Use of Cost Audit Report in Direct Tax Assessment

Definition of Cost :

While writing this paper I asked **Perplexity AI** application the tool used for research the definition of cost it said as follows.

"Cost is the amount of resources , typically measured in money used up or given to produce goods and services and in fundamental for budgeting , pricing , and financial decision making" I do not know where from this information picked up by the AI tool but I do not agree this definition. Had it been correct or acceptable to any one then I must say the specific word "benefits" derived from spending the expenses for definite purpose is missing. So the app did not consider the word "benefits". Any expenses which generates benefits to a particular purpose say manufacturing / administration/ selling/ distribution etc. or rendering services are called and accepted as cost. That is why the concept of **abnormal loss** are taught in cost accountancy. Abnormal loss is also cost which was spent for a particular purpose but did not generates any benefits so abnormal loss are not considered as cost. So expenses which are normal and beneficial to a particular purpose is considered as cost. So all expenses are not cost but all cost are expenses.

So generation of benefits to production or rendering services are the mandatory requirement to consider an expenses as cost. In financial accounting no distinction is made whether it is normal or abnormal. In cost and management accountancy a separate chapter is available to understand the normal or abnormal expenses to absorb in cost of sales or production. In financial accountancy abnormal expenses are charged to the statement of profit and loss account. So finally cost is an expenses followed by generation of benefits to the target and normal in character.

The direct tax law allows any expenses if it is incurred exclusively for the purpose of business and commercial expediency.

For example material consumption as per financial accounts may not be same as per cost accounts and thereby shown in CRA3. While assessing the tax , AO may ask for discrepancies between the two sets of data. In financial accounts this data are calculated based on opening balance plus purchase less closing stock lacking product wise granularity but in cost accounts it is necessary or mandatory to define material consumption product wise so that inflated claim of consumption are identified. So in assessing material consumption for financial accounts no scope to determine the data for over consumption or pilferage of same. Hence AO may gather information regarding expired raw material which showed as consumption or wastage of resources but loss to the entity and recognize as consumption. Hence AO can identify indicators of over consumption and apply his discretion towards alllowability. So genuineness of expenses on raw materials can be analysed from CRA 3 if referred where product wise consumption of raw material are shown. While CRA 3 aids scrutiny to protect genuine expenses from disallowance on efficiency grounds and be useful in assessing the tax if it is looked into.

Examples of expenses not considered in cost but in financial books.

a) In cost calculation depreciation is absorbed in cost provided the property plant and equipment are utilized at normal level but in financial accounts no such concepts are available. The detail discussion on capacity are available in cost accounting standard introduced by ICMAI. In financial accountancy depreciation are not calculated on capacity utilization. So depreciation are charged irrespective of utilization.

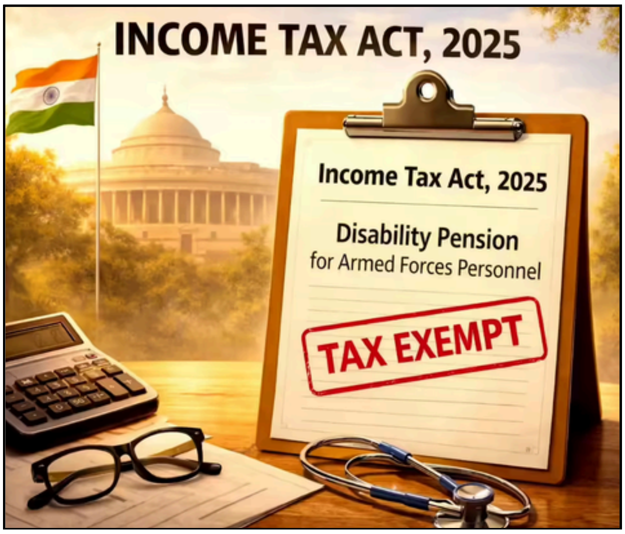
b) Expenses incurred in CSR are not at all considered in cost accounts since no benefits are derived from spending of CSR expenses which ultimately charged to financial P/L accounts. This expenses are charged to P/L as per requirement of Co Act 2013.

c) Though CSR expenses are spent and allowable in companies Act 2013 as statutory compliance without generating benefits to the product or services but are allowed in taxation law. So taxation law does not consider the benefits of expenses. If an expenses are incurred for exclusive purpose of business then AO can not deny it. So cost efficiency has no meaning in income tax over expense allow ability. Taxation laws gives consent to commercial expediency ignoring cost efficiency.

d) Bad debts occurred are allowed to hit financial P/L account but no scope in costing P/L account.

e) In come from exchange gain creates in come from other sources and ultimately enhance the profit are obviously considered in financial account but no relevancy in cost accounts.

f) Interest on term loan taken for capital expenditure may escape in cost accounts with the concept that the machine which has purchased with borrowed finance or from own resource can perform in the same level. So the interest may considered in reconciliation statement which has discussed later on.



Income Tax Act 2025:

In income Tax Act nothing has been mentioned about normal and abnormal expenses. It concentrates on allowable and disallowable expenses. In old income tax act 1961 u/s 37 maximum expenses are allowed other than capital and personal expenditure. In the income tax Act 2025 under section 34 any expenditure (not being an expenditure of the nature specified in sections 28 to 33,44 to 49, 51and 52 and not being in the nature of capital expenditure or personal expenses of the assesse), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing income from business or profession. It is relevant for allow ability of expenses provided it is paid which is quite natural. In cost audit no such payment or not paid concept is applicable to consider any expenses as cost. So cost is an expenses which is paid or not paid or irrespective of its payment status provided it generates benefits under normal condition. In income computation and disclosure standard no such concept of normal or abnormal expenses is available.

In tax accounting standard (ICDS) basically some expenses related to provision creation or valuation of unsold finished goods , valuation of construction contract etc. are dealt with.

In Income tax act there is no concept of cost but expenses only. AO may refer the term cost instead of allowing expenses to verify the genuine and beneficial use of resources which is scarce in our economy. Proper utilization of resources can make our country cost competitive. However, AO is not bound to assess the benefits of expenses incurred as per present Taxation Law. A suitable example can be used here in respect of depreciation. Depreciation of PPE can not depend on period but on usage. In income tax Act AO will allow full depreciation if it is put to use but in cost account the same depreciation are identified on use of such PPE and the balance goes to reconciliation statement

GST Act 2017:

In GST Act 2017 input are considered when it is used in furtherance of business though the definition of furtherance of business are not discussed in GST Act in details. So here also normal or abnormal concept is not available. If inputs are consumed more than standard the act is not allowed to dis allow such expenses as input. Hence AO can not get any value added data while start assessment of taxable profit.

The concept " furtherance of business" has been dealt with GST Act 2017 with out definition. There is no scope in GST Act to disallow input credit irrespective of over consumption of inputs if it is for furtherance of business. In Income Tax Act AO can not dis allow the consumption of excess inputs which can be identified from cost audit report. So CRA 3 can be helpful in identifying excess or abnormal expenses but can not help AO in dis allowing the same while calculating the taxable liability. Hence income tax assessment can not make an assesse cost competitive but can have peer in review of expenses charged P/L account while comparing both sets of data.

Tax Audit:

In tax audit quantification of production , sales and valuation of unsold finished goods are recognized which AO is utilized in tax computation. But it does not recognized normal and abnormal character of expenses which is mainly discussed in cost audit report. From tax audit report AO can not convinced himself regarding authenticity of normal business expense incurred to arrive such disclosed profit. Though he is bound to accept as expenses if it justify as normal commercial spending.

Capacity Utilization and normal Capacity. In any business model , utilization of strength of the organization is very important to assess its profitability. The detail study on capacity utilization has already been published by ICMAI in its cost accounting standard. In cost accounts we recognize cost based on actual capacity utilization considering cost incurred under normal capacity utilization. So in case of under utilization of capacity revised cost statement is prepared taking the cost normally incurred under normal utilization. So capacity utilization is an important aspect in profit calculation which is not considered in tax audit report. Similarly under utilization of capacity makes the organization operating below BEP.

Income Tax Act does not recognize the level of operation viz. normal capacity or achievable capacity utilised. It allows only expenses incurred for the purpose of business irrespective of level of operation without justification of expenses as against income. Unfortunately income tax Act does not even consider or refer the budgeted expenses and income also to peer review of expenses. Income Tax Act 1961 does not consider efficient use of scarce resources but to be restricted in allowing any expense if it is for the exclusive purpose of business.

Use of cost audit report in tax assessment:

The assessing officer gets the information to find out the cost of sales for each product which is audited by cost auditor from abridged cost statement captured for each auditable product to arrive at total profit earned from regular business. The cost audit report mandatorily declares the installed capacity with addition during the year and captive consumption with loss of capacity utilization when compared with achievable capacity and actual capacity utilized for which AO is assessing profit earned.

If the unit operated below achievable capacity but expenses incurred as per installed capacity the AO can easily understand the abnormal expenses charged in statement of profit and loss account certified by financial auditor. The financial audit never asks for benefit from spending or over spending but cost audit mandatorily assess the cost ought to absorb as per normal or achievable capacity.

In income tax audit report nowhere it is mentioned the normal or abnormal expenses but confined to allowable and dis allowable expenses. The difference between tax audit and cost audit lies while tax audit refers to allowable and dis allowable expenses but in cost audit it identifies the normal and abnormal expenses turns to cost subsequently.

But unless AO knows the normal expenses how he can allow such. Hence referring cost audit report will be beneficial to differentiate allowable or disallow such expenses to arrive at correct profit. In Income tax act expenses are allowed when it is wholly and exclusively spent for the business. Though purpose may be identified but may not be normal and no benefits derived from spending. In GST act any thing is considered as inputs when it is for the furtherance of business but may not for normal consumption. But in cost audit all the expenses are meant for specific purpose with defined benefit followed by normal capacity or achievable capacity utilization.

Example: As per cost audit report profit reveals say INR 100 but as per financial audit report INR 80 as profit certified or audited. Under such a situation AO can identify the expenses charged to FIN P/L but not in costing P/L The assessing officer can call for expenses charged to FIN P/L with details. The AO refers two annexures attached with cost audit report which is placed below namely abridged cost and reconciliation statement.

A) Abridged cost statement.

PART-B

Figures in crore

2. ABRIDGED COST STATEMENT

	Name of product	XXXXXXX					
	CTA heading	XXXX					
	Unit of measure	KG					
		Production	Finished goods purchased	Finished stock adjustments	Captive consumption	Other adjustments abnormal loss	Quantity sold
	Current year						
	Previous year						

S.No.	Particulars	Current year		Previous year	
		Amount (Rs.)	Rate per Unit (Rs.)	Amount (Rs.)	Rate per Unit (Rs.)
1	Material Consumed (details as per para 2A a separate annexure)				
2	Process Materials/Chemicals				
3	Utilities (detail as per para 2B a separate annexure)				
4	Direct Employee Cost				
5	Direct Expenses				
6	Consumable stores & spares				
7	Repairs & Maintenance				
8	Quality Control expenses				
9	Research & Development Expenses				
10	Technical know-how fee/royalty				
11	Depreciation/Amortisation				
12	Other Production Overheads				
13	Industry specific operating expenses (detail as per para 2C a separete annexu				
14	**Total (1 to 13)**				
15	Increase/Decrease in Work-in-progress				
16	Less: Credits for recoveries, if any				
17	Primary packing cost				
18	Cost of Production/Operations (14+15 to17)				
19	Cost of finished goods purchased				
20	Total cost of production and purchases(18+19)				
21	Increase/Decrease in stock of Finished Goods				
22	Less: Self/Captive Consumption)				
23	Other adjustments				
24	Cost of Production/Operation of Product Sold (20+21 to 23)				
25	Administrative Overhead				
26	Secondary Packing Cost				
27	Selling & Distribution Overheads				
28	Cost of sales before interest(24 to 27)				
29	Interest & Financing Charges				
30	Cost of Sales (28+29)				
31	Net sales realisation (net of taxes and duties)				
32	Margin [Profit/Loss as per cost accounts] (31-30)				

Notes:- interest on fund utilized for working capital considered others will consider in Reco statement

B) Reconciliation statement

PART-D (2)

2. PROFIT RECONCILIATION

S.No.	Particulars	Current year
1	Profit or loss as per Cost Accounting Records	
	(a) For audited product(s)	
	(b) For un-audited product(s)	-
2	Add: Income not considered in cost accounts: -	
a)	Earlier Years Sales	
b)	Revenue from Consultancy / Construction Project	
c)	Interest Income (others)	
d)	Interest on Employee Loans	
e)	Liability/Provision written back	
f)	Exchange Rate Variation (Gain)	
g)	Late Payment Surcharge	
h)	Receipt of Director's Sitting Fee from other organization	
i)	Profit on sale/disposal/settlement of insurance claim	
j)	Excess on physical verification	
k)	Profit on Sale of Projects	
l)	Realization of Loss due to Business Intruption	
m)	Prior Period Income	-
n)	Other Income	
	TOTAL (2)	-
3	Expenses not considered in Cost Accounts	
a)	Expenditure on Self Generated CERs/VERs	
b)	Losses out of Insurance claims	
c)	Compensation for land and interest on arbitration/court cases	
d)	Diminution in value of stores and spares	
e)	Loss on sale of asset	
f)	Exchange Rate Variation (Loss)	
g)	CSR Expenditure	
h)	Rebate to Customers	
i)	Interest to Beneficiary States	
j)	Bad & doubtful debts/advances/claims/interest provided	
k)	Shortage in store	
l)	Written off Stores/Bad debts/Advances/Claims/Expenses	
m)	Provision for contingencies/CAT Environment/Others	
n)	PROJECT EXPENSES PROVIDED FOR	
o)	Others Misc Exp.	
p)	Abnormal Cost due non-oprational of Power House)	
q)	Expenditure deferred for next years (Special Maintanance).	
r)	Rebate to customers under ATMANIRBHAR BHARAT Package	
s)	REGULATORY INCOME - EMPLOYEE REMUNERATION & BENEFITS (WAGE REVISION)	
t)	Fare Valueation adjustment on Subordinate debt/other IND AS adjustment	
	TOTAL (3)	-
4	**Difference in valuation of stock between financial accounts and cost accounts**	
5	**Other adjustments,if any**	
	Add:	
a	VRS Expenditure	
b	Income from Finance Lease	
	TOTAL (5)	
6	**PROFIT AS PER FINANCIAL ACCOUNTS (excluding Other Comprehensive Income for C**	-

Conclusion :

Cost audit report CRA-3 may be useful in detecting the overspending in comparison to revenue earned but AO do not get any mandate to follow it in computation of tax. Present tax law is based on spending in commercial purpose not to be cost conscious and thereby proper utilization scarce resources of this country. It is recommended that cost audit report may looked into while doing tax assessment exclusively for manufacturing companies and make this country cost competitive globally.

Abstract :

The word normal and benefits are mandatory for considering any expenses as cost. Mere purpose is not enough in deciding any expenses as cost. In cost audit report we follow this principle. Use of cost audit report makes AO understood that which is normal and beneficial to each product or each activity independently and consolidated for the business as whole. But present Tax Laws does not have such mandate to use it to analyze the two sets of data.

Reference:

i) No AI tool was used in preparing this paper.

ii) section 34 of the Income Tax Act 2025

iii) Abridged cost and reconciliation statement are the product of MCA. We use it as per mandatory annexure in CRA3

iv) experience in industries for the last 35 years

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