

# *Analytical Speaking*

VINOD KOTHARI & COMPANY

## **Cost Auditor Appointment- Is your company required to appoint one?**

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Cost Audit is a tool in the hands of the management of a company to control costs and also to identify probable wastes and inefficiencies. The roots of cost accounting can be traced back to 1925, when a large number of firms were awarded contracts on “cost plus” basis and the Government started verifying and investigating the cost structure of such firms.

The advent of cost audit in Companies Act, 1956 (“Act”) began with an amendment in 1965 to incorporate the provisions relating to the maintenance of Cost Accounting Records and Cost Audit by the specified companies. Such amendments were made on the basis of recommendations received from Vivian Bose Commission, Dutta Commission and Shastry Committee. The relevant provisions relating to cost audit in the Act are:

- Section 209(1)(d) relating to books of accounts to be kept by the company
- Section 233B relating to audit of cost accounts in certain cases specified by the Central Government

The Ministry of Corporate Affairs (“MCA”) has been consistent in its efforts to make companies more responsible towards its investors and has been taking significant steps in this regard. Recent developments of and commendable steps taken by the MCA to make companies more accountable in the case of cost audits are:

1. General Circular no. 15/2011 dated April 11, 2011 relating to appointment of cost auditors in companies (General Circular 1)<sup>1</sup>.
2. Cost Audit Order dated May 02, 2011 (CAO 1)<sup>2</sup>.
3. Cost Audit Order dated May 03, 2011 (CAO 2)<sup>3</sup>.
4. The Companies (Cost Accounting Records) Rules, 2011 dated June 03, 2011 (Accounting Rules) <sup>4</sup>.
5. The Companies (Cost Audit Report) Rules, 2011 dated June 03, 2011 (Audit Report Rules) <sup>5</sup>.
6. Cost Audit Order dated June 30, 2011 (Order 1) <sup>6</sup>.
7. Master Circular no. 02/2011 on cost accounting records and audit (Master Circular) <sup>7</sup>.

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<sup>1</sup> [http://www.mca.gov.in/Ministry/mcaoffices/CAB\\_Circular\\_15-2011\\_11Apr2011.pdf](http://www.mca.gov.in/Ministry/mcaoffices/CAB_Circular_15-2011_11Apr2011.pdf)

<sup>2</sup> [http://www.mca.gov.in/Ministry/mcaoffices/CAB\\_Order\\_02may2011.pdf](http://www.mca.gov.in/Ministry/mcaoffices/CAB_Order_02may2011.pdf)

<sup>3</sup> [http://www.mca.gov.in/Ministry/mcaoffices/CAB\\_Order\\_03may2011.pdf](http://www.mca.gov.in/Ministry/mcaoffices/CAB_Order_03may2011.pdf)

<sup>4</sup> [http://www.mca.gov.in/Ministry/notification/pdf/Common\\_Record\\_Rules\\_03jun11.pdf](http://www.mca.gov.in/Ministry/notification/pdf/Common_Record_Rules_03jun11.pdf)

<sup>5</sup> [http://www.mca.gov.in/Ministry/notification/pdf/Revised\\_Report\\_Rules\\_03jun11.pdf](http://www.mca.gov.in/Ministry/notification/pdf/Revised_Report_Rules_03jun11.pdf)

<sup>6</sup> [http://www.mca.gov.in/Ministry/mcaoffices/CAB\\_Order\\_30june2011.pdf](http://www.mca.gov.in/Ministry/mcaoffices/CAB_Order_30june2011.pdf)

<sup>7</sup> [http://www.mca.gov.in/Ministry/pdf/Circular\\_2-2011\\_11Nov2011.pdf](http://www.mca.gov.in/Ministry/pdf/Circular_2-2011_11Nov2011.pdf)

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8. General Circular no. 67/2011 dated November 30, 2011 relating to Cost Accounting Records and Cost Audit- clarifications about coverage of certain sectors there under (General Circular 2) <sup>8</sup>.
9. General circular no. 68/ 2011 dated November 30, 2011 relating to Cost Accounting Records and Cost Audit- clarifications regarding applicability and compliance requirements (General Circular 3) <sup>9</sup>.
10. Cost Audit Order dated January 24, 2012 (Order 2) <sup>10</sup>.

### ***Previous scenario:***

Earlier, the Central Government had the practice of issuing company specific Cost Accounting Record Rules for specific companies intended to maintain records u/s 209 (1)(d) of the Act. Till 31<sup>st</sup> March, 2011 there were 44 such industries which were notified by the Central Government.

Although the Rules were notified separately for each such industry, the basic premise remained the same except providing for special characteristics of these industries i.e the Rules required the books of account to be kept in a manner that the cost of production and cost of sale of each type of product for every quarter of the financial year and for the financial year as a whole can be properly calculated in the prescribed forms (which differ from industry to industry).

### ***Current scenario:***

The General Circular 1 deals with the appointment of cost auditors by the companies and laid down specific stress on assigning more power to Audit Committee, apart from prescribing the method for appointment of a cost auditor.

The CAO 1 lays down the applicability criteria for the companies to get their accounts audited by a cost auditor. It specifies applicability to all companies to which the given Rules apply and:

1. Aggregate value of net worth as on the last date of the immediately preceding financial year exceeds five crores **or**,
2. The aggregate value of the turnover from the sale or supply of all the products or activities during the immediately preceding financial year exceeds twenty crores **or**
3. The company's equity or debt securities are either listed or in the process of being listed, in **or** outside India.

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<sup>8</sup> [http://www.mca.gov.in/Ministry/pdf/General\\_Circular\\_No\\_67\\_2011.pdf](http://www.mca.gov.in/Ministry/pdf/General_Circular_No_67_2011.pdf)

<sup>9</sup> [http://www.mca.gov.in/Ministry/pdf/General\\_Circular\\_No\\_68\\_2011.pdf](http://www.mca.gov.in/Ministry/pdf/General_Circular_No_68_2011.pdf)

<sup>10</sup> [http://www.mca.gov.in/Ministry/pdf/General\\_Circular\\_No\\_68\\_2011.pdf](http://www.mca.gov.in/Ministry/pdf/General_Circular_No_68_2011.pdf)

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The CAO 2 prescribed the applicability criteria mentioned in points 1,2 and 3 above to the companies to which the Rules apply as provided.

The Accounting Rules has further prescribed applicability criteria for maintaining records, form of the compliance report, time limit for submission of the compliance report, authentication of the Annexure to the compliance report as follows to every company:

1. Engaged in production, processing, manufacturing, or mining activities and
2. Aggregate value of net worth as on the last date of the immediately preceding financial year exceeds five crores or,
3. The aggregate value of the turnover from the sale or supply of all the products or activities during the immediately preceding financial year exceeds twenty crores or
4. The company's equity or debt securities are either listed or in the process of being listed, in or outside India.

However, the Accounting Rules are not applicable to activities or products for certain industries as provided.

The Audit Report Rules mainly prescribed that all the companies to which audit of the cost records has been ordered, shall file within 90 days of the commencement of the financial year for prior approval of the Central Government for appointment of the cost auditor and the cost auditor to also intimate his appointment within 30 days of the receipt of the appointment. It has also prescribed time limit for submission of report and specified the officials required to sign the report.

Order 1 has laid down that all the companies to which the Accounting Rules apply and

1. Which are engaged in production, processing, manufacturing or mining of products including intermediate or allied products; **and**
2. Wherein the aggregate value of the turnover made by the company from sale or supply of all the products or activities during the immediately preceding financial year exceeding rupees hundred crores; **or**
3. Wherein the company's equity or debt securities of the company are listed *or* are in the process of listing is to get its cost accounting records, shall get their cost accounts audited as per General Circular 1.

The Master Circular has specified the method of calculating limits u/s 224 (1B) apart from specifying that in case a firm of cost accountants is appointed, any one of the partners is required to sign the report and mere affixing of the firm's name will not be allowed.

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The General Circular 2 has clarified certain points relating to circulars/ notifications already issued. It also clarifies that, intermediate or allied or final products of industries provided in Order 1 shall only be covered under cost audit and all other items shall be outside the purview of the order.

The General Circular 3 has clarified points regarding applicability and compliance requirements. It has also clarified that for the purpose of calculating 'turnover', taxes and duties shall not be considered.

The MCA in Order 2 has ordered 9 more industries to get their cost records audited in each of the FYs on or after April 01, 2012. This is however subject to the applicability criteria which are as follows:

1. Companies to which Companies (Cost Accounting Record Rules) 2011 are applicable **and**
2. Which are engaged in production, processing, manufacturing or mining of products of specified industries mentioned below including their intermediate or allied products **and**
3. Wherein the aggregate value of the turnover made by the company from sale or supply of all the products or activities during the immediately preceding financial year exceeding rupees hundred crores **or**
4. Wherein the company's equity or debt securities of the company are listed **or** are in the process of listing are required to get their cost accounting records, audited by a cost auditor for financial year commencing on and from 1<sup>st</sup> April, 2012.

For a list of the specified industries prescribed in Order 1 and Order 2 please refer **Annexure 1** to this note.

With this, all the earlier company specific cost audit orders passed so far by the Central Government shall stand withdrawn w.e.f April 01, 2012. Also, with the MCA issuing a blanket applicability criterion, the MCA has adopted a generic approach in the matter of cost audit.

The Order 2 also prescribes that companies to which this Order or the earlier orders issued on May 02, 2011 and June 30, 2011 were not applicable, but their products/ activities were covered under the company specific cost audit orders issued prior to March 31, 2011 shall comply with the company specific cost audit order till they stand withdrawn. Thus, such companies shall continue to comply with the company specific cost audit orders, unless they are superseded by fresh orders. The reason behind the MCA taking such a step is to tighten the regulatory norms for the specified industry and making the books of accounts of such industry more transparent to the investors but however, it would be too premature to comment the effect of such a stand before April 01, 2012.

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The MCA in its Master Circular has clarified the method of calculating the limit u/s 224(1B) of the Companies Act, 1956. On a simple reading, we can conclude that even if the company has not issued its formal letter of appointment but the cost auditor has given his consent, then such a company will be considered for the purpose of calculating of the limit u/s 224(1B). This is intended to ensure that the company complies with the provisions of General Circular no. 15/2011 dated April 11, 2011 wherein, the company is required to issue a letter of appointment within 30 days of filing application of appointment of cost auditor in *Form 23C*. The cost auditor is in turn required to file *Form* along with a copy of such appointment. Violation of any of these provisions will attract punishment for the defaulting party, be it the company or the cost auditor. However, with such a move of the MCA, both the parties are expected to abide by the General Circular no. 15/2011.

With the General Circular 1, the MCA has increased the scope of Audit Committee in the functioning of a company. Not only is the Audit Committee required to ensure that the cost auditor is free from any disqualifications, it is also entrusted with the responsibility of ensuring that the limits specified u/s 224(1B) are complied with and that a certificate of the cost auditor's independence and his "arm's length relationship" from the company be also obtained. With this General Circular, the Audit Committee has been made more accountable considering that traditionally it mainly oversaw the financial aspects of the company. With the Audit Committee being made the first point of reference, it remains to be seen if any notification is released hence forth to change the present constitution requirement of Audit Committee as per Clause 49 of the Listing Agreement. Further, in its General Circular no. 68/2011 dated November 30, 2011, the MCA has clarified that for the purpose of actually remaining true to "*arm's length relationship*", the cost auditor so appointed u/s 233B(2) shall not provide services relating to:

1. Design and implementation of cost accounting system
2. The maintenance of cost accounting records
3. Act as internal auditor

This is in the same lines as that of a statutory auditor not acting as the internal auditor of the company also.

The MCA has also prescribed the applicability criteria for maintenance of cost accounting records; vide its Notification dated June 03, 2011. Herein, it has been clarified that the Rules do not apply to body corporate governed by any Special Act say a partnership firm.

Certain amendments have also been made to the procedure of appointment of a cost auditor, which are given concisely below:

1. The MCA in its General Circular 1 has prescribed that:

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- a. The company needs to make an application to the Central Government in Form 23C within 90 days of the date of commencement of each financial year. If nothing on the contrary is heard within 30 days of the application, then the cost auditor can be deemed to be appointed and a letter of appointment can be issued.
  - b. It is to be noted that Form 23C is to be filed for each product under reference even if the same auditor is appointed for all the products. Earlier, no provision for deemed approval was present. With this, it is expected that the company will face lesser hassles and can go ahead with the appointment of cost auditor.
2. Further, with The Companies (Cost Audit Report) Rules, 2011 prescribing that the cost auditor is required to furnish his report within 180 days of the close of the financial year to which the report relates, it is a welcome step as this will also ensure that the company and the cost auditor are not subject to the penalty prescribed for non-compliance.

### **Our Analysis:**

The move of the MCA from passing company specific order to industry specific order is appreciable and welcomed. With the recent orders, circulars and Rules issued by the MCA, the role of a practicing cost accountant in the corporate sector has increased manifold. Also, with the cost auditors being required to attend Audit Committee meetings, proper cost management, efficiency in resource utilization will be ensured. This has also in a way has defined the scope of “internal control system”, which the Audit Committee is required to monitor. The Board of Directors have also been made an active part of the cost auditing process. Since the cost audit report is also required to be signed by the directors, the same should be adopted in a Board Meeting, after presenting in the Audit Committee meeting. The MCA has been coming up with clarifications regularly regarding the topic of cost audit. This is also indicative of the fact that certain provisions of the General Circulars issued are ambiguous. Thus, it can be expected that the MCA may come up with further clarifications on such circulars in the future.

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### **Annexure-1**

<b>Nature of Industry</b>	<b>Relevant Chapter of central Excise Tariff</b>
Cement	25, 38 and 68
Tyres and Tubes	40
Steel	72 and 73
Paper	47 and 48
Insecticides	38
Glass	70
Paints and varnishes	32
Aluminium	76
Jute, Cotton, silk, woolen or blended fibres/textiles	50-63
Edible Oil Seeds and Oils (incl Vanaspati)	12, 15
Packaged Food Products	2-25 (except Chapter 5, 6, 14, 23 and 24)
Organic and Inorganic Chemicals	28, 29, 32, 38 and 39
Engineering Machinery (incl. electrical and electronic products)	84, 85
Coal & Lignite	27
Mining & Metallurgy of ferrous & non ferrous metals	26, 74-83 (except chapter 76 and 77)
Tractors and other motor vehicles (incl. automotive component), engineering machinery (incl. electrical and electronic products)	84, 85 and 87
Plantation Products	8, 9, 21 and 40