Cost audit in its new paradigm & related aspects

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Whether or not the Indian cricket team wins the World Cup, the Indian Government deserves a cup for introducing the Cost Audit Report Rules, 2001. The Rules are radical and innovative. This article gives a bird's view of the Rules with an insect view of their nuances.

The Cost Audit Report Rules, 2001 (styled CARR) found as a value-engineered version of the Rules, 1996, is a hot topic in the industry and professional circles. The post liberalisation scenario in the economy witnessed the need for transparency in business operations. Most of the business legislations were given a re-haul. This write-up is an attempt at commanding and commenting on the new Rules, notified on 27.12.2001, which lays down that Cost audit report submitted on or after 1.10.2002 has to be in the new prescribed format.

Before delving into CARR, it is common knowledge that the objectives of maintenance of cost accounting records and its audit are to know the real cost, to determine the efficiency of operations, to ascertain the manufacturer's margin and to enable the fixation of a fair price for products covered under the regulatory mechanism, to detect whether the company's cost parameters are better than previous year(s), the fact of which may get masked by industry boom and overall operating profit. Further, with the globalisation of trade, should there arise a situation for levy on products from India in the destination markets, the records would serve as an authentic proof of cost to the foreign governments.

The maintenance of costing records is directed under 209(1)(d) by Central Government (CG) by notifying and prescribing Cost Accounting Record Rules for certain industries. So far, CG has notified 46 industries ranging from infant foods to motor vehicles till 2002 the latest in the list being petroleum, plantations and telecommunications. The rest may follow suit. Interestingly, the scope of existing cost accounting record rules relating to engineering industries, motor vehicles, chemical industries and mini steel plants have also been widened and as per press release 7/21.11.2002 those pertaining to bulk drugs, aluminium and milk food have been simplified. The audit of cost accounts is notified by CG by an Order under Section 233B of the Companies Act, 1956. The list of companies that are notified for cost audit is growing. Even foreign companies are covered under the ambit of cost audit as far as their Indian business is concerned.

Thus, Section 209(1)(d) requiring maintenance of cost accounting records is industry specific. Section 233B requiring audit of cost accounts is company specific i.e. CG can direct cost audit for a company if the industry to which it pertains has been notified for maintenance of cost records.

Significant changes ushered in Cost Audit Report Rules, 2001 (CARR)

The CARR, 1996 was confined to basic cost accounting requirements. Now the new report rules calls for voluminous and yet specific information. There are certain significant inclusions in the Annexure to the Report. A few of them are listed below:

- Date of board meeting wherein the Annexure & Proforma were approved;
- Name, qualification and designation of the officer heading the cost accounting section;
- Details in respect of each major input materials constituting at least 2% of the total material cost. This is more penetrative than Schedule VI — Part II requirement of the Companies Act where separate disclosure is required only for 10% or more;
- Non-moving stock, written off stock, results of physical verification;
- Quantitative details of salaries and wages (almost the whole of time-office details);

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- R & D expenses in a more elaborate format;
- Competitive margin against imports in a comprehensive manner;
- Value addition and distribution of earnings;
- Capitalisation of revenue expenditure;
- Central Excise reconciliation for duty and cenvat credit;
- Details of foreign technical collaboration for the product.

The structural differences between the old and the new rules is highlighted below:

In circular no. 6/2001 dated 20.8.2001, the Department of Company Affairs had specified that the cost auditor would also attend and participate at the meetings of the audit committee but without voting rights. The department has further clarified vide circular no. 2/2002 dt 9.1.2003 that cost auditor would attend audit committee meeting as an internal auditor of the company and not as member of the committee as audit committees are constituted only from directors.

Giving thrust, the number of audit committee meetings conducted by the company and those attended by the cost auditor is to be mentioned as per new Rules.

In meeting the rigours of reporting and to bring uniformity in understanding and application, for the guidance of the profession, the Institute has come out with four Cost Accounting Standards so far, covering classification of cost, capacity determination, overheads and captive consumption. The cost auditor needs to ensure that the annexure and proforma to the report are as per these standards.

Enhanced skills required of a cost auditor

The Cost auditor has come of age as a management auditor. Unlike the

#	**Points of distinction**	**Report Rules, 1996**	**Report Rules, 2001**
1	Applicability	Cost audit reports submitted before 30.09.2002	Cost audit reports submitted on or after 01.10.2002 irrespective of the financial year
2	Submission of costing records for cost audit	90 days from year end	135 days from year end
3	Submission of cost audit report to the Central Government	In triplicate with a copy to the company	In hard copy as well as soft copy with a copy to the Company. This soft copy as per Circular Dt. 26.11.2002 needs to be in non-rewritable CD ROM either in PDF/Abode Acrobat version 4.0 or Microsoft Office XLS Format
4	Authentication of annexure and proforma to the cost audit report	Not required earlier	To be authenticated by the company secretary and at least one director or in the absence of company secretary, by at least 2 directors
5	Approval of annexure and proforma by Board of Directors	Not required earlier	To be approved by the Board before submission to CG
6	Auditors' observations and suggestions	Earlier, this was part of the annexure to the cost audit report, which covered general business profile	Now forms part of the main cost audit report itself New reporting requirements such as a. Adequacy of cost accounting system including inventory valuation b. Impact of lower/ higher price for related party transactions c. Pricing policy for domestic and export sales

			d. Performance of internal audit of costing records e. Steps to strengthen the company in competitive environment.....etc., introduce creativity in reporting.
7	Ratio Analysis	Identified ratios for- • product under reference • company as a whole	Identified ratios for • product under reference • factory as a whole • company as a whole New ratios relating to inventory turnover (RM, WIP, FG & Stores), various operating expenses as % of sales and Debt-Equity Ratio
8	Comparative data for the previous two years	Required only for a few elements	Required for all elements except those relating to excise reconciliation and physical verification of stock

statutory auditor, the cost auditor does not talk about "true and fair" view, but on a different plane gives an objective, all-round efficiency report. The cost auditor needs to be creative and practical in his 'observations and suggestions' part of the Report that would benefit the CG & company management. This means he has to sharpen his skills in perceiving, analysing, evaluating and intuiting given the vastness of the areas required to be covered and complexity of the industry. His reality judgements and value judgements are taken as professional bliss.

Preparedness for the new CARR implementation in a factory

This involves the following :

- Communication of the requirements to the user departments, mainly, purchase, stores, R & D, production, sales, finance and information system department.
- Involvement of these functional managers in the process.
- A robust system for recording the MIS required for the report.
- Detailed codification of each account in the general ledger suiting the requirements.
- Online generation of documents relating to purchase, consumption (including scrap), inter plant transfer and sales.
- Cost centres for recording cost.
- Maintenance of Fixed Assets Register cost-centre wise-
- Updation of cost rates of products and process, when there is change, by a nominated official within a week's time after due verification.
- System of monthly cost audit as a supplement by the company's internal audit team and their consolidated report on quarterly basis to the management
- Resource allocation to meet the above.
- A cross-functional approach in overcoming the impediments faced during implementation.

The position of the cost auditor is upgraded from a mere factory visitor to a welcome corporate guest. Though the report may make the middle managers feel uneasy both in terms of providing the particulars and the fear of getting exposed on shortfalls, the top management is happy to know his key findings. Ultimately, the report helps the organization in taking right decisions and course corrections.

Suggestions to ensure control and uniformity

Information on uncontrollable costs

It is evident that CARR is meticulously designed. It calls for cost information, be it fixed, variable or semi-variable, under various heads with corresponding figures of previous year(s). The cost incurred is a fact, sometimes bitter. The trend in cost lends itself to further analysis. Keeping in mind the ultimate objectives of control, it is necessary to know the controllable and uncontrollable elements of cost. Academicians rush to distinguish between the two linking it to scales and urgency of production, time frame and one's own perception. While the cost auditor, despite not being a technician belonging to any industry, is required to suggest measures in respect of cost control and cost reduction as part of his report (Para 4), surprisingly the CARR does not cast a specific obligation on the company to state the uncontrollable items of cost.

In a competitive environment, introspection, however embarrassing, avoids future injury and the companies may be required to state the uncontrollable costs briefly with reasons in the Annexure in both absolute terms and also as % of sales, as % of fixed / variable cost.

Disclosure in Annual Accounts

As per Part II of Schedule VI to the Companies Act, 1956, any item under which the expenses exceed 1% of the total revenue of the company or Rs.5,000 whichever is higher, is to be shown as a separate item in the profit and loss account and not combined with any other item to be shown under "miscellaneous expenses". In this context, the Cost Audit Report Rules (CARR), 2001 require detailed disclosure on quality control expenses (Sl. No.15) and pollution control expenses (SI.No.16). In a world of growing consciousness of quality as the surviving mantra and environment management as a success factor (hospital clean and garden green!), a discerning investor would like to know but may not find such a disclosure on materiality grounds. Accordingly, in the interest of transparency, Part II could be amended requiring companies to state the information on these two expenses irrespective of the 1% cut-off, preferably in CARR format.

Disclosure in Board Report

Currently under Section 217(1)(e) of the Companies Act, 1956, the board has to report on energy conservation. As part of corporate governance, the disclosure on "pollution control" could be introduced for Form A industries with particulars of measures taken, cost and additional investments.

Central Excise Reconciliation

In the excise regime, various audit teams (CERA, internal audit, special audit team, etc.,) require the manufacturer to produce a statement on excise duty paid to suppliers vis-a-vis its availment, total duty paid (cenvat utilization and PLA) vis-a-vis its collection from customers and the reconciliation of general ledger balance of cenvat and PLA with the balances in excise registers. Many a time, despite a sincere attempt, the reconciliation gets defeated either due to want of time/ competent person or due to absence of link between the ledger and the register. This is more than bank reconciliation and any gap becomes a matter of concern to both company management as well as the statutory authorities. Keeping this serious requirement in mind and excise duty being an important element of cost, as a step in the right direction, the CARR requires this reconciliation for the product under reference. It is suggested that this reconciliation on a quarterly basis could be performed by the company (whether or not the cost audit is directed for the company) and be preferably certified by the statutory auditor. The day is not far when the corporate world would be advised to file for each factory an audit certificate on "Reconciliation of excise duty for the year ended 200X" with the Excise authorities.

Independence

Given the noble objectives of cost audit, the independence of the cost auditor is a matter on the sunny side. Section 233B(5) rules out appointment of a person as a cost auditor if he is disqualified under 226(3) and (4). This is a safeguarding provision to ensure independent persons carry out cost audit. In line with the recommendations of the Naresh Chandra Committee holding as to who can be an independent director, it may be considered that the following persons are ineligible to act as cost auditor for a company:

- If he is related to promoters or management at the board level or one level below the board
- If he is a significant supplier or customer of the company
- If he has been a director of the company for more than three terms

This would safeguard the image of the profession and provide broad-based opportunity to professionals. □

MUTUAL LEARNING IN A COST AUDIT