



ICMA
Pakistan

Cost Accounting Framework



Institute of Cost and Management Accountants of Pakistan

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Introduction

1. Purpose and Status

The Cost Accounting Framework sets out the concepts that underlie the preparation and presentation of Cost Statements for stakeholders. The prime objectives of the framework are to:

- (a) Assist the reporting units in measurement total and unit cost and help them in using such data for decision-making. Cost determination involves:
 - i. Measurement & Recognition.
 - ii. Collection of cost data.
 - iii. Assigning the source expenses to cost object in a way that is meaningful for the organization.
- (b) There are three broad purposes for using cost data:
 - i. Operational control.
 - ii. Assessment and Evaluation.
 - iii. Predictive planning.

Industries need a very basic structure and framework for defining the elements of cost and accumulating the cost in an appropriate format.

The Cost Accounting Framework is a guiding document and defines overall boundaries for development and application of Cost Accounting Standards. This framework may not be treated as Cost Accounting Standard in itself and hence does not define Standard for any particular measurement or disclosure issue.

This framework may be revised from time to time on the basis of the Regulator's/Board's experience of working with it.

This framework has been prepared keeping in view the cost accounting standards under review by Joint Committee of Institute of Cost & Management Accountants of Pakistan, Institute of Chartered Accountants of Pakistan and Securities and Exchange Commission of Pakistan. Therefore, in case of any clarification, relevant cost accounting standard may be referred to.

2. Objectives of Cost Accounting Framework include

- (a) Assist the Regulator/Standard Setting Body /Board in the development of Cost Accounting Standards.
- (b) Assist the Board in promoting harmonization of regulations, Cost Accounting Standards and procedures relating to the presentation of cost statements by providing a basis for reducing the number of alternative accounting treatments.
- (c) Coordinate with the International Cost Accounting Standard Bodies in adopting such standards.
- (d) Assist Accountants in interpreting, analyzing and applying International Cost Accounting Standards.
- (e) Assist Cost Auditors to form an opinion as to whether Cost Reports conform to Cost Accounting policies and prevailing regulations & Cost Accounting Standards.
- (f) Assist users (both internal & external) of cost reports in interpreting the information contained in the cost statements.

3. Scope

The Cost Accounting Framework deals with:

(a) The Objective of Cost Statements Measurement & Recognition.

The overall objective is to provide information about the total and unit cost of the product produced or service rendered, efficiency of the resources utilized, effectiveness of business operations with respect to capacity utilized, performance of each department or unit of the business as compared to standards. It also highlights changes in cost position of an enterprise that is useful to users in making economic decisions.

(b) The Qualitative Characteristics of the Cost Statements.

This framework deals with determination of the usefulness of information in cost statements/ reports including but not limited to:

- Understandability
- Relevance
- Materiality
- Reliability
- Faithful Representation
- Neutrality
- Prudence
- Completeness
- Comparability

An important implication of the qualitative characteristic of cost statements is that users be informed of the cost accounting policies employed in the preparation of the cost statements, any changes in those policies and the effects of such changes. Users may be able to identify differences between the cost accounting policies for like transactions and events, for example impact of using different inventory valuation methods on cost and profitability. The disclosure of the accounting policies used by the enterprise helps to achieve comparability.

However, the need for comparability shall not be confused with mere uniformity and shall not be allowed to become an impediment to the introduction of improved Cost Accounting Standards. It is not appropriate for an enterprise to continue in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

As users wish to compare the cost position, performance and changes in cost position of an enterprise over time, it is important that the cost statements show corresponding information for the preceding periods also.

(c) The definition, recognition and measurement of the elements from which cost statements are constructed.

(d) Cost statements/ reports which have been required by various orders issued by the Commission/ Regulator from time to time.

This Framework also applies to the cost statements of all commercial, industrial and business reporting enterprises, whether in the public or the private sectors in accordance with the law.

4. Users of Cost Statements/ Reports

The users of cost statements/ reports include primarily internal and specifically external stakeholders. Statutory requirement regarding circulation of Cost Audit Reports is provided vide SRO # 1/2008 dated September 26, 2008, which requires the reports to be circulated to Members, Directors, Shareholders of the company, the Commission and the concerned Registrar.

In case of public utility companies, regulator and other Government Authorities like Competition Commission of Pakistan (CCP), Oil and Gas Regularity Authority (OGRA), Pakistan Telecommunication Authority (PTA), National Electric Power Regulatory Authority (NEPRA), or others, would occasionally need and use the cost data specifically to determine tariff and monitor price for the welfare of the masses.

5. Books of Account to be kept by Company

In case of a company engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or Labour or the other inputs or items of cost as may be prescribed, if such class of company is required by the Commission by a general or special order to include such particulars in the books of accounts. Overall guideline includes Companies (Audit of the Cost Accounts) Rules 1998, SRO# 846(1)/98 dated July 24 1998 or any other order/ rules/ notification framed or to be framed by the Commission. Further, maintenance of the Cost Accounting Records by the companies vide following orders:

- (a) Cost Accounting Record Order 1990 (SRO 1131 (1)/90 of November 1, 1990, Vegetable Ghee & Cooking Oil)
- (b) Cost Accounting Record Order 1994 (SRO#386(1)/94ofMay 14th 1994)
- (c) Cost Accounting Records Order 2001 (SRO # 97(1)/2001 of February 13th 2001)
- (d) Cost Accounting Records Order 2012 (SRO # 243(1)/2012 of March 08, 2012, Chemical Fertilizer Industries) New Addition
- (e) Draft Cost Accounting Records Order, 2012 (SRO # 302(1)/2012 of March 26, 2012)
- (f) Draft Cost Accounting Records Order, 2012 (SRO # 371(1)/2012 of April 17, 2012) Synthetic and Rayon Industries (Draft for seeking public comments before finalization)
- (g) Draft Cost Accounting Records Order, 2012 (SRO # (1)/2011 of March 19, 2012)

6. Audit of Cost Accounts

Where any company or class of companies is required under clause (e) of sub section (1) of section 230 of the Companies Ordinance, 1984 to include in its books of accounts, the particulars referred to therein, the Federal Government may direct that an audit of cost accounts of the company shall be conducted in such manner and with such stipulations as may be specified in the order by an auditor who is a Chartered Accountant within the meaning of the Chartered Accountant Ordinance, 1961 (X of 1961), or a Cost and Management Accountant within the meaning of the Cost and Management Accountants Act, 1966 (XIV of 1966); and such auditor shall have the same powers, duties and liabilities as an auditor of a company and such other powers, duties and liabilities as may be prescribed.

(Also see circular No.09 Reference.No.Co-258 (2) RCP/91 of July 29, 2000.)

7. Considerations while preparing of Cost Statements

- (a) **Objectivity.** Objectivity is characteristic of a cost statement that it should be free of any biasness.
- (b) **Accuracy.** It is the degree to which cost accounting information reflects the accuracy in the intended cost data and statements desired for the reporting.
- (c) **Verifiability.** It is a very important characteristic of cost accounting information and Cost Statements that leads independent reviewers to arrive at similar conclusions.
- (d) **Measurability.** It is a characteristic of a causal relationship enabling users of cost information from cost reports to be quantified with a reasonable amount of effort.
- (e) **Relevance, Reliability, Un-biasness, Comparability and Timeliness.** An undue delay in the reporting of the information may lose its relevance. Management needs to balance the relevant merits of timely reporting and the provision of the reliable information. To provide information on a timely basis, it is necessary to report before all aspects of a transaction or other event are known (like overheads), thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information, even highly reliable, will be of little use to users who have had to make decisions in the interim period. In achieving the balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision making needs of users.
- (f) **Balance between Benefit and Cost.** The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The principle is that the benefits derived from information must exceed the cost of providing it. The evaluation of benefits and costs is, however substantially a judgmental process. Nevertheless, standard setters, the preparers and users of cost statements should be aware of this constraint.
- (g) **Balance between Qualitative Characteristics.** Appropriate balance or trade-off between qualitative characteristics is necessary in order to meet the objective of cost statements. The relative importance of the characteristics in different cases will be a matter of professional judgment.

8. True and Fair view/ Fair Presentation

Cost statements should be showing a true and fair view of, or as presenting fairly, the cost position, performance and changes in cost position of an enterprise. Although this framework does not deal directly with this concept, the application of the principal qualitative characteristics and of appropriate accounting standards results in cost statements that convey a true and fair view, or present fairly such information.

9. The Important Elements of Cost

- (a) **Direct Material.** Raw materials and other materials which can be directly identified with production normally constitute major part of cost. Raw materials are the materials which directly go into the process of manufacture and physically constitute a part of the product. Data for raw materials consumption have to be provided for the year under audit, as well as for the previous two years, for comparison.

The relevant Cost Accounting Standard (CAS) and the record rules provide the manner in which the record of cost and quantity of raw materials shall be maintained and the manner cost is arrived at. The cost of raw materials includes all direct charges upto works, such as freight, inward transport handling, insurance etc. The basis of costing of raw material shall be consistently followed.

- (b) **Direct Labour:** Detailed particulars relating to wages and salaries must be included in Cost Accounting Records. Such information includes total wages paid for all categories of employees, separately in respect of the following:
- i. Direct Labour Cost on production, Total man-days of direct labour available and actually worked for the year.
 - ii. Average number of workers employed for the year, direct labour cost per unit of output of the product by giving information in respect of each.
 - iii. Brief explanation of reasons for variances, if any, as compared to the previous two years.
- (c) **Other Direct Cost.** The other direct costs include those costs that are not appropriate to include in other cost categories. Other direct costs are directly related to the product or services rendered. They must be separately identified, recorded and discussed in detail.
- (d) **Factory overhead.** The factory overheads include all indirect expenses related to the production including the following but not limited to:
- i. **Indirect material.** Indirect materials may not be directly identifiable with the production process but help production. Materials which are relatively of insignificant value, although may be directly conducive to production will also be classified as indirect material.
 - ii. **Indirect Labour.** Indirect labour cost includes indirect employees' cost on production, administration, selling, distribution, bonus to workers and employees, other employee costs, if any (including taxes and levies), and total employees cost, salaries and perquisites of directors and chief executive.
 - iii. **Stores and Spare parts.** Although Para 6 of Appendix III of the Companies (Audit of Cost Accounts) Rules 1998 refers to stores and spare parts kept in stock by the entity, the expenditure per unit of output on stores etc., Para 6(a), is related to repairs and maintenance. Provisions of the applicable cost accounting record orders/rules also refer to consumable stores, the consumption of some or all of which may be identifiable with, or directly chargeable to production. The cost auditor should examine and comment upon the system of stores accounting, i.e. recording of receipts, issues and balances, both in quantities and values.
 - iv. **Depreciation.** Cost accounting record orders/rules require that record of all fixed assets, in respect of which depreciation is to be provided, shall be maintained. Depreciation shall be charged according to the depreciation policy of management (straight line or reducing balance method) based on the useful life of the asset. Any basis adopted shall be consistently followed. If any basis, other than the useful life of the asset is followed, the impact of providing excess or less depreciation shall be pointed out. Provisions of the Companies Ordinance, 1984 in regard to depreciation shall be kept in view.
 - v. **Power and Energy.** The separate record of consumption of different sources of power and energy utilized for the operations of the entity shall be maintained for analysis and economic decision-making. The record of consumption of each source of power and energy shall be provided for the year under audit along with previous two years for consumption.
 - vi. **Repair and Maintenance.** It is essential to establish control over repair and maintenance costs and to devise effective means for charging maintenance cost to departments receiving

the services. Repair and maintenance costs traceable to benefiting departments are classified as direct department costs, even though they may originate in a maintenance department. All such actual maintenance costs shall be charged to a maintenance department and the department supervisor shall be responsible for keeping costs within budget. However, because maintenance is a service function, its costs ultimately shall be allocated to departments receiving the service. The record of the repair and maintenance for each service shall be maintained separately and provided for audit.

10. Allocation of Overheads

The basis of allocation or apportionment of overhead cost to cost centers, cost pools or departments shall be in accordance with the accepted principles of cost accounting, quantification of services rendered by service departments to cost centers; or on the basis of activities which are cost drivers.

11. Capacity

Capacity is extremely crucial and the most important aspect of Cost Accounting Framework. Proper Capacity management and utilization helps reporting units to reduce unit cost, increase efficiency and make them competitive. Hence framework puts special emphasis on reporting units to define state and express their capacities in every respect for availing numerous benefits of maintaining Cost Accounting Record and thereafter conducting audit of such record.

Rated capacity, normal capacity and practical capacity facilitate regulator, standard setting body, industry and reporting units in management planning and decision-making.

12. Disclosures

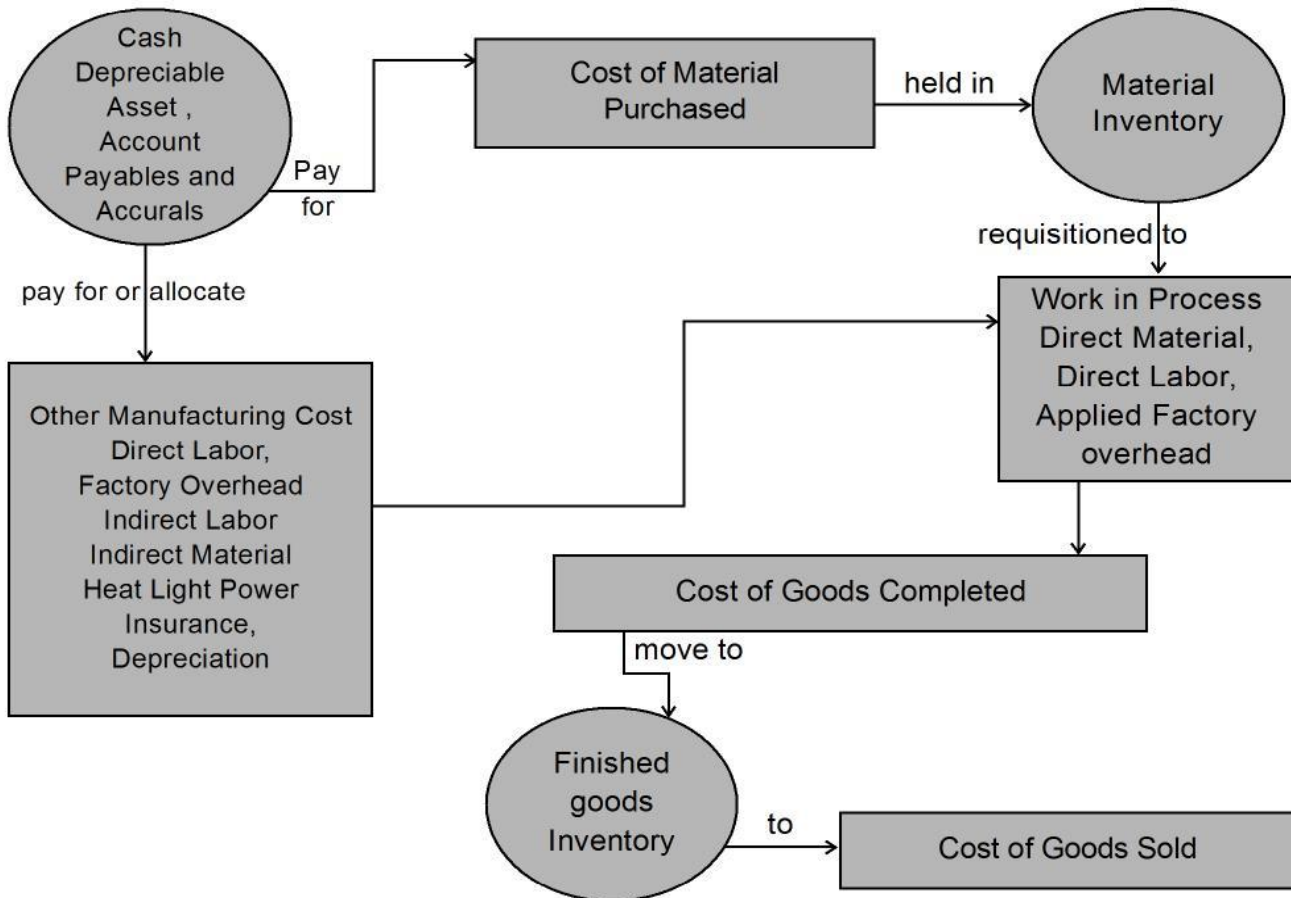
The Framework requires reporting unit to disclose the following information:

- (a) A statement of rated, normal or practical productions capacity of reporting unit, in terms of:
 - i. Available plant & machine hours or production units.
 - ii. Available number of skilled, semi-skilled and technical manpower to convert raw material into finished production.
 - iii. Availability of other elements and facilities required for making the production process possible.
- (b) A statement of actual utilization of such capacity and the reasons of difference between the two and any change in capacity should be incorporated with the prior approval of the Board of Directors. Firms may modify the capacity levels by considering the utilization of the plant or various departments in the light of meeting average sales demand over a period long enough to level out the peaks and valleys which come with seasonal and cyclical variations.

13. Flow of Manufacturing Costs

Direct and indirect materials are first stored in raw material inventory (RMI), usually a stockyard, warehouse, or storeroom, until they are needed in production. When production begins and manufacturing inputs start to be used, their costs are accumulated in Work in Process (WIP). When manufacturing inputs enter the production process of the factory, their costs shall be transferred from raw material inventory to work in process. When the product is completed, the product's cost is transferred from work in process to finished

goods inventory. When the product is sold, its cost is transferred from finished goods inventory to cost of goods sold (CGS).



14. Cost Components

Defining cost components include a budgetary cost statement or a standard cost statement showing the break-up of elements of cost. Some of the important concepts relating to framework are discussed as follows:

- (a) **Standards Costing & Standard Revenues.** Standard input-output ratio is very important for determination of standard costs and standard revenues. In case of multi product environment, product wise break-up shall be required to be provided. Reporting unit must be defined not only in terms of standard cost of each unit of product produced or service rendered but also in terms of standard selling price of each unit to support management in determination of standard gross profit margin. This standard cost helps in profit optimization by applying gross profit analysis, sales mix and cost variance analysis techniques. Determination of standard Input - Output ratio, normal loss/wastage is also beneficial for claiming exemption of Income Tax, Sales Tax, Custom Duty (under Form-S) for local manufacturers as well as tax concessions & duty drawback for manufacturing export oriented units (EOUs) from Federal Board of Revenue. Determination of standard spoilage or normal loss helps to improve the process, reduce costs by avoiding abnormal loss and maintaining spoilage within normal limits.
- (b) **Pooling of Cost and its Assignment.** In order to ascertain true and accurate cost, chart of accounts must facilitate pooling of expenses, specifically for each product providing break-up into

direct costs (material, labour & other direct costs), indirect costs and other components of cost. Such cost accumulation may be achieved through cost centers or departmentalization.

In the second phase all such indirect costs, whether relating to production or to service departments, shall be apportioned /allocated to cost unit on equitable basis.

- (c) **Cost Accounting Software.** For effective and accurate cost determination, it is imperative to define a comprehensive chart of cost accounts separately to be used through cost accounting system. Alternatively, where separate cost accounting system is not developed, such chart of cost accounts may be integrated within the existing Financial Accounting and Reporting System.
- (d) **Variance Analysis & Cost Control.** Benefits and utilities of standard cost may be achieved by comparing actual results with standards through established variance analysis techniques, including but not limited to, Cost & Revenue Variances. This helps to:
- i. Make comparison of actual performance with standard consumption norms (technical standards) of raw material, labour, power and other input costs in respect of industrial average at national level.
 - ii. Make comparison of last three to five year's average of the company.
- (e) **Other Uses of Cost Information.** Most of the invisible losses of reasonable financial implications are not reflected in the traditional financial books of accounts or financial statements. Therefore, these losses escape the attention of the Financial Auditor. This Framework requires reporting units to address following unattended areas giving rise to such losses as follows:
- i. Loss arising from non-utilization of optimum plant capacity
 - ii. Loss arising from over capitalization and high markup
 - iii. Loss arising from unfavorable input/output ratios
 - iv. Loss arising due to lack of budgetary controls and non-existence of costing procedures for products or services and variance analysis thereof.
 - v. Loss arising from low yield of inputs
 - vi. Loss arising from inefficiency of boilers, loss of steam because of leakage or evaporation of steam etc. Such loss may cause damage to environment and extra cost may be incurred as penalty from environmental agencies.
 - vii. Loss arising from non-existence of Research & Development and not switching to improved & efficient technologies
 - viii. Loss arising from inefficient use of human resources.
 - ix. Loss arising from liquidity problems due to:
 1. Blocking of funds in slow moving and dead inventories
 2. Slow recovery of Receivables
 3. Poor management of funds
 4. Uneconomical procurement planning

15. Analysis beyond Traditional Boundaries

An extremely important aspect of maintaining and using cost accounting records and using them for managerial decision-making, helping in understanding and controlling hidden aspects of an organization including but not limited to the following:

(a) Gross Profit Analysis.

- i. In case of multiple products, gross profit from each product shall be separately shown to assess profit contribution from each product.
- ii. In case the rate of gross profit varies from year to year, the reasons for variations shall be analyzed.

(b) Break-Even Analysis. It is necessary to find out breakeven point of production/ sales to match fixed cost of the industrial unit with contribution to get positive results.

(c) Review of actual results of Capital Expenditure on BMR. The companies do spend funds on Balancing Modernization and Replacement (BMR). Framework encourages analyzing the financial impact of:

- i. Return on Investment (ROI)
- ii. Internal rate of Return (IRR)
- iii. Payback Period
- iv. Any other ratios relevant to the situation

16. Date of Issue and Effective Date

This framework was approved by the National Council of ICMA Pakistan in its 306th meeting vide Agenda Item No 4188 held on December 20, 2013 and is applicable on all reviews falling due subsequent to this date.



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