of replacement. The United States considered fair value accounting but rejected the idea for various reasons, including its emphasis on the maintenance of dollar capital.

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[1] "Under the deprival value approach, assets are valued at an amount that represents the entire loss, both direct and indirect, that might be expected to be incurred by an entity if that entity were deprived of the service potential or future economic benefits of the assets at the reporting date. Thus the value to the entity in most cases will be measured as the replacement cost of the services or benefits currently embodied in the asset, given that deprival value will normally represent the cost avoided as a result of controlling the asset and that the replacement cost represents the amount of cash necessary to obtain an identical or equivalent asset." (*Guidelines on Accounting Policy for Valuation of Assets of Government Trading Enterprises Using Current Valuation Methods*, issued by the Steering Committee on National Performance Monitoring of Government Trading Enterprises (Australia), October 1994).

Net Realizable and Recoverable Values

Why reduce historical incurred costs for lower net realizable or recoverable values?

.109 It might be argued that recognizing losses for these factors prior to sale, retirement, or other disposition of inventory or PP&E fails to recognize some unique factors of the government environment. Governments may price goods and services on the basis of full costs. Also, governments may maintain extraordinary levels of certain inventories and PP&E to meet their responsibilities to citizens. Where these factors are operative, it might be argued that cost fluctuations due to the application of financial accounting rules are not relevant to performance measurement in government. The United States does not have a lower of cost or market rule for such inventories. Nor does it recognize lower recoverable values for general PP&E. Only when inventories are specifically identified as excess, obsolete or unserviceable does the United States recognize lower net realizable values. Most other countries have not made exceptions to the applicability of rules for recognizing lower net realizable or recoverable values.

Deferred Maintenance

Why not include deferred maintenance in recognized costs?

.110 Deferred maintenance of PP&E is an economic cost for both the private sector and the government. However, because there is not a liability that meets present recognition and measurement criteria, deferred maintenance is not generally recognized in either sector. Because of the political environment, including a preference for funding new programs and the lack of visibility of some government infrastructure, deferred maintenance can be a greater problem for government.

.111 Several measurement methods (including condition assessment surveys and life cycle forecasts) are available, but none is generally accepted as a sufficient measurement basis for the purposes of financial accounting. When a generally accepted method of measurement and related maintenance standards, such as a definition of “acceptable condition”, are developed, United States standard setters plan to consider requiring the recognition of deferred maintenance costs.

.112 An alternative treatment to deferred maintenance for the recognition of costs associated with the physical assets, including infrastructure assets, is the use of an appropriate depreciation methodology. The practice of reporting the periodic loss of service potential as a period expense — depreciation — is widely accepted for the purposes of financial accounting. The purpose of depreciation is to allocate the cost of a physical asset over a period so that accurate measurements of expenses are achieved. Depreciation is then the allocation of that cost as the service potential of physical assets are consumed.

.113 The following chart illustrates the kind of cost information that might be made available by an entity whose PP&E is experiencing material amounts of deferred maintenance. Deferred maintenance information is only relevant when the service potential of the related asset may need to be restored, e.g., information about clearly unneeded assets should not be provided.

Figure 4.1

CATEGORY	METHOD	ASSET CONDITION (See Note 1)	COST TO RETURN TO ACCEPTABLE CONDITION (See Note 2)	CRITICAL	NON-CRITICAL
Buildings	Condition Assessment Survey	4	$100,000 – 125,000	$75,000	$25,000 – 50,000
Communications Eqp/Systems	Condition Assessment Survey	4.5	$10,000 – 15,000	$2,000	$8,000 – 13,000
Laboratory Equipment	Condition Assessment Survey	5	$500,000 – 550,000	$300,000	$200,000 – 250,000
Heating & Air Cond. Eqp	Condition Assessment Survey	5	$40,000 – 42,000	$5,000	$35,000 – 37,000

Note 1: Condition Rating Scale:

Excellent	1
Good	2
Fair	3
Poor	4
Very Poor	5

Note 2: Acceptable condition is “fair” or 3.

Related Party Transactions

Rather than basing costs on prices charged in transactions among government departments (related parties), why not recognize the full costs incurred?

.116 The costs of goods and services may include the costs of input from contributing related parties as well as the costs of the entity that actually delivers or provides the goods or services to the public. Because measuring the cost of outputs is frequently an objective of financial reporting, it may be appropriate for governments to require that prices for inter-entity transactions be based on full cost. This is required in Australia and is the practice in New Zealand. Where this is not required, it may be appropriate in government accounting to replace transaction prices, when they are different or when no price is charged, with the full costs actually incurred. To do so, the entity that receives the goods or services must determine the costs incurred by the supplying entity and make accounting entries to impute the full cost and recognize the related financing source. This is done in the United States.

Excluding Certain Costs

Why not use comprehensive cost accounting standards to determine the cost of the cost objects of inventory and PP&E rather than applying accounting standards that specifically exclude certain types of costs?

.117 Financial accounting standards specifically exclude certain costs that might not be excluded if the classification and assignment rules discussed in Chapter 3 were incorporated in financial accounting. For example, borrowing costs, which under an IASC permitted alternative could be included in PP&E, would be included under the cause-and-effect assignment rule. Other costs such as the indirect costs of administration, storage and development are specifically excluded under IASC standards, to prevent possible overstatements of inventories and PP&E. But these might be included in inventories and PP&E under some circumstances if cost accounting standards were the basis for financial accounting. Excluding indirect but assignable costs, although appropriate under IASC standards for financial accounting, may sometimes result in understating the full costs of outputs when inventories are sold or transferred.

Interest on Capital Employed

Should interest on the capital employed in holding inventories and PP&E be recognized as a cost?

.118 In addition to the costs of storing inventories and maintaining PP&E, holding these assets also consumes capital. The question that arises is, should the cost of funds invested by an entity in its inventories and fixed assets, where such capital is not represented by interest-bearing debt of the entity, be recognized as an element of cost?

.119 In the private sector, companies have used the cost of capital as a benchmark to determine performance of their operating units. For example, General Electric in the United States subtracts the cost of capital invested by an operating unit from the unit's net earnings to derive the residual income of the unit. The unit is considered profitable if its residual income is positive. However, external financial reports of private sector companies only recognize interest on debt as an expense; the cost of the capital derived from stockholders' equity is not recognized. Government-wide reports would normally follow the same approach and only recognize interest on outstanding government debt. But, the published reports of a government's operating units could recognize the full cost of the capital invested in PP&E, inventories and possibly receivables. That cost might be calculated on the basis of the government's borrowing rate or the private sector cost of capital, or on some other basis. The cost might be billed to the government entity by the central government or imputed and recognized as a non-cash element of cost. Financial accounting standards, if applied to government, would likely recognize any cost of capital billed. However, as mentioned earlier, there are no financial accounting standards for imputing unbilled costs, whether they be the cost of capital or other types of costs such as the unreimbursed (rent free) services of buildings.

.120 In New Zealand, each government department receives appropriations for the full cost of producing its outputs, including that element of cost levied by the government as a capital charge. These appropriations are accounted for as revenue by the departments. Twice each year, each department calculates and pays a capital charge to the government. The appropriation does not specify how much is to be incurred in respect of each type of expense, so a department can reduce its capital charge by reducing its capital, without its appropriation being reduced. This provides each department with an incentive to manage its capital assets carefully and not to retain assets that are not generating value.

.121 In the United Kingdom, the recognition of a capital charge is accepted as an important feature of implementing resource accounting and budgeting. Each department, as a cost in its operating cost statement, will report the capital charge. A purpose of imposing the capital charge is to enable department managers to evaluate the cost of using capital and current resources on an equivalent basis. The United Kingdom government believes that the capital charge will encourage the efficient utilization of capital by creating incentives to dispose of unwanted or uneconomic assets and will also improve decision-making with respect to the acquisition of new capital assets.

.122 In the United States, where the question is under study, standard setters published an *Invitation for Views: Accounting for the Cost of Capital by Federal Entities* (1996). This publication surveys practices in the private and public sectors and deals with the usefulness of capital cost information, what assets might be included in the capital base and how they might be valued, alternatives for capital cost rates, and the accounting and reporting procedures necessary for the implementation of this concept.

.123 Interest on capital employed is one of the major economic costs of many government activities. Excluding these costs from the financial statements of the component entities of the national government may result in misleading performance information and wasteful use of resources.

Weapons Systems and Heritage Assets

Are there specific governmental costs to acquire assets that could be recognized as a period expense?

.124 With two major exceptions (weapons systems and heritage assets), the United States requires the full costs of production, as determined under its various financial and cost accounting standards, to be capitalized in inventories and PP&E. For example, even excess capacity costs are currently considered to be part of the full cost of production. As such, they are included in inventories and the cost of related programs. Other countries might treat excess capacity as a non-production cost and as a period expense to be excluded from output costs. There probably would be agreement among many countries that most other non-production costs, e.g., non-pension post-employment benefits are period expenses. But on what basis could production costs be treated as period expenses?

.125 U.S. standard setters believe that the costs related to the acquisition of weapons systems and most heritage assets should be treated as period expenses. Their reasons include the belief that the consumption of service potential of these types of assets cannot be reliably measured through depreciation because they have an indeterminate or unpredictable useful life. Further, they believe these assets provide a unique good or service for which there is not necessarily a periodic output against which to match costs. Furthermore, the United Nations' System of National Accounts expenses outlays for military assets.

.126 Other countries on the accrual basis of accounting do not follow the same practice with respect to weapons systems and heritage assets. Their statement of financial position reflects the acquisition costs of the assets when incurred (or their value) and they recognize depreciation (or loss due to destruction) as the measure of the consumption of service potential.

Natural Resources

Should stocks of natural resources owned by the government be valued and the values sold or otherwise removed be reported as a cost?

.127 Many governments own or control a major portion of the natural resources in their countries. For example, the U.S. government controls much of the related natural resources on the 29 percent of the land of the country owned by the government. In most cases, these assets were acquired at little or no historic cost.

.128 In the United States, there is little accounting at present for these assets and their use. This is also true for many other countries. Currently, there are no IASC financial accounting standards for natural resources.

.129 From an economic standpoint, the stock of these assets can be a major portion of a government's wealth and the values sold or removed can have a major effect on whether the country is better off or worse off based on the activities of government. A World Bank publication, *Monitoring Environmental Progress (MEP): A Report on Work in Progress*, points out that one major portion of national wealth is natural capital and that depletion of natural resources, without offsetting increases in produced capital and human capital, can result in dire consequences to a country's economy.

.130 The values of natural resources, especially hard rock minerals, oil, natural gas and similar non-regenerative resources, are hard to determine. But unless the values of the natural resources consumed can be accounted for in some fashion, the costs of many governments will be substantially understated.

CONCLUSION

.131 There are a number of potential differences between financial accounting standards and cost accounting concepts. Issues concerning the applicability of financial accounting standards to cost accounting are considered by the PSC when developing International Public Sector Accounting

Standards and by those in government who adopt accounting standards. These considerations can have significant effects on reported operating results. If different concepts are adopted for cost accounting, then reconciliations will be required if there is to be understandability and acceptance of the cost-related data presented in cost and performance reports. Even with reconciliations, significant inconsistencies may cause confusion and loss of credibility of the information presented. Also, if they are dealt with differently, there will be some difficulties in developing efficient and effective cost systems needed for financial and cost accounting. It seems clear that financial accounting standards and cost accounting concepts should be addressed concurrently and differences should be minimized.

CHAPTER 5: SYSTEMS REQUIREMENTS

.132 In designing a cost system, the overall objective is to use the concepts and processes of cost accounting systematically to satisfy management information objectives. To do so, systems requirements need to be established for:

- Information — What types of data are needed for the system to operate?
- Functions — How will the data be used to produce the cost information desired?
- Integration — How will the cost system fit into the overall information system?
- Security — How will the system be protected from failures of availability, confidentiality and integrity?

.133 Once systems requirements are established, it should be possible to choose the system type best suited to meeting those requirements, and make appropriate hardware and software selections.

.134 Designing and installing a managerial cost accounting system can be challenging because:

- Information and functional requirements can be complex if the system is to satisfy a variety of managerial needs as well as support financial accounting applications.
- To be efficient, the cost accounting system should exchange information with many existing managerial systems as well as most accounting systems, rather than be a stand-alone system.

.135 Cost objects, classification schemes, and assignment methods will need to be coordinated and set in detail. Operating and program data, such as units of output, will need to be integrated with accounting data. The need to make comparisons of costs incurred with budgets or plans adds complexity to the systems design.

.136 If the cost system is integrated with other systems, interfaces with other systems will need to be defined. To the extent that the cost system is not integrated with existing systems, other sources for the required data will need to be developed.

.137 Experience in New Zealand suggests that any initial failure of management to specify the government's requirements in the detail required to develop systems will result in costly redesign.

INFORMATION REQUIREMENTS

.138 Both financial and non-financial information needs will have to be defined and the sources of the data identified. Common cost objects will be needed to pull together the flows of other accounting and operating information from different systems and organize that information by organization and program. For example, cost objects might be identified by both organization and by program in descending level of detail as follows:

Organizational Units	Programs
Reporting entity	Program responsibility segment
Organizational responsibility segment	Sub-program responsibility center
Organizational responsibility center	Project number
Departmental center	Project phase Contract identification number

.139 Additional cost objects would normally include the particular products and services produced by organizational responsibility centers and program responsibility segments. If cost information is needed for budgeting, and accounting is on an accrual basis and budgeting is on a cash basis, then budget accounts may need to be added as cost objects. Activities should be added as cost objects if additional program detail is needed below the sub-program responsibility center or if activity based costing (ABC) is to be implemented as an integral part of the cost system.

.140 A cost classification scheme will need to be developed to support the cost objects chosen. In addition to the basic cost classifications mentioned in Chapter 3, i.e., fixed vs. variable, controllable vs. non-controllable, etc., costs might also be classified as follows:

- general ledger accounts;
- additional object class accounts (or cost elements) to provide the lower level of detail needed for cost assignment;
- cost incurred by other entities for this entity's programs; or
- reporting period.

.141 Because of the likely need to be able to relate revenue received from the sale of government goods and services to costs, revenue codes would normally be included in the cost classification scheme. Normally, costs would also be classified by budget account for funds control. Further, cost classifications might be established to provide data for cost analysis, such as the geographic location or groups of people receiving government goods, services, or benefits.

.142 The cost objects and cost classifications just discussed and the cost assignment methods to be discussed provide the structures needed to provide actual cost information. But a cost system also needs to accumulate physical unit data and comparative data of various kinds in both monetary and physical units. Examples of such data are:

- actual and planned units of output, such as the number of particular goods or services produced or provided;
- input units, such as hours spent;
- estimated or planned costs; or
- actual, estimated and planned revenue for goods and services sold.

.143 The system needs to provide accumulators for this type of data generated by other systems and transferred to the cost accounting system or introduced directly into the cost accounting system. To make needed calculations and comparisons, the other data will need to be accumulated by the time periods, e.g., month, year, comparable to the monetary cost data.

.144 Multiple cost objects and cost classifications can be accommodated in a single system because of the sorting, accumulation, and calculating capacities of the modern computer. Data gathering to feed computer programs can be expensive, however, and these operating costs of the system should be identified and included in the cost/benefit tradeoffs considered before deciding to invest in a new or upgraded cost system.

FUNCTIONAL REQUIREMENTS

.145 How the system will manipulate the data and information just described will need to be defined. The system's functional requirements will determine various processes the system will perform including, for example:

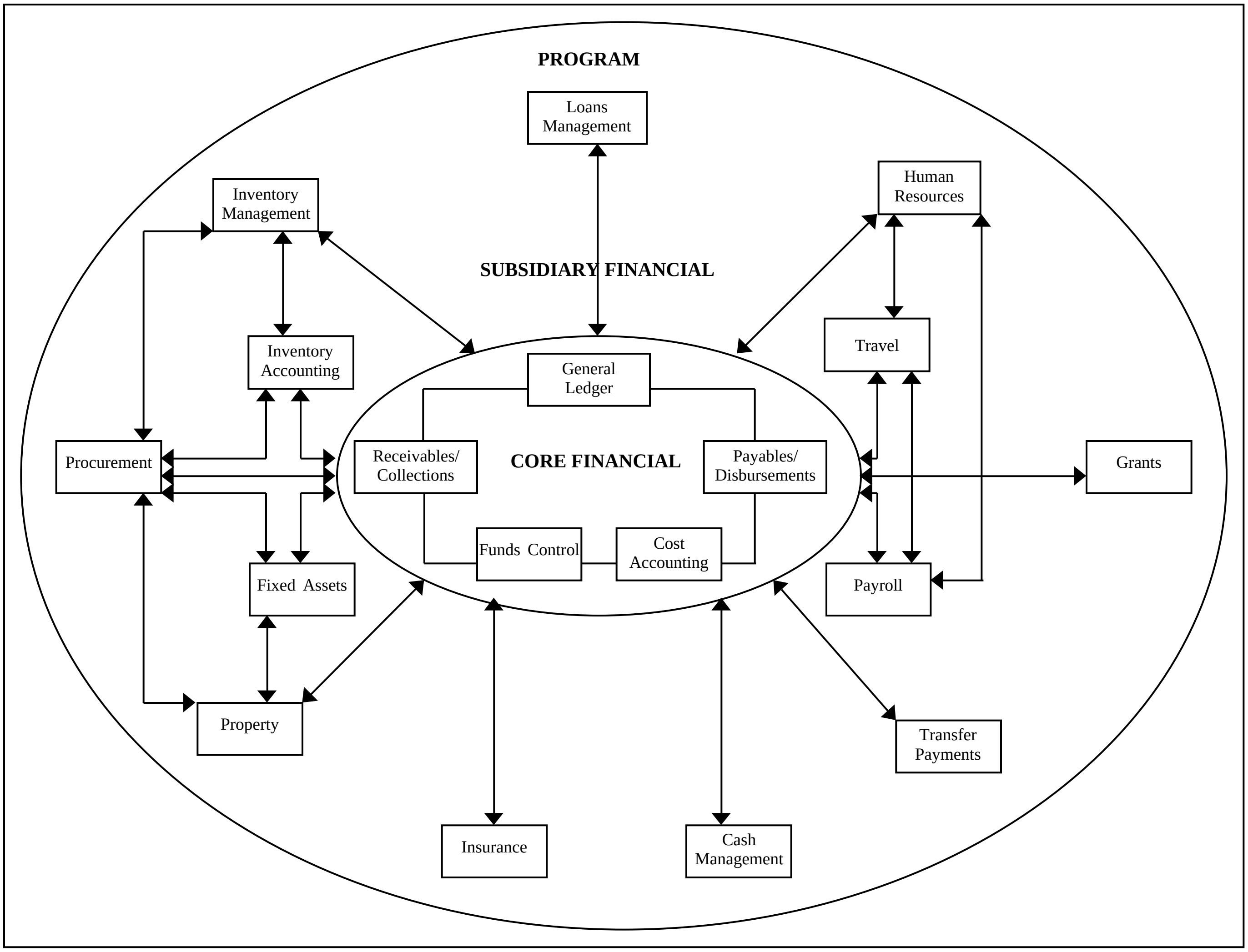
- maintaining certain data in the system, storing other data in other systems, drawing data from other systems, and transferring data to other systems, etc.;
- summarizing classified costs for assignment purposes and calculating costs assignable to various cost objects under assignment rules stored as formulas in the system;
- associating certain revenues with cost objects under other rules stored in the system;
- calculating unit costs; and
- preparing reports and providing access to supporting or other data in the system.

The greater the information and reporting requirements, the greater the complexity of the functional requirements.

INTEGRATION WITH OTHER SYSTEMS

.146 The number of systems with which a cost accounting system could interact varies greatly from country to country depending on how the government is organized, and other factors. The following chart used by the U.S. General Accounting Office illustrates the possible complexity of that interaction.

Figure 5.1



.147 Virtually all of the program systems on the outer ring shown in figure 5.1can provide non-financial information on units of inputs and outputs needed by the cost system in the core. For example, units produced might be maintained in the Inventory Management System or the data needed to make cost allocations, such as head count information, might be maintained in the Human Resources System. All the subsidiary financial systems in the middle ring provide even more detailed data to the cost accounting system than they do to the general ledger system. Also, the cost accounting system provides necessary cost information to make other systems functional, i.e., the inventory and PP&E systems.

.148 Because of the numerous data exchanges between systems that should occur to achieve efficiency and control, the flow of information between the cost accounting system and other systems needs to be carefully defined so that appropriate interfaces between systems can be built into the cost accounting software.

.149 Thus far in this discussion, it has been assumed that the values used in cost accounting are the same as those generated by the general accounting system. Where this is not the case, separate feeder systems will need to be developed to provide the cost data appropriate for the particular cost concept chosen for the cost system.

.150 There are a number of important management issues and cost/benefit questions raised by systems integration, and these are discussed in Chapter 7.

TYPES OF SYSTEMS

.151 Most government units need a process costing system, a job order costing system or both. In some circumstances they may need a hybrid system that incorporates both job order and process costing features.

.152 Process costing accumulates costs by individual processing sub-organizations and then finally by outputs of the organization. The output of a sub-organization either becomes the input of the next sub-organization in the production flow or becomes a part of the end product output. Normally, each sub-organization reports its costs, the completed units, and the work-in-process volume for each reporting period. When completed units are transferred from a sub-organization to the next sub-organization, the costs of those units are also transferred and are eventually incorporated in the cost of the organization’s end product.

.153 In government, process costing would normally be used by programs that involve repetitive processes to deliver similar goods or services. An example is making entitlement benefit payments to citizens. This involves a series of consecutive and repetitive processes of reviewing applications to establish eligibility, computing the amounts of benefits, and issuing checks.

.154 Job order costing accumulates and assigns costs to discrete projects or jobs. Resources consumed are identified with a job code rather than a process. This method is appropriate for operations that produce special order products or perform projects and assignments that differ in duration, complexity or input requirements. In government, job-order costing may be used in connection with the production of major weapons systems or for legal cases, research projects or repair work.

.155 Some governments may wish to set information requirements at the activity level, an even lower level than processes or jobs. The concept of ABC is that activities consume resources, although activities may sometimes be congruent with processes, if processes are defined narrowly. ABC can be used in conjunction with job-order costing or process costing to enhance the accuracy of these costing methods.

.156 The fundamental concept of ABC is that costs should be assigned to outputs through each of the various activities that the organization performs. Implementation of ABC requires four major steps:

1. Identify activities performed in an organization to produce outputs.
2. Assign or map resources to the activities.
3. Identify outputs for which the activities are performed.
4. Assign activity costs to the outputs.

.157 An advantage of ABC is that it minimizes distortions in product costing that result from arbitrary allocations of indirect cost. By tracing cost through activities, more accurate service or product costs are provided. ABC also helps evaluate the efficiency and cost-effectiveness of activities, especially if activities are ranked according to the value they add to the organization or its outputs.

.158 For example, where highly detailed and very accurate cost information is needed in connection with process improvement efforts to determine the costs of non-value-added activities, ABC can provide it.

However, costs of data accumulation for ABC are higher than conventional systems. For that reason and despite its advantages, activity based costing may be limited to occasional use by some governments. An endorsement of ABC for government use appears in the article "Beyond Product Costing", in *Articles of Merit – Competition* (IFAC, 1997).

.159 Many governments will also want to have the capability to do standard cost accounting in conjunction with the other costing methods discussed above. Standard costing is particularly appropriate for operations that produce services or products on a consistently repetitive basis, i.e., some process costing systems. As work is being done, actual costs incurred are compared with the predetermined standard costs of cost objects. The predetermined standard or "should-take" costs are set by cost analysis.

.160 Industrial engineers may assist in determining "should-take" rates and units for the standards. Variances from standard costs, as determined by the system, are then analyzed to determine the reasons for them and the possible corrective actions that should be taken.

.161 In the example given in paragraph .153 for entitlement benefit payments, large negative variances in the labor costs incurred in one of the processes, which were caused by less than standard unit production, would normally suggest management action to improve process effectiveness. In another situation, standard costs could help to manage the purchasing function by identifying material price variations. Standard costing can encourage improvements in efficiency and can help managers formulate budgets, control costs and measure performance.

.162 Adding standard costing capability would add significantly to the requirements of the systems. Information added would be the standard rates and standard units needed to compare the standard costs with actual costs. Functionality added would be processing capability, such as associating standards with actual costs and units, calculating variances of various types, and exchanging standards-related data with the inventory system.

COST ACCOUNTING SOFTWARE

.163 Cost accounting systems are common in the private sector. As a consequence, many off-the-shelf software systems have been developed by specialized software companies. They are commonly purchased by businesses of all sizes, including many large companies. Many of these companies have chosen to give up some relatively minor functionality rather than to try to develop their own systems or make extensive source code changes to customize the available off-the-shelf software. They do this to reduce design and installation costs, speed up the installation process, avoid problems and failures, and be able to rely on software suppliers for the systems updates that typically follow technical improvements in computer equipment.

.164 Fortunately, there are many similarities between the cost accounting requirements of government and the private sector and software suppliers are beginning to serve the government market. Also, other systems that should be integrated with the cost system are frequently similar to those in the private sector and some available off-the-shelf software provides relatively easy integration with other systems. Various types of software configurations are available, such as:

- stand-alone cost accounting software;
- financial accounting system software with built-in cost accounting capability; and
- comprehensive information systems software with built-in cost accounting capability.

.165 Cost accounting software is available with activity-based costing capability. But, in addition to such software with full systems capability, desktop ABC systems are also available to make off-line special cost studies.

.166 The choice of one configuration or another depends on many factors, including the capabilities of other existing systems software that interface with the cost system and the technical features of the computer equipment used with the software. In addition to the configurations mentioned above, there is also specialized off-the-shelf software that purports to have the capacity to overlay most existing systems and draw cost data from them for cost assignment processing by this special software.

TECHNICAL FEATURES OF COMPUTER EQUIPMENT

.167 Access to cost information can be facilitated by the technical features of the equipment operating systems that control the software. Three examples of technical features that have a great bearing on the success of a cost system are:

- ease of use that might be provided through a graphical user interface, e.g., Windows;
- flexibility in how information can be accessed and viewed, for instance information provided by "drill down" reporting and queries through the use of relational databases; and
- access to information when and where it is needed regardless of where in the government it resides through networking and client/server architecture.

CONCLUSION

.168 Governments, if they have a variety of management information needs, will usually find that cost accounting systems are preferable to reliance on cost analysis for cost information. Carefully setting detailed systems requirements that fit both management and financial reporting needs will avoid the high costs of redesign. Information requirements will normally need to encompass physical unit, planning and revenue data as well as cost data. Functional requirements will normally need to encompass a large variety of cost objects and classifications as well as be capable of accommodating different types of management reports. Implementing a cost system also raises the issue of systems integration, which has important management and cost implications. Selecting off-the-shelf software that has the capacity to satisfy most systems requirements and using it in conjunction with appropriate hardware may be preferable to trying to write software or attempting to upgrade existing software and equipment. The installation of cost systems, whether upgrading existing software or hardware, or purchasing new software or hardware, should be justified using a cost/benefit model.

CHAPTER 6: COST REPORTS

.169 The culmination of a managerial cost accounting system is the information it makes available to those who run the operations of government entities and make decisions about the future. The regular and periodic reports generated by the system should provide most of the information needed to trigger management action to control and reduce costs and to help management plan and budget. These reports should also provide cost-related information needed in accountability reports to higher levels of government management, legislative bodies and the general public. In addition to financial statements, these regular accountability reports may include reports on performance measurement and program evaluation.

SYSTEMS REQUIREMENTS FOR REGULAR PERIODIC COST REPORTS

.170 The cost system's functionality needs to include a report generator. Off-the-shelf software normally has built-in capacity to generate a variety of reports needed by management or to satisfy financial reporting requirements. But this capacity differs from one piece of software to another. Also, to use the capacity, the needed data must be put into the system and the rules for capturing, distributing, and calculating the information must be there.

.171 Management may not know what cost information they need. In establishing systems requirements, the users of cost information should be questioned about the information they might need. One of the ways to do that is to show users model cost reports of various types that reflect the tentative systems requirements. Another way is to involve them in reviewing the requirements before they are used for systems design and the acquisition of software and hardware.

.172 Off-the-shelf software normally has the ability to query the system and draw off special reports. How much of the information in the system should be displayed in regular periodic reports and how much should be left to be drawn upon by inquiry depends upon management's need for information. For example, regular periodic reports may not be needed to facilitate setting prices or making inter-unit cost reimbursements. Also, resolving the question of what goes into the regular periodic reports and how much detail is provided is also a matter of judging how much information management will be able to assimilate on a regular basis.

.173 In addition to being sure that management's known needs are well served, those responsible for setting systems requirements should consider providing the capacity for possible future needs or for expansion. For example, cost information by budget account may not be currently needed because the budget is on a cash basis. Or, management may be uncertain about whether activity-based cost information will be required on a regular basis. The cost of having additional capacity available may not be prohibitive considering the possible high cost of having to upgrade an existing system later.

TYPES OF REGULAR PERIODIC COST REPORTS

.174 There are a variety of approaches to reporting. The approach selected will be affected by the degree of autonomy provided to the individual units of government as well as management's perceived need for different types of information and different levels of detail. Examples of three different approaches follow.

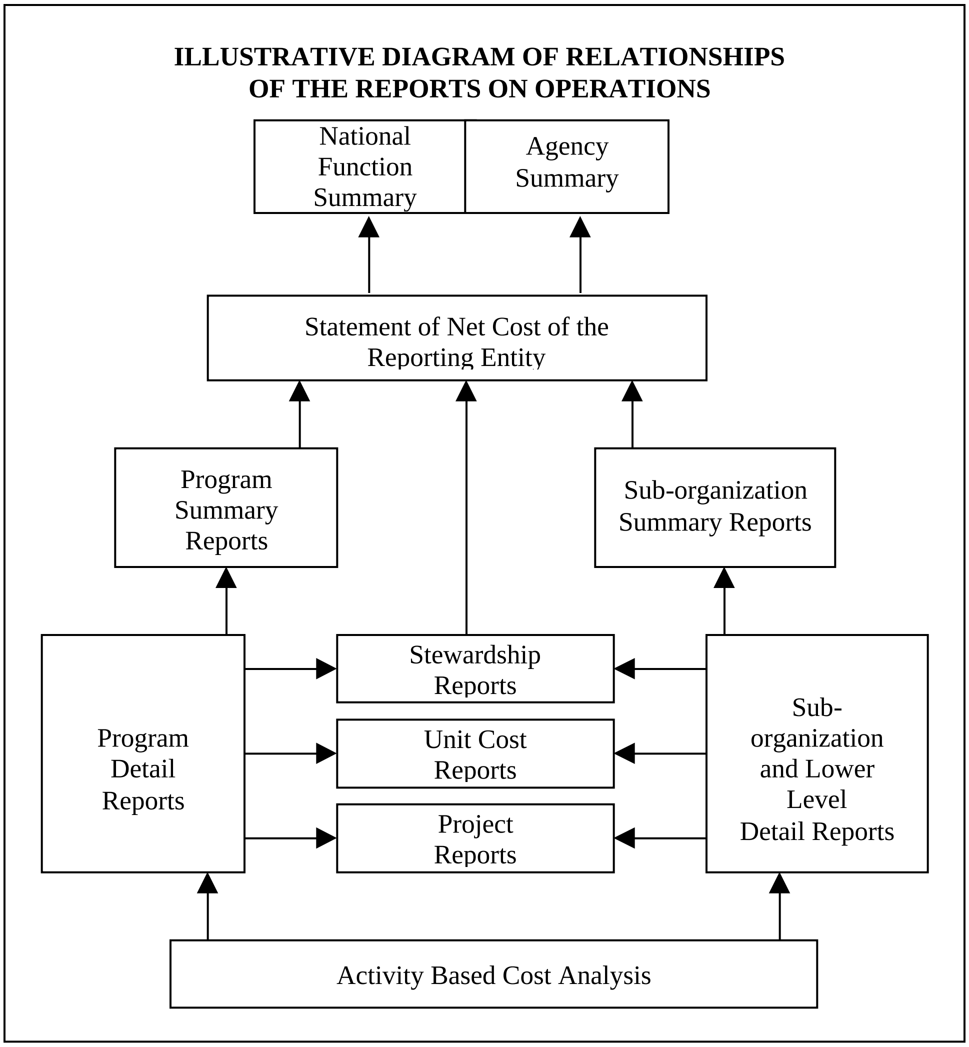
Standardized Reporting, Hierarchically Linked

.175 The United States General Accounting Office (GAO) has long advocated a set of regular reports for the United States government that would be similar to those of some major corporations. This proposal was included in a comprehensive report, entitled *Managing the Cost of Government, Building an Effective Financial Management Structure* (GAO, 1985). An updated version of that proposal is described below.

.176 The GAO proposal is for a reporting structure of hierarchically linked reports, as illustrated in Figure 6.1, that allows users to drill down from the published operating statement of the government agency, i.e., the

Statement of Net Cost, and other required external reports of cost information, through various levels of detail that should also support many internal management needs for regular periodic information. This results in a consistent view of basic cost information which should assist communication within the various management levels of the government, and between the management and the Congress and the general public.

Figure 6.1



.177 The reporting hierarchy shown above does not include budget reports in recognition of the fact that the United States' budget is largely a cash basis document and related funds control is exercised through other systems. Activity-based cost reports were not proposed as a part of the regular set of reports in recognition of the high operating costs of systems that support such reports. Instead, activity-based cost analysis would be used when required by circumstances.

.178 The Consolidated Financial Statements of the United States show the gross and net costs of the 18 functions of the United States government in its principal operating report, the Consolidated Statement of Net Cost, which follows in Figure 6.2.

Figure 6.2

United States Government
Consolidated Statement of Net Cost
for the Year Ended September 30, 1999

(In billions of dollars)	Gross cost	Earned revenue	Net cost
National defense....................................	451.2	38.0	413.2
Human Resources:			
Education, training, employment and social services	57.9	1.4	56.5
Health	140.6	0.7	139.9
Medicare..	207.0	21.7	185.3
Income security	188.0	6.2	181.8
Social Security	387.7	-	387.7
Veterans benefits and services (Note 11)	(43.2)	2.7	(45.9)
Total human resources	938.0	32.7	905.3
Physical Resources:			
Energy	12.9	12.4	0.5
Natural resources and environment	27.1	2.9	24.2
Commerce and housing credit	89.2	73.9	15.3
Transportation	44.1	1.1	43.0
Community and regional development	14.9	2.8	12.1
Total physical resources	188.2	93.1	95.10
Interest	230.1	-	230.1
Other Functions:			
International affairs..................................	29.6	9.6	20.0
General science, space, and technology	17.5	0.1	17.4
Agriculture	27.2	2.4	24.8
Administration of justice	31.2	1.6	29.6
General government	25.1	4.6	20.5
Total other functions	130.6	18.3	112.3
Total	1,938.1	182.1	1,756.0

The accompanying notes are an integral part of these financial statements.

.179 The Statement of Net Cost, illustrated below in Figure 6.3 to show various types of reporting, is also the principal operating report of each reporting entity of the United States Government.

Figure 6.3

ILLUSTRATIVE STATEMENT OF NET COST

Fiscal Year 199X

(thousands)

	Sub-organizations				
	A	B	C	D	Total
Program A:					
Public	$0	$28,000	$0	$0	$28,000
Less earned revenues	0	5,000	0	0	5,000
Net program costs	0	23,000	0	0	23,000
Program B:					
Intragovernmental	25,000	0	0	0	25,000
Public	126,000	0	0	0	126,000
Total	151,000	0	0	0	151,000
Less earned revenues	61,000	0	0	0	61,000
Net program costs	90,000	0	0	0	90,000
Program C:					
Program costs, public	9,690	0	0	0	9,690
Program D:					
Intragovernmental	23,000	16,000	0	0	39,000
Public	322,000	89,000	0	0	411,000
Program costs	345,000	105,000	0	0	450,000
Program E:					
Output A:					
Public – Total production	72,000	0	0	0	72,000
Less earned revenues	69,500	0	0	0	69,500
Net cost of output A	2,500	0	0	0	2,500
Output B:					
Public – Total production	222,000	0	0	0	222,000
Non-production costs	44,000	0	0	0	44,000
Net program costs	268,500	0	0	0	268,500
Program F:					
Weapons systems	0	0	27,000	0	27,000
Other costs	0	0	4,000	0	4,000
Program costs	0	0	31,000	0	31,000
Program G:					
Program costs, public	0	0	0	206,000	206,000
Non-production costs not Assigned to programs	7,500	3,400	2,300	1,000	14,200
Deferred maintenance (note X)					
Less other earned revenues not attributable to programs	1,900	1,700	400	0	4,000
NET COST OF OPERATIONS	$718,790	$129,700	$32,900	$207,000	$1,088,390

.180 Stewardship reports are also published, and provide the longer-term perspective on costs and outputs (or outcomes) needed to evaluate investment type programs, which are not reflected in operating balance sheets. Such investment programs include research and development and non-federal physical property as well as the investment in human capital. The stewardship report for human capital is illustrated in Figure 6.4. Stewardship reports are also used to establish safeguarding accountabilities for assets not reflected in operating balance sheets, such as heritage assets and weapons systems.

Figure 6.4

HUMAN CAPITAL
STEWARDSHIP INFORMATION
PROGRAM C – SUBORGANIZATION A
Transition Training Program for Former Navy Contractor Personnel
Fiscal Year 199X

Program Expenses (thousands):

	199T	199U	199V	199W	199X	Total
Sub-Program: Counseling						
Counseling Services	$646	$713	$937	$1,183	$1,259	$4,738
Sub-Program: Education						
Educational Services	786	2,381	3,860	5,621	7,053	19,701
Operation/Administration	574	960	1,027	1,164	1,378	5,103
Total	1,360	3,341	4,887	6,785	8,431	24,804
Total Program Costs	$2,006	$4,054	$5,824	$7,968	$9,690	$29,542

Program Outputs and Unit Costs:

						Yearly Average
Sub-Program: Counseling						
Participants Counseled	310	415	592	784	823	585
Unit Cost	$2,084	$1,718	$1,583	$1,509	$1,530	$1,685
Sub-Program: Education						
Years of Education Delivered	162	486	787	1,147	1,432	803
Unit Cost	$8,395	$6,874	$6,210	$5,915	$5,888	$6,656

.181 The published reports illustrated in Figures 6.1 to 6.4 may be supplemented by reports prepared for internal use. These reports include unit cost and program reports, reports for the sub-organizations of the reporting entities, and project reports. All the internal use reports provide for comparisons with planned costs and outputs.

.182 Program reports are appropriate for all programs and together with unit cost reports are especially useful in controlling and evaluating short-term programs typically funded by annual budget appropriations. They also serve to pull together the program costs when more than one sub-organization participates in a program.

.183 When the management structure is not congruent with the program structure, organization reports focus on the cost responsibility of the various organizations that contribute to the programs. Organization reports show object class account breakdowns at the cost control level and identify controllable costs.

.184 A unit cost and a program report are illustrated in Figures 6.5 and 6.6, respectively.

Figure 6.5

UNIT COST REPORT
PROGRAM E – OUTPUT A
Fiscal Year 199X
Units Delivered to the Public: 3,140,000[a]

	Dollars (thousands)	Cost Drivers[b]	Unit Costs	
Production Costs:				
Directly Assigned Costs:				
Inventory shipments	$10,000			
Payroll	7,500			
Inter-entity costs	750			
Supplies and materials	2,750			
Total Directly Assigned Costs	21,000		$6.69	
Distributed Costs:				
Inventory management	11,000	2,900		
Human resources	13,000	1,755		
Procurement	9,000	4,250		
Other common costs (specify)	10,000	5,000		
Other assigned costs	7,000			
Depreciation	1,000			
Total Distributed Costs	51,000		$16.24	
Total Production Costs	72,000		$22.93	*
Revenue:	69,500		$22.13	
Net Cost of Output A	$ 2,500		$0.80	

*Trend: $23.07 in 199V and $22.99 in 199W.

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[a] Units delivered is the output measurement in this example.

[b] Cost drivers are the basis for assigning cost. The figures shown are the amounts of the following cost drivers:
Inventory management (# of orders delivered to the public)
Human resources (# of employees)
Procurement (# of obligations incurred)

Figure 6.6

PROGRAM REPORT
PROGRAM E - OUTPUT A
Fiscal Year 199X
(thousands)

		Current Quarter			Year to Date		
Planned for Year	Description	Actual	Plan	Variance	Actual	Plan	Variance
3,250	**UNITS**	780	815	(35)	3,140	3,250	(110)
	SUMMARY						
$72,120	Production Cost	$18,001	$18,028	($ 27)	$72,000	$72,120	($120)
68,805	Earned Revenue	17,375	17,201	174	69,500	68,805	695
$ 3,315	**Net Cost**	**$ 626**	**$ 827**	**($201)**	**$ 2,500**	**$ 3,315**	**($815)**
	COST FACTORS						
	Directly Assigned:						
$9,935	Inventory shipments	$2,479	$2,480	($1)	$10,000	$9,935	$65
7,555	Payroll	1,882	1,890	(8)	7,500	7,555	(55)
750	Inter-entity costs	187	188	(1)	750	750	0
2,800	Supplies and materials	703	700	3	2,750	2,800	(50)
21,040		**5,251**	**5,258**	**(7)**	**21,000**	**21,040**	**(40)**
	Distributed:						
10,995	Inventory management	2,750	2,750	0	11,000	10,995	5
13,015	Human resources	3,247	3,250	(3)	13,000	13,015	(15)
8,970	Procurement	2,235	2,240	(5)	9,000	8,970	30
10,112	Other common costs	2,524	2,530	(6)	10,000	10,112	(112)
6,988	Other assigned costs	1,744	1,750	(6)	7,000	6,988	12
1,000	Depreciation	250	250	0	1,000	1,000	0
51,080		**12,750**	**12,770**	**(20)**	**51,000**	**51,080**	**(80)**
$72,120	**Total Production Cost**	**$18,001**	**$18,028**	**($27)**	**$72,000**	**$72,120**	**($120)**

.185 Project reports are needed for long-term capital projects, such as the construction of capital assets or the development of new weapons systems. This specialized reporting facilitates cost control, evaluation and funding over the multi-year life of such projects. A project report is illustrated in Figure 6.7.

Figure 6.7

PROJECT REPORT
WEAPONS SYSTEM 1
Status as of : (Date)
(dollars in thousands)

Project Status:

Project Phases:	Planned Cost (a)	Actual Cost	Estimated Cost To Complete	Total Cost to Complete (b)	Over (Under) Planned	Scheduled Completion	Months Over (Under)
Research and Development	$16,000	$20,000	$0	$20,000	$4,000	8/95	+2
Testing and Evaluation	4,000	3,000	0	3,000	(1,000)	1/96	
Design	10,000	11,000	0	11,000	1,000	9/96	+1
Procurement	70,000	10,000	65,000	75,000	5,000	10/97	+2 (d)
Total:	$100,000	$44,000	$65,000	$109,000	$9,000	(c)	

Funding Status:

				Obligations (f)	
Appropriation #	Description	Date	Amount	Amount	Unobligated
XXXXXX	Research and Development (FY92)	10/91	$20,000	$20,000	$0
XXXXXX	Research and Development & Testing and Evaluation (FY92 supplemental)	5/92	3,000	3,000	0
XXXXXX	Design and Procurement (FY95) (Prototype development)	10/94	10,000	10,000	0
XXXXXX	Design and Procurement (FY95 supplemental)	4/95	1,000	1,000	0
XXXXXX	Procurement (FY97)	10/96	70,000	35,000	35,000
	Totals		$104,000	$69,000	$35,000
	Current Estimate to Complete		$109,000 (b)		
	Over/(Under)		$5,000 (e)		

(a) Original planned cost to complete the project.
(b) Current estimate of total cost to complete the project.
(c) Estimate to complete exceeds planned costs by $9,000.
(d) Shows that the procurement phase is running two months over schedule.
(e) Shows additional budget authority needed to complete the project.
(f) Shows the status of obligations by appropriations.

.186 The GAO idea for standardized management reports below the level of the published reports has not been adopted. Many people in the more than 100 United States government reporting units want the freedom to develop their own cost accounting systems and reports. They argue that the type of cost information needed by managers may differ among various types of organizations, programs and activities. For example, the cost information useful to managers of a health care program may differ from that which is useful to managers of a loan guarantee program. Information needs may also differ among managers of various functions. For example, the information needs of budgeting and planning managers may differ from those of program managers.

.187 At present, information systems requirements for reporting units of the United States Government provide considerable flexibility, however they are not sufficiently detailed to ensure the capability to produce the illustrated management reports. The information in those management reports, because it backs up information in the published reports, should be available. It will be needed to respond to questions raised by higher levels of management, the Congress and the public.

Standardized Reporting with Different Features and More Detail

.188 Malaysia, recognizing the importance of cost information for management, implemented a cost accounting system before converting its accounting system to the full accrual basis. This system can function as a stand-alone system, but it now draws its data from the budgetary system for expenditures and budget data, from an asset management system for depreciation and for data on usage of materials and supplies, and from a manpower management system for employee cost data. This system provides a series of standardized management cost reports.

.189 Notably, this system has the facility for standard cost and variance analysis in addition to being able to make comparisons between actual cost and budget. Some of the regular reports produced by this system are more detailed than those proposed for use in the United States by GAO. For example, one report facilitates detailed variance analysis and another provides information on the cost of individual personnel working on a project.

.190 Malaysia's eight basic cost reports are listed in Figure 6.8.

Figure 6.8

Report Number	**Usage**
M 01	**Output Cost Summary** Prepare cost per unit information for each output of the Government Agency.
M 02	**Variance According to Output** Prepare comparison between actual cost and standard cost showing the variance between the two in total.
M 03	**Cost Variance According to Output** Facilitates user to make comparison between actual cost and standard cost and detail variance analysis.
M 04	**Cost Sheet (monthly)** Prepares component cost analysis by labor, materials, other direct cost and indirect cost for each output.
M 05	**Cost Comparison between Months** Prepare cost comparison information on a month to month basis.
M 06	**Budget Variance According to Expenditure** Allows user to make comparisons between actual cost and budget.
M 07	**Cost Sheet (cumulative)** Prepares cumulative and average cost for each output.
M 08	**Personnel Cost Contribution to Project Works** Gives information on individual personnel cost contribution towards a project or particular work if time sheet is prepared.

Individualized Cost Reports

.191 New Zealand manages its operations under a full accrual accounting and budgeting system. The financial reports of the various departments of government to higher levels of government reflect agreed-upon performance criteria, including cost of outputs, and compare actual performance against those criteria. But each department has freedom to operate as it wishes to achieve agreed-upon performance criteria, and accordingly, is able to adopt its own approach to financial management, its own financial information system and its own internal management cost reports.

.192 A summary of "appropriated revenues" (budgets) and "expenses" (costs) for the Department of Social Welfare (of the Government of New Zealand) and the performance detail reported for two of the summarized outputs follows in Figures 6.9, 6.10 and 6.11.

Figure 6.9

Statement of Departmental Expenditure and Appropriations

For the Year Ended 30 June 1998

Summary By Output Class *(Figures are GST inclusive where applicable)*	*Actual Expenditure ('$000s)*	*Appropriation Voted ('$000s)*
INCOME SUPPORT		
Applications for Benefits, Grants and the Community Services Card	**81,157**	**81,483**
Review of Benefits	**141,629**	**141,899**
Payments of Benefits and Grants and Issue of Community Services Card	**26,523**	**26,796**
Reduction of Fraud and Abuse	**25,246**	**25,309**
Debt Collection	**29,197**	**29,331**
Benefit Awareness Services	**5,252**	**5,377**
War Pension Services	**5,391**	**5,419**
Total Income Support	**314,395**	**315,614**
CYPFS		
Public Awareness Services	**4,801**	**4,287**
Risk Identification and Management	**52,082**	**52,338**
Family Resolution Services	**95,920**	**96,102**
Residential and Caregiver Services	**32,003**	**32,067**
Adoption and Information Services	**6,159**	**6,328**
Total Children, Young Persons and Their Families Service	**190,965**	**191,122**
NZCFA		
Contracting for the Provision of Social Services	**11,585**	**11,672**
Total New Zealand Community Funding Agency	**11,585**	**11,672**
SPA		
Policy Advice	**11,434**	**11,684**
Senior Citizens Services	**490**	**492**
Total Social Policy Agency	**11,924**	**12,176**
MSU		
Ministerial Servicing and Support Services	**3,716**	**3,718**
Total Ministerial Servicing Unit	**3,716**	**3,718**
Total	**532,585**	**534,302**

NOTE:
Output Class: War Pension Services is appropriated under Vote War Pensions; and Output Class: Senior Citizens Services is appropriated under Vote Senior Citizens. All other output classes are appropriated under Vote Social Welfare.

The Statement of Accounting Policies and Notes to the Financial Statements form part of and should be read in conjunction with these Financial Statements.

Source: New Zealand Department of Social Welfare, Annual Report for the Year Ending 30 June 1998.

Figure 6.10

Income Support

Output Performance Statements

For the Year Ended 30 June 1998

Review of Benefits

This Output Class includes the review for both primary and supplementary benefits payable under the Social Security Act 1964 and the Transitional Provisions Act 1990. It also includes the conveyance of information relating to customer entitlements, rights, duties and obligations, as well as the identification to the customer of the dangers of welfare dependency and activities they can undertake to avoid dependency.

Financial Performance

Actual 30 June 97 $'000		*Actual 30 June 98 $'000*	*Budget 30 June 98 $'000*
	REVENUE		
105,325	Crown	**124,697**	**124,697**
1,174	Other	**1,461**	**1,436**
106,499	**Total Revenue**	**126,158**	**126,133**
	EXPENSES		
59,038	Personnel	**66,763**	**66,259**
37,094	Operating	**47,637**	**48,467**
6,835	Depreciation	**7,485**	**7,421**
3,491	Capital Charge	**3,974**	**3,986**
106,458	**Total Expenses**	**125,859**	**126,133**
41	**NET OPERATING SURPLUS/(DEFICIT)**	**299**	**0**

Service Performance

Actual 30 June 97		*Actual 30 June 98*	*Budget 30 June 98*
	QUANTITY		
2,767,496	Reviews	2,962,087	2,714,000
	QUALITY		
86%	*Accuracy* Of the primary reviews processed, the percentage that are 100% accurate will be not less than	88%	80%
	TIMELINESS		
7.5 hours	*Accessibility* Services available for a minimum period on every departmental working day for	7.5 hours	7 hours
88%	Primary Reviews are processed on average within 5 working days	95%	70%

Source: New Zealand Department of Social Welfare, Annual Report for the Year Ending 30 June 1998.

Figure 6.11

Income Support

Output Performance Statements

For the Year Ended 30 June 1998

Reduction of Fraud and Abuse

This Output Class covers activities to reduce the level of benefit crime. Activities include investigations, information matching and initiatives to deter benefit crime.

Financial Performance

Actual *30 June 97* *$'000*		*Actual* *30 June 98* *$'000*	*Budget* *30 June 98* *$'000*
	REVENUE		
31,389	Crown	22,239	22,239
350	Other	262	258
31,739	**Total Revenue**	**22,501**	**22,497**
	EXPENSES		
17,741	Personnel	11,613	11,335
10,882	Operating	9,012	9,352
2,037	Depreciation	1,100	1,099
1,040	Capital Charge	708	711
31,700	**Total Expenses**	**22,433**	**22,497**
39	**NET OPERATING SURPLUS/(DEFICIT)**	**68**	**0**

Service Performance

Actual *30 June 97*		*Actual* *30 June 98*	*Budget* *30 June 98*
	QUANTITY		
33,043	Potential benefit crime cases investigated	49,060	40,000
46,625	The number of investigations conducted as a result of information matches with other agencies	56,815	50,000
26,242	The number of incorrectly paid benefits identified as a result of information matching	32,636	n/a
	QUALITY		
$2 for $1	On average, all investigations will result in debt establishments in excess of $2.5 for every $1 spent	$4.54	$2.50 for $1
100%	Percentage of investigation unit cases, where decisions are open to review, that will remain unchanged	100%	95%
74%	The percentage of investigations finalised within 60 working days of assignment	82%	80%

Source: New Zealand Department of Social Welfare, Annual Report for the Year Ending 30 June 1998.

.193 Other departments and ministries provide similar summary output reports, but the set of cost reports may differ in content, format, and detail. For example, reports of the Ministry of the Environment do not provide the service performance data to the level of detail provided by the Department of Social Welfare, but they include more detailed cost information by cost center and object class.

GENERALIZATIONS ABOUT REGULAR MANAGEMENT COST REPORTS

.194 Some useful generalizations can be made about the content and design of regular management cost reports. Management cost reports should:

- provide costs of outputs;
- be comprehensible to the level above operating management to whom operating management is responsible and be limited to what is considered essential management information;
- in some way identify controllable costs for each organization involved in producing outputs;
- provide sufficient detail to alert management to developing problems and, therefore, should compare actual costs with both plans or budgets, with standards, or with a combination of these, and compare actual costs with prior periods;
- be consistent with or reconcilable with the basis of accounting used to prepare financial accounting reports; and
- be relevant to budget planning and execution.

SPECIAL INFORMATION NEEDS

.195 The information and functional requirements of the system and the technical features of the computer equipment will determine the extent to which the system can respond to special inquiries. The system requirements should include capabilities not used for regular reports. For example, a labor distribution showing the payroll costs of a department might be requested if management wished to have detailed data in an effort to reduce the costs of that department shown to be high in the regular reports. In that case, the information would be in the system or stored outside the system, but whether it was easily accessible or not would depend on the functional capability of the system. To give another example, if the information requirements of the system include the option to “tag” data, then marginal cost reports for special projects or missions could be prepared even though the system did not regularly classify costs as fixed and variable. Also, if the processing requirements include the ability to accumulate costs at the activity level, then activity-based cost analysis could be done by the system should a problem or situation occur in a particular program, project or process, or if a particular organization or sub-organization should need the much more detailed information made possible by activity-based costing.

CONCLUSION

.196 Because modern systems can provide virtually all the cost information needed by management, governments have a wide variety of choices to make among reporting alternatives for internal management reports as well as for external reporting. Different governments and the different operating units of government do make different choices. However, there are certain basic generalizations about the proper content and design of regular reports that should be carefully considered.

CHAPTER 7: SENIOR MANAGEMENT ISSUES

.197 Cost accounting can be a major contributor to efficient and effective management and the communication of the results of government operations, but there are significant risks and costs associated with its implementation. Successful implementation depends upon whether senior management is sufficiently involved in answering these questions:

- What are the goals for cost accounting and what implementation strategies should be followed?
- How will cost accounting be used in budgeting?
- What managerial cost information is needed and what cost concepts should be adopted?
- What cost information will be included in government-wide reporting and in the management reports of the individual operating units?
- How will cost systems be integrated with other information systems and how will the systems of the operating units be integrated government-wide?

Senior management will normally need information and advice before it can deal with these issues.

.198 This Chapter seeks to help governments define the issues for consideration, and suggests approaches to be used to gather needed information and advice for senior management. Who senior management is and what the specific parameters of the issues are, as well as which particular approaches should be used to gather needed information and advice, depend upon a number of factors. Among them is the way the government is organized, e.g., the degree of decentralization, its present state of affairs and its present information system, and the way the government is operated, e.g., its governance approach, its internal control structure, the extent of its use of the private sector economic model.

.199 Because cost accounting is a management tool, the financial officers of the government and its individual operating units may not always be among the decision-makers. Whether they are or not, financial officers can bring knowledge of cost accounting and, therefore, should be key players in motivating senior management to define and address the issues. They can also help senior management choose and implement the approaches necessary to gather needed information and advice and assist in the periodic review of senior management's information needs. Active involvement with senior management will aid financial managers in discharging their responsibilities for defining cost objects, classifying costs and assigning them to cost objects. It will also be necessary for them to estimate the financial costs of implementing cost accounting.

SETTING GOALS AND IMPLEMENTATION STRATEGIES

.200 Many governments may not know what their ultimate goals are for cost accounting and some may not be ready to move quickly. As pointed out in Chapter 2, there are a variety of possible goals. In addition to the basis of financial accounting employed, other factors which will affect the goals and strategies to achieve them include receptivity of potential users of cost information, the extent and readiness of the other financial and operating systems, existing technical capacity and the availability of resources.

.201 Depending upon the particular situation, it may be preferable for many governments to implement cost accounting progressively, rather than to try to set an ultimate goal and move quickly to accomplish it. An incremental approach enables a government to move forward while experimenting and learning, and to revise goals and strategies as indicated.

.202 Implementation strategies should be set in the context of an overall plan for the development and use of information technology as suggested by the proposed IFAC Guideline on Information Technology *Managing Information Technology Planning for Business Impact*, (1998). Also, the funding and other resources for a new cost system should be justified by a business case that deals not only with anticipated costs and benefits, but also with risks, constraints and underlying assumptions. Establishing goals and strategies, and the overall plan and business case can best be accomplished after the other management issues posed in this Chapter are explored.

THE USE OF COST ACCOUNTING IN BUDGETING

.203 When instituting cost accounting, how it will be used in budgeting can only be resolved at the highest levels of government. Three examples illustrate this point.

.204 Cost accounting can be integral to an accrual-based budget, as it is in New Zealand; be combined with funds control in a budgetary system that focuses on both cost and cash, as is proposed in the United Kingdom; or be almost totally separate from an essentially cash-basis budget as it is, and may continue to be, in the United States.

.205 As noted earlier, in New Zealand cost accounting was a part of a total reformation of the way the New Zealand Government operates and, as a result, received full attention at the highest levels of government. It is now in place and operational.

.206 The United Kingdom is in the process of implementing its version of resource accounting and budgeting. This is part of an evolutionary change in the way that government operates. The impetus for the budgetary change in the United Kingdom has come from the top levels of Treasury, but the change does not have the same push of fiscal crisis that motivated New Zealand. In the United Kingdom, emphasis is being given currently to the education and training of management in the management uses of cost accounting. United Kingdom efforts build upon some success in using cost accounting in “value for money” management. But whether cost accounting will become integral to the budgeting process remains to be seen. Parliament will have to be convinced of the budgetary advantages. For this reason, the changes are being phased in, with Parliament being given the opportunity to use the cost information provided for the annual grant of resources in 2001.

.207 In the United States, except for a few specific instances where the disadvantages of the cash basis became painfully obvious and certain accruals were recognized in budgeting, there is no great interest in making a comprehensive change in the present cash-based budgeting system. No demand for change has been made by the United States Congress or by the top levels of the Administration. While there is interest in having some cost information to help formulate cash-based budgets, a systematic change in the way budgets are prepared is unlikely at present. An effort to provide such cost information is being led by the financial officers of the individual operating units of government. They must contend not only with cash and accrual differences in amounts, but also with budget account structures that are not built around government programs and outputs. Whether they can succeed even in this limited effort depends upon the response to the cost data provided by higher levels of management and the Congress.

DEFINING THE COST INFORMATION NEEDED AND THE COST CONCEPTS TO BE USED

.208 The answers to the two related questions of what cost information is needed and what cost concepts should be reflected in the information system will have a great impact on management’s ability to control and reduce costs, measure performance, set prices and perform other management functions.

.209 Earlier Chapters illustrate that these two questions have a number of possible answers. How particular cost concepts should reflect different kinds of management information objectives were discussed in Chapter 3, alternative full cost concepts were mentioned in Chapter 4, and various information issues were discussed in Chapter 5.

.210 The approaches adopted to define the parameters of these questions for senior management and provide the needed information and advice must include consideration of needed management information as well as needed cost information. Operating management must be involved. For example, performance measurement should integrate cost and other efficiency measures with a variety of effectiveness measures that are largely outside the realm of cost accounting.

.211 The importance of senior management involvement was recently underscored in the United States by the decision to defer the required implementation of cost accounting standards for one year until fiscal year 1998. One of the reasons given for the need to postpone implementation was that the financial officers of the various agencies and departments had not been successful in involving senior management in defining the cost information to be used in performance measurement.

REPORTING COST INFORMATION

.212 Chapter 6 illustrates a few of the many reporting alternatives available to governments.

.213 Senior management of the government should make the final decision on what cost-related information should be included in the financial statements, budgetary proposals and government top management reports. A number of factors will affect the information to be included, including the degree of management decentralization, how much cost control top management wants to exercise, the extent of the legislature's involvement in overseeing government operations, and the public's interest in the cost of government programs and outputs.

.214 A wide variety of questions will need to be considered, including whether performance measures will be included in the published financial statements, how cost information will be integrated with the budget if the budget is wholly or partly on a cash basis, what level of detail should be included in management reports, and what comparative information should be provided.

.215 Ideally, decisions on government-wide reporting should precede, or be contemporaneous with, reporting decisions at the level of the individual operating unit. The logic is that any reporting requirements imposed by government senior management could then be expanded to take into account the particular types of operations being conducted.

SYSTEMS INTEGRATION

.216 If the performance of managers is to be measured by cost information, the cost data must be consistent with other management information derived from other management systems, i.e., staff levels, outputs produced or delivered, program accomplishments. Some kind of systems integration is generally needed at the individual operating unit level because stand-alone cost systems are costly to operate and problematic. How much integration to seek and how that integration should be accomplished requires consideration of the adequacy of the other systems and the needed interfaces between systems. This leads to questions of whether to use off-the-shelf systems and which of the various configurations to use. It also leads to questions of the competence of government personnel to implement systems changes and, therefore, of the extent of reliance to be placed on consultants.

.217 Government-wide reporting requirements for cost dictate some uniform cost systems requirements for all the operating units of government and some systems integration across government. Uniform cost system requirements, because they are likely to lead to changes in many other systems, raise even broader integration questions. For example, if there are a large number of individual operating units, there are large potential cost savings from reducing the scope of the separate systems' design and development efforts of those operating units.

.218 Questions of government-wide systems integration should be resolved before, or contemporaneously with, questions of systems integration at the individual operating unit level.

APPROACHES TO RESOLVING THESE ISSUES

.219 All of the questions discussed in this Chapter are related and the answers, of necessity, are related as well. Appointing study and planning groups to address these questions in a coordinated fashion at both the government-wide and at the individual operating unit level is the most logical approach. Ideally, these groups should include several program managers and operations personnel and perhaps other users of cost information, the chief financial officer and chief information systems officer or their deputies, cost accountants, and systems designers. These groups should be coordinated by someone with access to senior management. Some direct participation by senior management is desirable.

.220 There are other approaches, discussed below, which may help to ensure that management has needed information and advice. The approaches may augment the work of study and planning groups appointed to deal with the issues in a coordinated fashion.

Educational Efforts

.221 Senior management needs to have a basic understanding of the potential value of cost accounting before it will be willing to charter appropriate study and planning groups. Senior management needs to see how cost accounting can help to improve the management of government. Program and other operating management personnel may also have little knowledge of the uses and benefits of cost accounting and how cost accounting may aid their decision-making. Legislators and others concerned with government budgets may also not understand what cost accounting can provide.

.222 Lack of knowledge of a significant portion of the government management group must be overcome before cost accounting can be successfully implemented. The management users of cost accounting will pay the costs of implementation in money and effort, will see changes in the information they are accustomed to using, and will need to make changes in the way they operate. Therefore, financial officers who have the necessary knowledge and perspective should lead educational efforts that could involve discussions, seminars and demonstration projects. Management should be led to see the benefits they will gain from implementing cost accounting. This publication could be part of a broad educational effort to create a readiness for cost accounting in the minds of management.

Business Process Reengineering First

.223 An argument can be made that a new cost system should not be implemented until management has gone through a careful study and evaluation of its existing business processes using business process reengineering techniques and has made the indicated changes to those processes. If a new cost system is installed before the processes of government have been rationalized and made more efficient, the new cost system will need to be changed to fit the changes in work flows, data flows, cost objects, etc., brought about by new business processes. Further, if the cost system is installed before other systems and technology enhancements in response to the reengineering effort are determined, additional changes may be required. These cost system changes can be costly.

.224 One of the results of reengineering first will be management exposure to the value of cost accounting. This is so because value-added cost analysis and activity-based cost studies are usually part of a reengineering effort. Because management must lead any reengineering effort, management “champions” for cost accounting may emerge.

Studies by Users or Experts

.225 Information and advice necessary to help senior management resolve particular issues can come from narrowly focused studies by users of cost information or by technical experts. Such studies can provide help to groups chartered to consider all the issues in a coordinated fashion. Or, these studies can be used without such broadly chartered groups. Such studies may also be helpful to build consensus, which may be necessary in decentralized governments. When studies of particular issues by users or experts are successful, sound goals and objectives or proposed standards can emerge that then can be endorsed or adopted by senior management.

.226 For example, in the United States, where a successful user-needs study was done, implementing standards and concepts recommended by the Federal Accounting Standards Advisory Board (FASAB) has been well accepted. One of the key concepts coming out of this Study was that “financial reports should assist users in evaluating the service efforts, costs and accomplishments of the reporting entity.” This concept resulted in senior management deciding to include the costs of the various programs and functions of government in the published operating statements of the government and in each of its operating units. It also led FASAB to consider the cost accounting consequences of many of its recommended financial accounting standards and the acceptance of these standards recommendations by senior management.

.227 Another study in the United States by the Joint Financial Management Improvement Program resulted in adopting a systems integration concept that was somewhat equivocal. This failure to endorse full systems integration led to the adoption of flexible systems requirements by senior management. This could prove to be problematic as cost systems are developed by each of over 100 agencies, departments and other reporting units of the U.S. government.

.228 When users' or experts' "needs" studies are used, resulting goals and objectives or standards should be stated clearly. Because of the importance of these studies, they should be carefully reviewed by senior management before they are endorsed or adopted.

Planning at the Operating Unit Level

.229 There is much at stake for the senior management of each government unit responsible for implementing government-wide standards and expanding upon those as necessary. Senior management of each operating unit should have sufficient information and advice to decide the basic questions for that unit. One way to do this is for each unit to appoint a steering committee to guide the work of study groups appointed to deal with particular aspects of cost accounting. Because of the operational significance of cost accounting, it may be advisable to appoint a program manager or a higher level operations person as chair of the steering committee, rather than the principal financial officer of the unit.

.230 The study groups will need to gather information on, for example, how existing systems actually function and exchange information, before recommending how to integrate a new cost system with existing systems.

.231 With appropriate information, the study groups can make recommendations on other issues such as:

- adding data, systems capabilities and reporting structures not required by the central government;
- upgrading versus replacing existing systems;
- hardware and software alternatives, particularly off-the-shelf software of various kinds and scope; and
- reliance on consultants for portions of the implementation work.

.232 After this is done and the cost/benefit questions are given initial consideration, the steering committee may charter some form of pilot or model within a small segment of the operating unit. This may be appropriate before planning is completed and implementation is authorized by the senior management of the unit. A pilot may be necessary to resolve uncertainties, demonstrate the benefits of cost accounting and secure the funding for full-scale implementation. The importance of studying and planning before senior management decisions are made, and implementation of cost accounting begun, cannot be overstated.

Staff Training

.233 Critical to the successful implementation of any new system is staff training. Accounting staff may require training to operate new systems. Managers may require training to interpret new information and to take appropriate action. In order to ensure that the benefits of new systems are maximized it is important that staff are given adequate training.

Continuous Involvement

.234 Senior management will need to have some continuous involvement in the implementation of cost accounting. There are several issues in particular which require attention, as discussed below.

Implementation can be a Long Process

.235 It will take time to gather needed information and advice, to set goals and implementation strategies, and to carry out those strategies, especially if progressive implementation is chosen. Senior management will need to stay involved to help deal with the problems that arise, the unforeseen delays and the needed changes that are part of the implementation of any new operating system and process. Senior management's continuing support is essential for ultimate success.

Support Activities

.236 Implementation can be an expensive exercise and sufficient funds must be made available for the various activities necessary to achieve successful implementation. One of the most important activities is staff training. The accounting staff will likely require training to operate the new systems and prepare the new reports. Management may require training to interpret the reports and take appropriate action.

Monitoring

.237 The accelerating pace of change in the public sector may require new information to deal with different conditions, new systems technology may provide new information capability and new cost concepts may call for different types of cost information. For example, the potential efficiencies of e-commerce are leading some governments to make major changes in their systems. Cost accounting and related processes should be changed periodically in response to new conditions, capabilities and concepts. It is critical that senior management monitors the quality and use of cost information and challenges government managers to improve it in response to change.

CONCLUSION

.238 Successful implementation of cost accounting requires senior management participation. Only senior management can set goals and implementation strategies, or answer questions of how cost accounting will be used, what information will be provided and included in reports, and what systems changes are most appropriate. Financial officers and various kinds and levels of operating management will need to be involved to ensure that senior management has the information and advice to make appropriate decisions. There are a variety of approaches that can be used to obtain the necessary level of senior management involvement. Once involved, senior management has a continuing role in implementation.

APPENDIX: GLOSSARY OF TERMS

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

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

Assigning Costs: A process that identifies specific costs with programs, outputs, activities or other cost objects. There are three appropriate methods of cost assignment, listed here in order of preference:
(a) directly tracing costs wherever economically feasible;
(b) cause and effect when determinable; and
(c) allocating costs on a reasonable and consistent basis.

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

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

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

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

Contract Costs: The costs of the goods and services used in complying with the provisions of an agreement between a buyer and a seller.

Controllable Cost: A cost that can be influenced by the action of the responsible manager. The term always refers to a specific manager since all costs are controllable by someone.

Cost: The monetary value of resources used or sacrificed or liabilities incurred to achieve an objective, such as acquiring or producing a good or performing an activity or service.

Cost Analysis: The development of cost information from cost records and other historical data sources, other than a cost accounting system.

Cost/Benefit Analysis: An analytical tool to systematically compare and evaluate the total costs and benefits (quantified to the extent possible) of alternatives.

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

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

Cost Study: The development of cost information independently of (or in conjunction with) cost and accounting systems using cost estimates or cost projections.

Differential Cost: The cost difference expected if one course of action is adopted instead of others.

Direct Cost: A cost that is specifically identified with a single cost object, or the cost of resources directly consumed by an activity. Direct costs are assigned to activities by direct tracing of units of resources consumed by individual activities.

Excess Capacity: Productive capacity in excess, on a relatively long-term basis, of that needed to supply the demand. It should be distinguished from “idle” capacity, which relates only to short-term imbalances in operational schedules.

Expense: Outflow or other using up of resources or incurring liabilities (or a combination of both), the benefits of which apply to an entity’s operations for the current accounting period but do not extend to future periods.

Fair Value: The amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction.

Fixed Cost: A cost that does not vary in the short term with the volume of activity. Also called Non-variable Cost.

Flexible Budget: One based on different levels of activity. It distinguishes between fixed and variable costs, thus allowing budgeting to be adjusted to the particular level of activities actually attained.

Full Cost: The sum of all costs required by a cost object, including the costs of activities performed by other entities, regardless of funding sources.

Imputed Cost: A cost properly attributed to a cost object even though no identifying transaction has occurred which would normally be recognized in the financial accounting records.

Incremental Cost: The increase or decrease in total costs that would result from a decision to increase or decrease output level, to add a service or task, or to change any portion of operations.

Indirect Cost: A cost that cannot be identified specifically with or traced to a given cost object in an economically feasible way.

Inter-entity: A term meaning between or among different reporting entities within a government. It commonly refers to activities or costs between two or more agencies, departments, ministries or bureaux of government.

Job Order Costing: A method of cost accounting that accumulates costs for individual jobs or lots. A job may be a service or a manufactured item, such as the repair of equipment or the treatment of a patient in a hospital.

Marginal Cost: The increase in total costs resulting from one additional unit of activity at any specific activity level.

Opportunity Cost: The value of the alternatives foregone by adopting a particular strategy or employing resources in a specific manner.

Outcome: The impacts on, or consequences for, the community, of the activities of government. Desired outcomes provide the rationale for government action and are the basis for decisions concerning outputs generated as part of the range of possible interventions (as explained in the *Purchase Agreement Guidelines*, The New Zealand Treasury, 1995).

Output: Any specific product or service generated from the consumption of resources.

Performance Measurement: A means of evaluating efficiency, effectiveness and results. A balanced performance measurement scorecard includes financial and non-financial measures focusing on quality, cycle time and cost.

Process: The organized method of converting inputs (people, equipment, methods, materials and environment) to outputs (products or services).

Process Costing: A method of cost accounting that first collects costs by processes and then allocates the total costs of each process equally to each unit of output flowing through it during an accounting period.

Product: Any discrete, traceable or measurable good or service provided to a customer.

Production Cost: All the costs reasonably related to bringing goods, services or benefits to consumers.

Program: Generally, an organized set of activities directed toward a common purpose or goal that a governmental entity undertakes or proposes to carry out its responsibilities.

Project: A specific, non-recurring cost object whose total cost is to be determined, such as a particular physical item of property, plant or equipment.

Relevant Costs: Those expected future costs that will differ among the alternatives considered in decision-making.

Responsibility Center: An organizational unit headed by a manager or a group of managers who are responsible for its activities.

Responsibility Segment: A significant organizational, operational, functional or process component that has the following characteristics:

(a) its manager reports to the entity's top management;
(b) it is responsible for carrying out a mission, performing a line of activities or services, or producing one or a group of products; and
(c) for financial reporting and cost management purposes, its resources and results of operations can be clearly distinguished, physically and operationally, from those of other segments of the entity.

Standard Costing: A costing method that attaches costs to cost objects based on reasonable estimates or cost studies and by means of budgeted rates rather than according to actual costs incurred. Also the anticipated cost of producing a unit of output, or a predetermined cost to be assigned to products produced.

Sunk Cost: A past cost that is unavoidable because it cannot be changed, no matter what action is taken.

Systems Integration: A unified set of systems that provide effective and efficient interrelationships among software, hardware, personnel, procedures, controls and data. Specifics which define the extent of integration may include single entry for all data, common data definitions and database, ease of systems changes, seamless systems interfaces, real time access by all users, electronic transfers, interoperability and distributed processing.

Systems Requirements: (Cost Accounting Systems Requirements) All the definitions of data and information, processing functionality and integration with other systems needed to design and implement or purchase an EDP based cost accounting system.

Tax Expenditures: Estimates of the revenue foregone because of preferential provisions of the tax structure.

Traceability: The ability to assign a cost directly to a specific activity or cost object by identifying or observing specific resources consumed by the activity or cost object.

Unit Cost: The cost of a selected unit of a good or service. Examples include the monetary cost per ton, machine hour, labor hour or department hour.

Value-added Activity: An activity that is judged to contribute to customer value or satisfy an organizational need. The attribute "value-added" reflects a belief that the activity cannot be eliminated without reducing the quantity, responsiveness or quality of output required by a customer or organization.

Variable Cost: A cost that varies with changes in the level of an activity, when other factors are held constant. The cost of material handling to an activity, for example, varies according to the number of material deliveries and pickups to and from that activity.

Variance: The amount, rate, extent, or degree of change, or the divergence from a desired characteristic or state. Often used to measure and evaluate the differences between actual cost and standard cost.

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– SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, 1995
– SFFAS No. 6, *Accounting for Property, Plant and Equipment*, 1995
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<u>**Annexure-XVII**</u>

<u>DRAFT</u>

COST ACCOUNTING RECORDS RULES

MINISTRY OF CORPORATE AFFAIRS

NOTIFICATION

NEW DELHI, the ____________

G.S.R……… - In exercise of the powers conferred by sub-section (1) of section 642, read with clause (d) of sub-section (1) of section 209 of the Companies Act, 1956 (1 of 1956), and in supersession of the Cost Accounting Records Rules as specified in the Appendix, except as respects things done or omitted to be done before such supersession, the Central Government hereby makes the following rules, namely:-

1. **Short Title and Commencement-** (1) These rules may be called the Cost Accounting Records Rules, ______.

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

2. **Definitions and Interpretations. -** In these rules, unless otherwise so provided,---

   (a) "Cost" means a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services;

   (b) "Cost of materials consumed" means cost of material of any nature used for the purpose of production of a product or a service including cost of procurement, freight inwards, taxes and duties, insurance etc. directly attributable to the acquisition but excluding trade discounts, rebates, duty drawbacks, refunds on account of cenvat, sales tax and other similar items;

   (c) "Labour cost" means all payment made or incurred towards employees, permanent or temporary, for their services;

   (d) "Other items of cost" means expenses other than material cost or labour cost which are incurred to carry out an activities;

   (e) "Conversion cost" means cost of converting material into finished product, typically including direct labour, direct expense and production overhead but excluding bought out materials and services;

(f) "Cost of production" means the total cost of direct material, direct labour and direct expenses plus absorbed production overheads.

3. **Application-** (1) These rules shall apply to every company engaged in the production, processing, manufacturing, or mining activities prescribed in clause (d) of sub-section (1) of section 209 of the Companies Act, 1956.

Provided that these rules shall not apply to a company,-

(a) wherein, the aggregate value of machinery and plant installed as on the last date of the preceding financial year, does not exceed the limit as specified for a small scale industrial undertaking under the provisions of Micro, Small and Medium Enterprises Development Act, 2006;

(b) the aggregate value of the turnover made by the company from sale or supply of all its products or activities during the preceding financial year does not exceed ten crores of rupees;

(c) the company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(d) it is not a bank, financial institution or an insurance company;

(e) it does not have borrowings (including public deposits) in excess of rupees five crore at any time during the immediately preceding accounting year; and

(f) it is not a holding or subsidiary company of a company which is not a small sized company.

4. **Maintenance of records-** (1) Every company to which these rules apply, including all units and branches thereof shall, in respect of each of its financial year commencing on or after the commencement of these rules, keep proper books of account relating to utilisation of materials, labour and other items of cost in so far as they are applicable to any of the products produced, processed, manufactured or mined.

(2) The books of account referred to in sub-rule (1) shall be kept on regular basis in such manner so as to give a true and fair view of the cost of materials consumed, conversion cost, cost of sales, sales and margin and shall make it possible to calculate per unit cost of production and cost of sales for each of its products and activities for every financial year. Every such books of account shall

be completed not later than ninety days from the close of the financial year of the company.

(3) The statistical and other records shall be maintained in accordance with the provisions of these rules and be in line with the generally accepted cost accounting principles and cost accounting standards. For the purpose of these rules, the expression "cost accounting standards" means the standards of cost accounting, if any, recommended by the Institute of Cost and Works Accountants of India constituted under the Cost and Works Accountants Act, 1959 (23 of 1959), and as may be prescribed by the Central Government.

Provided that the cost accounting standards issued by the Institute of Cost and Works Accountants of India shall be deemed to be the cost accounting standards until the cost accounting standards are prescribed by the Central Government.

(4) The statistical and other records shall be maintained in such a manner as to enable the company to exercise, as far as possible, control over the various operations and costs with a view to achieve optimum economies in utilization of resources. These records shall also provide the necessary data which may be required to be furnished under Cost Audit Report Rules, 2001 as prescribed under section 233B of the Companies Act, 1956 and amended from time to time.

(5) Every such record, maintained under these rules shall be reconciled with the records prescribed under section 211 of the Companies Act, 1956, indicating expenses or incomes included or excluded, extra-ordinary items or abnormal costs, difference in value of stocks, depreciation and variance due to related party transactions etc.

(6) It shall be the duty of every person, referred to in sub-section (6) and (7) of section 209 of the Companies Act, 1956 (1 of 1956), to take all reasonable steps to secure compliance by the company with the provisions of these rules in the same manner as he is liable to maintain accounts required under sub-section (1) of section 209 of the said Act.

5. **Authentication of records -** (1) Records maintained under clause (4) of these rules, shall be approved by the Board of Directors of the company within one hundred and thirty five days from the close of the company's financial year to which these records relates.

(2) Every company except as specified in the proviso to sub-rule (1) of rule 3 shall file a compliance certificate, to the Central Government within such time and manner as may be prescribed.

Provided that provisions of sub-rule (2) of rule 5 shall not apply to a company,-

(a) wherein, the aggregate value of machinery and plant installed as on the last date of the preceding financial year, exceeds the limit as specified for a medium scale industrial undertaking under the provisions of Micro, Small and Medium Enterprises Development Act, 2006;

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

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

(d) it is a bank, financial institution or an insurance company;

(e) *it has borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and*

(f) *it is a holding or subsidiary company of a company which is not a small and/or medium sized company.*

6. **Penalty -** If a company contravenes the provisions of rule 3, 4 and 5, the company and every officer thereof who is in default, including the persons referred to in sub-rule (6) of rule 4 shall, be punishable as provided under sub-section (2) of section 642 read with sub-sections (5) and (7) of section 209 of Companies Act, 1956 (1 of 1956).

7. **Savings-** (1) The supersession of the Cost Accounting Records Rules as specified in the Appendix, shall not in any way affect-

   a) any right, obligation or liabilities acquired, accrued or incurred thereunder;

   b) any penalty, forfeiture or punishment incurred in respect of any contravention committed thereunder; and

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

(2) Companies required to maintain records under Cost Accounting Records Rules as specified in the Appendix, shall continue to do the same under the respective rules till the Cost Accounting Records Rules, _____ become applicable to them.

APPENDIX

(See Rule ___)

List of Cost Accounting Records Rules which have been superseded:

1. Cost Accounting Records (Cycles) Rules, 1967
2. Cost Accounting Records (Tyres & Tubes) Rules, 1967
3. Cost Accounting Records (Air-Conditioners) Rules, 1967
4. Cost Accounting Records (Refrigerators) Rules, 1967
5. Cost Accounting Records (Batteries other than Dry Cell Batteries) Rules, 1967
6. Cost Accounting Records (Electric Lamps) Rules, 1967
7. Cost Accounting Records (Electric Fans) Rules, 1969
8. Cost Accounting Records (Electric Motors) Rules, 1969
9. Cost Accounting Records (Aluminium) Rules, 1972
10. Cost Accounting Records (Vanaspati) Rules, 1972
11. Cost Accounting Records (Bulk Drugs) Rules, 1974
12. Cost Accounting Records (Jute Goods) Rules, 1975
13. Cost Accounting Records (Paper) Rules, 1975
14. Cost Accounting Records (Rayon) Rules, 1976
15. Cost Accounting Records (Dyes) Rules, 1976
16. Cost Accounting Records (Polyester) Rules, 1977
17. Cost Accounting Records (Nylon) Rules, 1977
18. Cost Accounting Records (Textiles) Rules, 1977
19. Cost Accounting Records (Dry Cell Batteries) Rules, 1978
20. Cost Accounting Records (Steel Tubes and Pipes) Rules, 1984
21. Cost Accounting Records (Engineering Industries) Rules, 1984
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23. Cost Accounting Records (Bearings) Rules, 1985
24. Cost Accounting Records (Formulations) Rules, 1988
25. Cost Accounting Records (Steel Plant) Rules, 1990
26. Cost Accounting Records (Insecticides) Rules, 1993
27. Cost Accounting Records (Fertilizers) Rules, 1993
28. Cost Accounting Records (Soaps & Detergents) Rules, 1993
29. Cost Accounting Records (Cosmetics & Toiletries) Rules, 1993
30. Cost Accounting Records (Footwear) Rules, 1996

31. Cost Accounting Records (Shaving Systems) Rules, 1996
32. Cost Accounting Records (Industrial Gases) Rules, 1996
33. Cost Accounting Records (Sugar) Rules, 1997
34. Cost Accounting Records (Industrial Alcohol) Rules, 1997
35. Cost Accounting Records (Motor Vehicles) Rules, 1997
36. Cost Accounting Records (Cement) Rules, 1997
37. Cost Accounting Records (Milk Food) Rules, 2001
38. Cost Accounting Records (Mining and Metallurgy) Rules, 2001
39. Cost Accounting Records (Electronic Products) Rules, 2001
40. Cost Accounting Records (Electricity Industry) Rules, 2001
41. Cost Accounting Records (Plantation Products) Rules, 2002
42. Cost Accounting Records (Petroleum Industry) Rules, 2002
43. Cost Accounting Records (Telecommunications) Rules, 2002
44. Cost Accounting Records (Chemicals) Rules, 2004

Annexure-XVIII

DRAFT

COST AUDIT REPORT RULES

MINISTRY OF CORPORATE AFFAIRS

NOTIFICATION

NEW DELHI, the ____________

G.S.R......... - In exercise of the powers conferred by sub-section (4) of section 233B, read with sub-section (1) of section 227 and clause (b) of sub-section (1) of section 642, of the Companies Act, 1956 (1 of 1956), and in supersession of the Cost Audit Report Rules, 2001, except as respects things done or omitted to be done, before such supersession, the Central Government hereby makes the following rules, namely:-

1. **Short Title and Commencement-** (1) These rules may be called the Cost Audit Report Rules, ______.

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

2. **Definitions -** In these rules, unless otherwise so provided,---

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

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

   (c) "Form-I" means the Form prescribed in these rules for filing Cost Audit Report and other documents with the Central Government;

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

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

   (f) "Product Group" means a group of homogenous and alike products, produced from same raw materials & by using similar or same production process, having similar physical/chemical characteristics & common unit of measurement, and having same or similar usage/application;

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

3. **Application-** These rules shall apply to every company in respect of which an audit of the cost accounting records has been ordered by the

Central Government under sub-section (1) of section 233B of the Act. The Cost Audit Report submitted on or after the date these rules have come into force, irrespective of the financial year of the company to which it relates, shall be in the form prescribed under these rules.

Provided that these rules shall not apply to a company,-

(a) *wherein, the aggregate value of machinery and plant installed as on the last date of the preceding financial year, does not exceed the limit as specified for a micro, small or medium scale industrial undertaking under the provisions of Micro, Small and Medium Enterprises Development Act, 2006;*

(b) *the aggregate value of the turnover made by the company from sale or supply of all its products or activities during the preceding financial year does not exceed fifty crores of rupees;*

(c) *the company's equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;*

(d) *it is a bank, financial institution or an insurance company;*

(e) *it has borrowings (including public deposits) not in excess of rupees ten crore at any time during the immediately preceding accounting year; and*

(f) *it is not a holding or subsidiary company of a company which is not a small and/or medium sized company.*

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

(2) Every Cost Auditor, who submits a report under sub-rule (1), shall also give detailed unit-wise and product-wise Cost Audit Report, alongwith all other cost details, statements, schedules, etc., duly authenticated by the Cost Auditor, to the company.

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

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

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

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

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

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

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

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

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

9. **Saving of action taken or that may be taken for contravention of Cost Audit Report Rules, 2001-** It is hereby clarified that the supersession of the Cost Audit Report Rules, 2001, shall not in any way affect-

a) any right, obligation or liabilities acquired, accrued or incurred thereunder;

b) any penalty, forfeiture or punishment incurred in respect of any contravention committed thereunder; and

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

Annexure-XVIII

FORM-I	**Form for filing Cost Audit Report and other documents with the Central Government**

[Pursuant to section 233B(4), 600(3)(b) of the Companies Act, 1956 and rule 2(c) and rule 4 of the Cost Audit Report Rules, 2001]

PART I - GENERAL INFORMATION

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

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

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

2 (a) *Name of the company ☐

(b) *Address of the registered office or of the principa place of business in India of the company ☐

3 (a) *Financial year From ☐ (DD/MM/YYYY)

(b) To ☐ (DD/MM/YYYY)

4 (a) *State number of Product Groups for which the Cost Audit Report is being submitted ☐

(b) *Details of such Product Groups of the company *(Number of rows depending on 4(a) above)*

Nane of the Product Group	***Major Products/Activities Covered***

5 (a) *State number of Product Groups/Activities which are not covered in the Report ☐

(b) *Details of such Product Groups/Activities of the company *(Number of rows depending on 5(a) above)*

Nane of the Product Group	***Major Products/Activities Covered***

6 (a) *Number of Cost Auditors appointed by the company ☐

(b)

*Names of Cost Auditor(s) ***(Number of rows depending on 6(a) above)***	Membership No. of Partner/Proprietor certifying the audit report	Income Tax PAN No. of the Firm/Proprietor	Service Request Number (SRN) of relevant Form 23C

PART II - COST STATEMENT & PROFIT RECONCILIATION

Abridged Cost Statement (Summary of all the Audited Product Groups)

Particulars	**UOM**	**Current Year**	**Previous Year**
Materials Consumed (including Process Chemicals)			
Utilities			
Direct Employees Cost			
Direct Expenses			
Consumable Stores & Spares			
Repairs & Maintenance			
Depreciation/Amortization			
Other Production Overheads			
Quality Control Expenses			
Research & Development Expenses			
Total (Gross Cost of Production)			
Add/Less: Stock-in-Process Adjustments			
Less: Credits for Recoveries, if any			
Packing Cost			
Net Cost of Production			
Increase/Decrease in Stock of Finished Goods			
Less: Self/Captive Consumption (incl. Samples, etc.)			
Production Cost of Goods Sold			
Administrative Overheads			
Selling & Distribution Overheads			
Interest & Financing Charges			
Cost of Sales			
Net Sales Realization (Net of Taxes)			
Margin			
Export Benefits			

Profit Reconciliation (For the Company as a Whole)

Particulars	**UOM**	**For Audited Product Groups**	
		Current Year	**Previous Year**
Profit or Loss as per Cost Accounts			
Add: Incomes not considered in Cost Accounts			
Less: Expenses not considered in Cost Accounts			
Add/Less: Difference in Stock Valuation			
Adjustment for others, if any			
Profit or Loss for the Audited Product Groups			
Profit or Loss for the unaudited Product Groups/Acitivities			
Total Profit or Loss of the Company as per Financial Accounts			

PART-III

Attachements:

1 Cost audit report as per Cost Audit Report Rules, 2009 **Attach**

2 Optional attachement(s) - if any **Attach**

List of attachements

Remove attachement

Verification:

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

☐ I have been authorised by the Board of directors' resolution number ☐ dated ☐ (DD/MM/YYYY) to sign and submit this form.

☐ I am authorised to sign and submit this form.

To be digitally signed by:

Managing Director or director or manager or secretary (in case of an Indian company) or an authorised representative (in case of a foreign company) Digital Signatures

*Designation

*Director identification number of the director or Managing Director; or Income-tax PAN of the manager or of authorised representative; or Membership number, if applicable or income-tax PAN of the secretary (secretary of a company who is not a member of ICSI may quote his/her income-tax PAN)

*Director of the company Digital Signatures

*Director identification number of the director

Modify **CheckForm** **Prescrutiny** **Submit**

For office use only:

This e-Form is hereby registered

Digital signature of the authorising officer Submit to BO

FORM OF THE COST AUDIT REPORT

[See rule 2(c) and rule 4]

I/We,.. having been appointed as Cost Auditor(s) under Section 233B of the Companies Act, 1956 (1 of 1956) of ....*(mention name of the company)* having its registered office at .... *(mention registered office address of the company)* (hereinafter referred to as the company), have examined the books of account prescribed under clause (d) of sub-section (1) of section 209 of the said Act, and other relevant records in respect of the .... (mentions name/s of product group/s) for the period/year .... *(mention the financial year)* maintained by the company and report, in addition to my/our comments in para 8 relating to auditor's observations and suggestions.

1 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.

2 In my/our opinion, proper cost accounting records, as prescribed under clause (d) of sub-section (1) of section 209 of the Companies Act, 1956, have/have not been maintained by the company.

3 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.

4 In my/our opinion, the said books and records give/do not give the information required by the Companies Act, 1956 in the manner so required.

5 In my/our opinion, the said books and records are/are not in conformity with the Cost Accounting Standards issued by the Institute of Cost & Works Accountants of India.

6 Detailed cost statements and schedules thereto in respect of the product groups/activities of the company duly audited and certified by me/us are/are not kept in the company.

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

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

(a) Cost accounting system followed by the company
(b) Adequacy of inventory valuation
(c) Adequacy of internal audit of cost records
(d) Areas requiring improvement in operations and profitability
(e) Areas requiring cost control and cost reduction
(f) Any other area relevant to cost audit.

Dated: this ____ date of _________ 200_
at _________ (mention name of place of signing
this report)

SIGNATURE & SEAL OF THE COST AUDITOR (S)

MEMBERSHIP NUMBER (S)

ANNEXURE

Table-A: Quantitative Information (For the Product Group only)

Name of the Company			
Name of the Product Group			
Names of Units covered by the Product Group			
Names of Major Products covered by the Product Group			
Particulars	**UOM**	**Current Year**	**Previous Year**
Total Installed Capacity (in-house)			
Total Production Quantity (in-house)			
Capacity Utilization (in-house)			
Total Production Quantity (through third parties, if any)			
Add: Opening Stock of Finished Goods			
Less: Closing Stock of Finished Goods			
Less: Self/Captive Consumption (incl. Samples, etc.)			
Total Available Quantity			
Quantity Sold (Domestic)			
Quantity Sold (Exports)			

Table-B: Abridged Cost Statement (For the Product Group only)

Particulars	**UOM**	**Current Year**	**Previous Year**
Materials Consumed (including Process Chemicals)			
Utilities			
Direct Employees Cost			
Direct Expenses			
Consumable Stores & Spares			
Repairs & Maintenance			
Depreciation/Amortization			
Other Production Overheads			
Quality Control Expenses			
Research & Development Expenses			
Total (Gross Cost of Production)			
Add/Less: Stock-in-Process Adjustments			
Less: Credits for Recoveries, if any			
Packing Cost			
Net Cost of Production			
Increase/Decrease in Stock of Finished Goods			
Less: Self/Captive Consumption (incl. Samples, etc.)			
Production Cost of Goods Sold			
Administrative Overheads			
Selling & Distribution Overheads			
Interest & Financing Charges			
Cost of Sales			
Net Sales Realization (Net of Taxes)			
Margin			
Export Benefits			

Table-C: Materials Consumed (For the Product Group only)

Particulars	**UOM**	**Current Year**	**Previous Year**
Indigenous:			
(a) (specify)			
(b)			
(c)			
Self Manufactured:			
(a) (specify)			
(b)			
(c)			
Imported:			
(a) (specify)			
(b)			
(c)			
Total			

Table-D: Power, Fuel & Utilities (For the Product Group only)

Particulars	**UOM**	**Current Year**	**Previous Year**
Power (Purchased)			
Power (Self Generated)			
Steam			
Water			
Compressed Air			
Others, if any (specify)			
Total			

Table-E: Other Production Overheads (For the Product Group only)

Particulars	**UOM**	**Current Year**	**Previous Year**
Employees Welfare Cost			
Rent, Rates & Taxes			
Insurance			
Security Expenses			
Royalty & Technical Know-how Fee			
Travelling & Conveyance Cost			
Miscellaneous & Other Expenses			
Total			

Table-F: Administrative Overheads (For the Product Group only)

Particulars	**UOM**	**Current Year**	**Previous Year**
Employees Cost			
Consumption of Stores & Spares			
Repairs & Maintenance			
Rent, Rates & Taxes			
Insurance			
Corporate/Head Office Expenses			
Depreciation/Amortization			
Miscellaneous & Other Expenses			
Total			

Table-G: Selling & Distribution Overheads (For the Product Group only)

Particulars	UOM	Current Year	Previous Year
Employees Cost			
Repairs & Maintenance			
Rent, Rates & Taxes			
Insurance			
Advertisement & Publicity			
Freight & Transport			
Royalty on Sales			
Commission/Discount on Sales			
Depreciation/Amortization			
Miscellaneous & Other Expenses			
Total			

Table-H: Profit Reconciliation (For the Product Group only)

Particulars	UOM	Current Year	Previous Year
Profit or Loss as per Cost Accounts			
Add: Incomes not considered in Cost Accounts			
Less: Expenses not considered in Cost Accounts			
Add/Less: Difference in Stock Valuation			
Adjustment for others, if any			
Profit or Loss of the Product Group			

Table-I: Value Addition (For the Product Group only)

Particulars	UOM	Current Year	Previous Year
Gross Sales (excluding returns & trading sales)			
Less: Excise Duty, etc.			
Net Sales			
Adjustment in Stocks			
Less: Cost of bought out materials			
Less: Cost of bought out services			
Value Added			

Table-J: Central Excise Duty (For the Product Group only)

Particulars	UOM	Current Year	Previous Year
Total Excise Duty Payable			
Excise duty Paid through Cenvat Account (Inputs)			
Excise duty paid through Cenvat Account (Capital Goods)			
Excise duty paid through Cenvat Account (Service Tax)			
Net Excise duty payable in cash			
Add: Cess Payable			
Add: Education Cess			
Total Net Excise Duty & Cess Payable in Cash			
Excise duty paid through Personal Ledger Account (PLA)			

Table-K: Key Performance Indicators (For the Product Group only)			
Particulars	**UOM**	**Current Year**	**Previous Year**
Net Value of Fixed Assets			
Net Working Capital			
Capital Employed			
Net Worth			
Net Sales (excluding excise duty)			
Value Added			
Total Number of Employees			
Margin as per Cost Accounts			
Net Sales per Employee			
Value Added per Employee			
Margin per Employee			
Net Sales / Capital Employed			
Margin / Capital Employed			
Margin / Net Worth			
Margin / Net Sales			
Margin / Value Added			
Value Added / Net Sales			
Raw Materials Inventory / Materials Consumed			
Work-in-Progress Inventory / Cost of Production			
Finished Goods Inventory / Cost of Sales			
Interest & Financing Charges / Total Borrowings			

SIGNATURE OF THE COST AUDITOR (S	COMPANY SECRETARY	DIRECTOR
MEMBERSHIP NUMBER (S)	MEMBERSHIP NUMBER	DIN NUMBER

ANNEXURE-XIX

TABLE SHOWING PROPOSED CAS AND RELEVANT PARA IN CARR

A. COMPONENTS OF COST:

		Para in Cost Accounting Records Rules
1	Materials.	Schedule-I-Materials: Raw materials, components, manufactured components , semi-finished items like castings and forgings Bought out materials Direct Materials, Consumable Stores, small tools, machinery spares, Jigs and dies ,Wastages, spoilages, Rejections and Losses of Materials, Scrap Loss and Melting Loss, casings ,other tubular items, drilling bits
2	Salaries and Wages/ Employee Costs	Schedule-I-Wages and Salaries, overtime wages, piece rate wages ,incentive wages ,production bonus ,casual labour, Idle time record cost centre wise ,method of accounting idle time costs, wages and salaries for capital works
3	Direct Expenses	
4	**Transportation cost (CAS-5) @**	
5	Utilities.	Schedule-I-Utilities: Power, Water, Steam, Effluent Treatment
6	Service Department Expenses.	Schedule-I-Service Department Expenses(laboratory, transport, dispensary, township , fire fighting, security etc -if significant and material)
7	Repairs and Maintenance.	Schedule-I-Workshop Repairs and Maintenance tool room expenses
8	Cost of Packing-Primary & Secondary	Schedule-I-Packing, Packing Expenses
9	**Production/ Operation Overheads. (CAS-3) @**	Schedule-I-Overhead Expenses
10	Pollution Control Expenses	Schedule-I-Pollution Control
11	**Administrative Overheads. (CAS-3) @**	Schedule-I-Overhead Expenses
12	**Head/Corporate Office Overheads. (CAS-3) @**	Schedule-I-Overhead Expenses
13	**Selling Overheads (CAS-3) @**	Schedule-I-Overhead Expenses
14	**Distribution Overheads. (CAS-3) @**	Schedule-I-Overhead Expenses
15	Depreciation	Schedule-I-Depreciation
16	Amortization	Schedule-I-Lease Charges
17	Royalty, Technical Know how and Intellectual Property Charges.	Schedule-I-Royalty, Technical Know How Fee
18	Research and Development Expenses.	Schedule-I-Research and

		Development Expenses, Product Development Charges
19	Quality Control Expenses.	Schedule-I-Quality Control Cost
20	Interest and Borrowing Cost.	Schedule-I-Interest and other Borrowing Costs
21	Treatment of Revenue for Cost Statements (Including treatment of Government Grants, subsidies and incentives in Cost Accounts)	Schedule-I-Incentives on Export

B. COST ACCOUNTING METHODOLOGY AND PROCEDURES:

22	**Classification of Cost.(CAS-1) @**	Annex. To CAR-Cost Accounting System
23	Presentation of the cost statements	Schedule-I-Cost Statements, Proforma in Annexure to the Cost Audit Report
24	Identification and recognition of Cost Centers	Annex. To CAR-Cost Accounting System
25	**Capacity Determination. (CAS-3) @**	Schedule-I-Production Records, statistical records
26	**Valuation of Captive Consumption.(CAS-4) @**	Schedule-I-Captive Consumption
27	Stock Valuation	Schedule-I-Work-in-progress and Finished Goods
28	Cost Variances	Schedule-I-Adjustment of cost variances
29	Cost of conversion	
30	**Determination of Arm's Length Price. (CAS-6)@**	Schedule-I-Inter-company transactions
31	**Joint Product and By-product Cost. (CAS-DRAFT)@**	Schedule-I-Joint Products, By products
32	**Determination of Average Transportation Cost (CAS-5) @**	
33	Reconciliation of Cost and Financial Statements.	Schedule-I-Reconciliation of Cost and Financial Accounts
34	Shared Services Cost including outsourcing.	
35	Profit Centers and Reportable Segments under Cost Reporting.	Annex. To CAR-Cost Accounting System
36	Return on Capital Employed.	
37	Predatory Pricing.	
38	Non-cost Income and Expenses.	Schedule-I-Reconciliation of Cost and Financial Accounts, Annex. To CAR-Cost Accounting System
39	Capital Assets manufactured in house	Schedule-I- Expenses of Capital Nature

@ Existing Cost Accounting Standards/Draft CAS

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ANNEXURE-XX

General Purpose Cost Statement					
(Based on Cost Accounting Standards)					
				In Rupees	
Items of Cost	CAS Table Ref	Code	Quantity	Rate (Per Unit)	Amount
Material Cost	A 1	A			
Employee Cost	A 2	B			
Direct Expenses (E.g.: Royalty based on production)	A 3	C			
Utilities (Fuel, Power, steam and others)	A 5				
Primary Packing Cost	A 8				
PRIME COST (A+B+C)		D			
Production/Operation Overhead	A 9	E			
1) Consumable stores and spares	A 1				
2) Depreciation (Plant & Machinery and Factory Building)	A 15				
3) Repair and Maintenance (Plant & Machinery and Factory Building)	A 7				
4) Service Department Cost	A 6				
5) Transportation Cost	A 4				
6) Quality Control Cost	A 19				
7) Pollution Control Cost	A 10				
WORKS COST (D+E)		F			
Administrative Overhead (Relating to Production)	A 11	G			
1) Employee Cost	A 2				
2) Others	A 11				
Amortization Cost	A 16	H			
Royalty, Technical Knowhow and IPR Cost	A 17				
Research and Development Cost	A 18	I			
COST OF PRODUCTION (F+G+H+I)		J			
Stock Adjustment (Finished Goods)	A 27	K			
Adjustment for Cost Variances	B 28	L			
COST OF GOODS SOLD (J+K+L)		M			
Administrative Overhead (Other than Production)	A 11	N			
1) Employee Cost	A 2				
2) Head/Corporate Office Cost	A 12				
3) Others	A 11				
Interest and Borrowing Cost	A 20	O			
Selling Overhead (Marketing and Distribution)	A 13,14	P			
1) Employee Cost	A 2				
2) Brokerage and Commission	A 13				

3) Advertisement	**A 13**				
4) Secondary Packing Cost	**A 14**				
5) Warehousing and Storage	**A 14**				
COST OF SALES (M+N+O+P)		**Q**			
SALES REVENUE	**A 21**	**R**			
PROFIT MARGIN (Q-R)		**S**			

* * * * *

ANNEXURE-XXI

COST ACCOUNTING STANDARDS - ISSUE PLAN

No.	Details	Nature	Nature
1	Materials.	Cost Component	CARR Related
2	Salaries and Wages/ Employee Costs	Cost Component	CARR Related
4	Transportation Cost (CAS-5)	Cost Component	CARR Related
5	Utilities.	Cost Component	CARR Related
7	Repairs and Maintenance	Cost Component	CARR Related
8	Cost of Packing-Primary & Secondary	Cost Component	CARR Related
11	Administrative Overheads (CAS-3)	Cost Component	CARR Related
22	Classification of Cost (CAS-1)	Cost Methodology	General
25	Capacity Determination (CAS-3)	Cost Methodology	General
26	Valuation of Captive Consumption (CAS-4)	Cost Methodology	General
30	Determination of Arm’s Length Price (CAS-6)	Cost Methodology	General
31	Joint Product and By-product Cost (CAS-DRAFT)	Cost Methodology	General
32	Determination of Average Transportation Cost (CAS-5)	Cost Methodology	General
3	Direct Expenses	Cost Component	CARR Related
6	Service Department Expenses	Cost Component	CARR Related
13	Selling Overheads (CAS-3)	Cost Component	CARR Related
14	Distribution Overheads (CAS-3)	Cost Component	CARR Related
9	Production/ Operation Overheads (CAS-3)	Cost Component	CARR Related
10	Pollution Control Expenses	Cost Component	CARR Related
12	Head/Corporate Office Overheads (CAS-3)	Cost Component	CARR Related
15	Depreciation	Cost Component	CARR Related
16	Amortization	Cost Component	CARR Related
17	Royalty, Technical Know how and IP Charges	Cost Component	CARR Related
18	Research and Development Expenses	Cost Component	CARR Related
19	Quality Control Expenses	Cost Component	CARR Related
20	Interest and Borrowing Cost	Cost Component	CARR Related
21	Treatment of Revenue for Cost Statements	Cost Component	General
23	Presentation of the cost statements	Cost Methodology	General
24	Identification and recognition of Cost Centers	Cost Methodology	General
27	Stock Valuation	Cost Methodology	General
28	Cost Variances	Cost Methodology	CARR Related
33	Reconciliation of Cost and Financial Statements	Cost Methodology	CARR Related
37	Predatory Pricing.	Cost Methodology	General
29	Cost of conversion	Cost Methodology	General
34	Shared Services Cost including outsourcing	Cost Methodology	General
35	Profit Centers & Reportable Segments under Cost Reporting	Cost Methodology	General
36	Return on Capital Employed	Cost Methodology	General
38	Non-cost Income and Expenses	Cost Methodology	General
39	Capital Assets manufactured in house	Cost Methodology	General

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ANNEXURE-XXII

IFRS MODEL FINANCIAL STATEMENT

IAS 1.8(b) C	**Consolidated income statement for the year ended ……………………**				
		Notes	**Year**	**Year**	
IAS			**Ended**	**Ended**	
REF			**Curr Yr**	**Prev Yr**	
	Continuing operations				
IAS 1.81(a)	Revenue	1	xxxxx	xxxxx	
IAS 1.88	Cost of sales	2	xxxxx	xxxxx	**Relevant to CAS**
IAS 1.83	Gross Profit (1-2)	3	xxxxx	xxxxx	
IAS 1.83	Investment revenue		xxxxx	xxxxx	
IAS 1.83	Other gains and losses		xxxxx	xxxxx	
IAS 1.81(c)	Share of profits of associates		xxxxx	xxxxx	
IAS 1.88	Distribution expenses		xxxxx	xxxxx	**Relevant to CAS**
IAS 1.88	Marketing expenses		xxxxx	xxxxx	**Relevant to CAS**
IAS 1.88	Occupancy expenses		xxxxx	xxxxx	**Relevant to CAS**
IAS 1.88	Administration expenses		xxxxx	xxxxx	**Relevant to CAS**
IAS 1.81(b)	Finance costs		xxxxx	xxxxx	**Relevant to CAS**
IAS 1.88	Other expenses		xxxxx	xxxxx	**Relevant to CAS**
IAS 1.83	Profit before Tax		xxxxx	xxxxx	
IAS 1.81(d)	Income Tax Expense				
IAS 1.83	Profit for the year from continuing operations		xxxxx	xxxxx	
	Discontinued operations				
IAS 1.81(e)	Profit for the year from discontinued operations		xxxxx	xxxxx	
IAS 1.81(f)	Profit for the year		xxxxx	xxxxx	
	Attributable to:				
	Equity holders of the parent		xxxxx	xxxxx	
	Minority interest		xxxxx	xxxxx	

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Annexure-XXIII

International Practices in Cost Accounting Standards

Country	Existence of CAS	Objective	Common aspects	Unique aspects	Other Aspects
USA	Yes. Issued by Federal Govt	CAS mandatory for large value suppliers to Govt. Various authorities such as Securities Commission, Federal Trade Revenue, Department of Justice etc extensively access the cost information of organizations.	Contains measurement, assignment and allocation principles of cost accounting.	Specific inclusions and exclusions prescribed.	CFO Act mandates management accounting in Govt Bodies undertakings. US GAAP also contains standards to the effect of using cost accounting concepts such as cost of sales and overheads reporting.
UK	No. CIMA Terminology on Management Accounting is widely used	Guidelines non mandatory. Management Accounting is accorded the highest priority as a source of competitive advantage.	Since UK institute is the parent body of many management accounting bodies many of their terminology and guidance notes are adopted as a base.	Regulatory bodies such as Airports, Communications, Educational Sector, Energy, Food standards, Pensions, Postal services, Railways, etc extensively use costing information of the business entities. UK Educational sector through the Treasury Green Book uses cost accounting standards for subsidy disbursement.	Pioneers in developing International practices. The UK accounting standards have incorporated Cost of sales and overhead reporting as a part of the financial reporting to the shareholders.

Canada	No. Good practice guidance on Management Accounting are provided by CMA Canada	Guidelines non mandatory. But Fiscal Act provides for assurance of certain management accounting information by Government finance controllers.	No cost accounting standards are prescribed by any authority in Canada. Only good practice guidance publications are provided by CMA Canada which is valued very much.	The taxation authorities seek information on cost and management accounting directly from the company. The anti trust jurisprudence has definition of cost terminologies which can be a cost standard for dealing with predatory pricing situation. The anti trust jurisprudence has definition of cost terminologies which can be a cost standard for dealing with predatory pricing situation. Public supply contract specifies the components and the methodology of cost accumulation. Cost plus contract is generally used in awarding contracts. Each contract or series of similar contracts would contain guidelines as to the nature and quantum of allowable costs.	The GAAP of Canada itself contains certain costing practices in reporting such as Cost of Sales, Overheads disclosure, etc for external reporting purposes only.

Japan	Original foundation provided by Government by making cost accounting standards compulsory in post war scenario. Ministry of Finance, Business Accounting Committee issued cost accounting standards in 1962.	Cost Accounting Standards also practiced in Army, Navy and Building ministry.	Cost Accounting Standards adherence considered as a social discipline for Japanese companies.	Internal audit reports to be forwarded to shareholders of Japanese Companies also listed in USA.	Cost Accounting and its interface with operational cost management taken to micro level in Japanese companies. Target Cost Management taken to strategic level by Japanese companies.
Korea	Yes. CAS legally prescribed. Enacted on April 1, 1998.Amended on Dec 8, 1999	This Standard should be applied to the measurement of costs incurred in connection with the production of goods	General Principles and classification of costs prescribed. Cost Accounting records made compulsory in law after 1998 for select category of companies, mainly banks.	Cost Accounting system including Standard costing methods prescribed	The cost accounting information can be accessed by the external auditors who are expected to comment on this compliance.
France	Universally accepted single system of cost analysis and product costing applicable to all sectors, by Government Decree issued in 1982.	Cost Accounting System described in the Govt. Decree	Most of the principles are common	Cost analysis framework is to be incorporated in the industry specific standard financial accounting chart of accounts. The charts of accounts for those industries whose main line of business requires Government contracts, such as telecommunications ,aviation, aerospace electronics	The CNC (Conseil National de la Comptabilite, the official standard setting body of Ministry of Finance and Economy) has asked that each industrial sector define a basic or minimum cost analysis framework tailored to its activities or processes.

				and defence are used by Government agencies as the reference for cost audits. They are de facto compulsory	
Germany	Yes through enactments	In Germany, statutory instruments have been enacted to achieve uniformity and consistency in accounting for contracts with public authorities and to avoid calculation of the cost price at excessive rates.	Most of the principles are common	PR 30/53 – Statutory instrument for prices of contracts with public authorities by the Department of industry. Regulation of pricing based on cost prices. PR 1/72- Statutory instrument for prices of public construction work or contracts financed by government investment. Regulation for the calculation of prices of construction works on the basis of cost price.	Privatized and regulated business like postal services access the cost accounting information of companies. Certain cost accounting concepts such as cost of sales reporting and overheads disclosure are already built into German practice.
Finland	No.	Accounting Ordinance of 1992 was issued to fulfil European union directives and achieve harmonization.	Concept of variable costing in inventory valuation recognised by Business Taxation and Accounting Act 1973	War time law for cost based pricing from 1940 by the Ministry of Supply, Regulation 27 of June 1942, and Appendix 3.	Nil

China	No separate standard is available.	Cost information in any public company accessed by Ministry of Finance and Ministry of Commerce. Used for customs tariff purposes	Cost centres in business is part of framework of internal accounting	Accounting standards for Business enterprises not only influence external reporting but also set the framework of internal accounting.	Chinese GAAP itself contains concepts such as cost of sales and overheads in presentation of financial information.
Greece	No. Government issued circulars to regulate trivial details of cost measurement. Prudential decree code 186/92, was adopted and accounting plan including group9 made compulsory for tax reporting also.	Govt for tax purposes. Since January 1991, companies that meet certain size requirements must use the accounts of group 9 (and the related rules) in the computation of the cost of goods sold and the inventory.	Account classification contains familiar terms	Hellenic Greek made mandatory from 1987 and includes management accounting in the chart of account heads	HGAP Account title group contains A/c Heads such as: Reciprocal accounts, Cost Reclassification, Cost Centers, Manufacturing Costs, Standard Cost Variance, Cost of Goods Sold, Differences in Accounting treatment, etc.,

Annexure-XXIV

Extracts from the Report of the Committee on Infrastructure, Planning Commission (Secretariat for Committee on Infrastructure)

Definition of Infrastructure:

1. While Infrastructure is recognized as a crucial input for economic development, there is no clear definition of infrastructure according to the current usage of the term in India. For policy formulation, setting of sectoral targets and monitoring projects, a clear understanding of what is covered under the rubric of 'infrastructure' is necessary to ensure consistency and comparability in the data collected and reported by various agencies over time. The National Statistical Commission headed by Dr. C. Rangarajan, attempted to identify infrastructure based on some characteristics.

2. This Note compiles definition of infrastructure from various reports/notifications of different agencies and concludes with decision taken by the Empowered Sub-Committee of the Committee on Infrastructure on this subject in the meetings held on 11th January, 2008 and 2nd April 2008 under the chairmanship of Deputy Chairman, Planning Commission.

Dr. C. Rangarajan Commission's Notion of Infrastructure (2001):

3. The Rangarajan Commission indicated six characteristics of infrastructure sectors, (a) Natural monopoly, (b) High-sunk costs, (c) Non-tradability of output (d) Non- rivalness (up to congestion limits) in consumption, (e) Possibility of price exclusion, and (f) Bestowing externalities on society. Based on these features (except b, d, and e), the Commission recommended inclusion of following in infrastructure in the first stage:

   - Railway tracks, signalling system, stations
   - Roads, bridges, runways and other airport facilities
   - T&D of electricity
   - Telephone lines, telecommunications network
   - Pipelines for water, crude oil, slurry, waterways, port facilities
   - Canal networks for irrigation, sanitation or sewerage.

4. The Commission further recommended that considering characteristics (b), (d) and (e) also, the above list may be extended to include the following in the second stage:

ANNEXURE-XIX

TABLE SHOWING PROPOSED CAS AND RELEVANT PARA IN CARR

A. COMPONENTS OF COST:

		Para in Cost Accounting Records Rules
1	Materials.	Schedule-I-Materials: Raw materials, components, manufactured components , semi-finished items like castings and forgings Bought out materials Direct Materials, Consumable Stores, small tools, machinery spares, Jigs and dies ,Wastages, spoilages, Rejections and Losses of Materials, Scrap Loss and Melting Loss, casings ,other tubular items, drilling bits
2	Salaries and Wages/ Employee Costs	Schedule-I-Wages and Salaries, overtime wages, piece rate wages ,incentive wages ,production bonus ,casual labour, Idle time record cost centre wise ,method of accounting idle time costs, wages and salaries for capital works
3	Direct Expenses	
4	**Transportation cost (CAS-5) @**	
5	Utilities.	Schedule-I-Utilities: Power, Water, Steam, Effluent Treatment
6	Service Department Expenses.	Schedule-I-Service Department Expenses(laboratory, transport, dispensary, township , fire fighting, security etc -if significant and material)
7	Repairs and Maintenance.	Schedule-I-Workshop Repairs and Maintenance tool room expenses
8	Cost of Packing-Primary & Secondary	Schedule-I-Packing, Packing Expenses
9	**Production/ Operation Overheads. (CAS-3) @**	Schedule-I-Overhead Expenses
10	Pollution Control Expenses	Schedule-I-Pollution Control
11	**Administrative Overheads. (CAS-3) @**	Schedule-I-Overhead Expenses
12	**Head/Corporate Office Overheads. (CAS-3) @**	Schedule-I-Overhead Expenses
13	**Selling Overheads (CAS-3) @**	Schedule-I-Overhead Expenses
14	**Distribution Overheads. (CAS-3) @**	Schedule-I-Overhead Expenses
15	Depreciation	Schedule-I-Depreciation
16	Amortization	Schedule-I-Lease Charges
17	Royalty, Technical Know how and Intellectual Property Charges.	Schedule-I-Royalty, Technical Know How Fee
18	Research and Development Expenses.	Schedule-I-Research and

		Development Expenses, Product Development Charges
19	Quality Control Expenses.	Schedule-I-Quality Control Cost
20	Interest and Borrowing Cost.	Schedule-I-Interest and other Borrowing Costs
21	Treatment of Revenue for Cost Statements (Including treatment of Government Grants, subsidies and incentives in Cost Accounts)	Schedule-I-Incentives on Export

B. COST ACCOUNTING METHODOLOGY AND PROCEDURES:

22	**Classification of Cost.(CAS-1) @**	Annex. To CAR-Cost Accounting System
23	Presentation of the cost statements	Schedule-I-Cost Statements, Proforma in Annexure to the Cost Audit Report
24	Identification and recognition of Cost Centers	Annex. To CAR-Cost Accounting System
25	**Capacity Determination. (CAS-3) @**	Schedule-I-Production Records, statistical records
26	**Valuation of Captive Consumption.(CAS-4) @**	Schedule-I-Captive Consumption
27	Stock Valuation	Schedule-I-Work-in-progress and Finished Goods
28	Cost Variances	Schedule-I-Adjustment of cost variances
29	Cost of conversion	
30	**Determination of Arm's Length Price. (CAS-6)@**	Schedule-I-Inter-company transactions
31	**Joint Product and By-product Cost. (CAS-DRAFT)@**	Schedule-I-Joint Products, By products
32	**Determination of Average Transportation Cost (CAS-5) @**	
33	Reconciliation of Cost and Financial Statements.	Schedule-I-Reconciliation of Cost and Financial Accounts
34	Shared Services Cost including outsourcing.	
35	Profit Centers and Reportable Segments under Cost Reporting.	Annex. To CAR-Cost Accounting System
36	Return on Capital Employed.	
37	Predatory Pricing.	
38	Non-cost Income and Expenses.	Schedule-I-Reconciliation of Cost and Financial Accounts, Annex. To CAR-Cost Accounting System
39	Capital Assets manufactured in house	Schedule-I- Expenses of Capital Nature

@ Existing Cost Accounting Standards/Draft CAS

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- Rolling stock on railways
- Vehicles, aircrafts
- Power generating plants
- Production of crude oil, purification of water
- Ships and other vessels.

5. However, the Rangarajan Commission recommended that the list of infrastructure activities should be finalized by the Ministry of Statistics and Programme Implementation (MOSPI) on the basis of the characteristics recommended by them for identification of infrastructure.

Dr. Rakesh Mohan Committee Report (1996) and the Central Statistical Organisation (CSO):

6. Dr. Rakesh Mohan Committee in “The India Infrastructure Report” included Electricity, gas, water supply, telecom, roads, industrial parks, railways, ports, airports, urban infrastructure, and storage as infrastructure. Except industrial parks and urban infrastructure, all these sub-sectors are treated by CSO also as infrastructure.

Reserve Bank of India (RBI) circular on Definition of Infrastructure:

7. As per the RBI, a credit facility is treated as “infrastructure” lending” to a borrower company which is engaged in developing, operating and maintaining, or developing, operating and maintaining any infrastructure facility that is a project in any of the following sectors, or any infrastructure facility of a similar nature:

   (i) a road, including toll road, a bridge or a rail system;
   (ii) a highway project including other activities being an integral part of the highway project;
   (iii) a port, airport, inland waterway or inland port;
   (iv) a water supply project, irrigation project, water treatment system sanitation and sewerage system or solid waste management system;
   (v) telecom services whether basic or cellular, including radio paging, domestic satellite service (*i.e.* a satellite owned and operated by an Indian company for providing telecom service), network of trunking, broadband network and internet services;
   (vi) an industrial park or special economic zone;
   (vii) generation or generation and distribution of power;
   (viii) transmission or distribution of power by laying a network of new transmission or distribution lines;
   (ix) construction relating to projects involving agro-processing and supply of inputs to agriculture;

(x) construction for preservation and storage of processed agro-products perishable goods such as fruits, vegetables and flowers including testing facilities for quality;

(xi) construction of educational institutions and hospitals;

(xii) any other infrastructure facility of similar nature.

8. For raising external commercial borrowings funds, the RBI has defined infrastructure to include (i) power, (ii) telecommunication, (iii) railways, (iv) road including bridges, (v) sea port and airport, (vi) industrial parks and (vii) urban infrastructure (water supply, sanitation and sewage projects) vide their circular dated 2nd July, 2007.

Insurance Regulatory and Development Authority (IRDA):

9. The IRDA vide their notification dated 14th July 2000, regarding Registration of Indian Insurance Companies Regulation, 2000 stipulates that every insurer in the business of *life insurance* shall invest and at all time keep invested *not less than 15%* of his controlled funds in *Infrastructure and Social sector*. Besides, those insurers who are in the business of *General Insurance* (*i.e. non-life insurance)* are required to invest and at all time keep invested *not less than 10%* of their controlled funds in *Infrastructure and Social sector*. For this purpose, IRDA defines infrastructure to include road, highway, bridges, airport, port, railways including BOLT, road transport system, water supply project, water treatment system, solid waste management system, irrigation project, industrial parks, sanitation and sewerage system, generation-transmission-distribution of power, telecom, project for housing, or any other public facility as may be notified in the official gazette.

Income Tax Department:

10. For an infrastructure company, S*ection 80-IA* of the Income Tax allows deduction of 100% profit from its income during initial 5 years of operation and then 30% deduction of profit from income during another 5 years. For this purpose infrastructure covers electricity, water supply, sewerage, telecom, roads & bridges, ports, airports, railways, irrigation, storage (at ports) and industrial parks/SEZ.

World Bank:

11. The World Bank treats power, water supply, sewerage, communication, roads & bridges, ports, airports, railways, housing, urban services, oil/ gas production and mining sectors as infrastructure.

Economic Survey:

12. The Economic Survey considers power, urban services, telecommunications, posts, roads, ports, civil aviation, and railways under infrastructure sector.

Decision of the Empowered Sub-Committee of the Committee on Infrastructure on definition of infrastructure:

13. The Empowered Sub-Committee of the Committee on Infrastructure in its meetings held on 11th January, 2008 and 2nd April 2008 under the chairmanship of Deputy Chairman, Planning Commission discussed the subject matter. There was consensus on including the following in the broad definition of infrastructure:

    (i) Electricity (including generation, transmission and distribution) and R&M of power stations,
    (ii) Non-Conventional Energy (including wind energy and solar energy),
    (iii) Water supply and sanitation (including solid waste management, drainage and sewerage) and street lighting,
    (iv) Telecommunications,
    (v) Road & bridges,
    (vi) Ports,
    (vii) Inland waterways,
    (viii) Airports,
    (ix) Railways (including rolling stock and mass transit system),
    (x) Irrigation (including watershed development),
    (xi) Storage,
    (xii) Oil and gas pipeline networks.

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