RESEARCH PAPERS

The Case for Mandatory Cost Audit in the Pharmaceutical Industry of Pakistan

A Sample Study of two Identical Pharma Companies in Pakistan and India to determine variance in share of expenses and difference in Marketing Strategy

By Research and Publications Directorate, ICMA Pakistan

The Case for Mandatory Cost Audit in the Pharmaceutical Industry of Pakistan

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Preamble:

The Institute, since the very beginning, had been making consistent efforts to convince the government to introduce necessary provisions in the corporate laws for making cost audit obligatory for all manufacturing companies. In 1980, when the draft Companies Ordinance was issued by the government for comments, the Institute got a welcome opportunity to accelerate its efforts in this direction. A delegation headed by Mr. Riyaz H. Bokhari, the then President of the Institute, held a meeting with the then Finance Secretary to impress upon the government the need for making Cost Audit mandatory for manufacturing companies. Several meetings were also held with Chairman, Corporate Law Authority (now SECP) to discuss incorporation of cost audit provisions in the Ordinance. Eventually, the Institute's efforts bore fruit and in 1984, the government promulgated the Companies Ordinance which included a new Section 258 relating to audit of cost accounts of companies and allowing both the Cost and Management Accountants and the Chartered Accountants to conduct cost audit. Soon after the enforcement of Companies Ordinance, 1984, the Institute started preparing draft Cost Accounting Records Rules (CARRs) for different manufacturing industries.

The Institute developed CARRs based on consultations with experts and its members employed in the respective industries. These CARRS were developed initially for twelve sectors viz. cement, sugar, ghee and oil, chemical fertilizer, cotton textile, synthetic and rayon, pharmaceutical, electric power generation, engineering, electric cables and conductors, motor vehicle and bicycle industries.

The first Cost Accounting Records Order was issued by the government in November 1990 for 'vegetable and cooking oil industry'. The second CAR Order was issued in May 1994 for 'cement industry' and the third CAR Order in February 2001 for 'sugar industry. In 2008, the SECP issued a 'Companies Cost Accounting Records (General Order), 2008 for cost audit in five sectors namely fertilizer, thermal energy, petroleum refining, natural gas and polyester fiber, however this Order was withdrawn, just after three years of its enforcement, in August 2011. Subsequently, the government issued CAR Orders for the 'Chemical Fertilizer' industry in March 2012; Synthetic & Rayon industry in December 2012; and lastly Electric Power Generation Industry in September 2015. Hence, after a long span of almost twenty six years, the cost audit regime in Pakistan was confined to just six sector viz. cement, sugar, oil & ghee, chemical fertilizer, synthetic and rayon and electric power generation industries. This did not last long. In January 2015, the government issued a notification for extending the applicability of CAR Order on 'synthetic and rayon industry' until further order. Similarly, in February 2016, the SECP also withdrew the CAR Order for ghee and oil industry, in place of which it has introduced cost audit in this sector through QCR-rated auditors by ICAP and ICMA Pakistan. Hence, with these developments, the cost audit regime has shrunk to just four sectors at the moment.

Cost Accounting Record Rules for Pharmaceutical Industry issued in 2000

The Institute developed and then forwarded a draft of Cost Accounting Record Rules (CARRS) for the pharmaceutical industry to the government way back on 29th September 2000. The government immediately issued a notification vide SRO # 745 dated 18th October 2000 to elicit public comments.

However, the government received resistance from the pharma industry to enforce this order. This is evident from the fact that the Standing Sub-Committee of the Overseas Investors Chamber of Commerce and Industry (OICCI) which held a meeting on 12th March 2001 deliberated on this issue in detail and showed concern on the issuance of this Order. The Annual Report 2001 of OCCI includes (in Appendix) the minutes of this meeting of Standing Sub-Committee on Corporate Sector. A few excerpts from the minutes are reproduced below to indicate how much concern the pharma industry was on issuance of the Draft Cost Accounting Record Order for the Pharmaceutical industry:

Quote: *The meeting was informed that on 18th October, 2000 SRO No. 745(l)/2000 was issued on which comments were invited from the Pharmaceutical Industry.* ***This has caused a lot of concern amongst Pharmaceutical members.*** *Glaxo's Representative informed the meeting that the last date for the industry to respond has been extended to 15th March, 2001 and the PPMA is preparing a response to the above notification…… This matter was taken up with the Chairman, Securities & Exchange Commission of Pakistan, Mr. Khalid Mirza when he visited the Chamber on 7th November, 2000 by a Representative of Lever Brothers Pakistan Limited.* ***It was pointed out to the Chairman that the prescribed records are too onerous and create problems for the industry,*** *which is now maintaining computerized records. The Chairman, SEC responded by saying that if special dispensation was to be sought by anyone so effected, this may be considered. …… It was suggested that Members of the Pharma industry should prepare a suitable response to the notification and seek dispensation.* : **Unquote**

(Minutes of OICCI Standing Sub-Committee on Corporate Law Monday, 12th March 2001 at 11:30 A.M at OICCI)

The sentences in bold point towards the concerns of the pharma companies on said draft Order.

Cost Accounting Record Rules for Pharmaceutical Industry issued in 2013

The Institute continued its efforts to persuade the government to introduce obligatory cost audit for the pharmaceuticals industry and eventually a draft Pharmaceutical Industry (Cost Accounting Records) Order, 2013 was issued by the SECP vide SRO # 343 dated April 23, 2013. This draft Order required the pharmaceutical companies to maintain such cost accounting records, including all particulars relating to utilization of material, labour or other inputs of items of cost, to determine total product cost. It also intended to standardize cost accounting systems in pharma industry as per international requirements.

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Again the pharma industry expressed its reservations on the issuance of the above CAR Order due to which the SECP apparently has held its enforcement in abeyance. The Research and Publication Directorate of ICMA Pakistan took up this matter with the SECP which has apprised that CAR 2013 is still under consideration of the Commission and it intends to proceed keeping in view the best interests of the corporate sector and with mutual understanding of all stakeholders, including ICMA Pakistan.

Reservations of Pharma Industry on mandatory Cost Audit

Since the pharmaceutical industry in Pakistan is mostly dominated by multi-national companies which depend much on foreign investment for its operations and marketing, as such they strongly resisted to any such move for making cost audit obligatory. They are of the viewpoint

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that mandatory cost audit is tantamount to disclosing their confidential business data and also it would have a negative impact on their cost of doing business that would reduce global competitiveness.

The above viewpoint is supported by the following observations made in the **Pakistan Business Council (PBC) Research Unit** research report titled 'Comparative Analysis of Companies (Audit of Cost Accounts) Rules, 1998 with prevailing Legislation in India, Bangladesh and 10 other countries:

Quote: *Cost audits require access to information regarding processes and other confidential data the disclosure of which could adversely affect a firm's competitive advantage if it is leaked out. Local and foreign investment has drastically fallen in Pakistan over the last few years and* ***measures like Compulsory Cost Audit are seen by investors as a serious negative.*** *In view of the prevailing practices in other successful economies, it is advisable that* ***Mandatory Cost Audits be removed from legislation as it is unnecessarily intrusive and increases the cost of doing business.*** : **Unquote**

The paper was released by the Pakistan Business Council (PBC) soon after the issuance of draft Cost Accounting Record Order for Pharmaceutical Industry in 2013. The above observations clearly indicate that the pharma industry in Pakistan is not in favour of mandatory cost audit for reasons that in their opinion are justified. **However, there are some valid reasons as well for cost audit in the pharma industry, which we would discuss in later part of this paper.** Here, let us have a look at other reservations of the pharma industry (mostly multinationals) for not having cost audit in the industry:

- **Additional Corporate Reporting Requirement -** The pharma industry opines that introduction of CAR order and its requirements are an extension of corporate law requirements, in addition to mandatory statutory reporting, statutory and internal audits and directives of Drug Regulatory Authority (DRA). They say that the industry is already subject to compliance under various statutes like Corporate Law, Income Tax Laws, Sales Tax Laws, Customs Act, Drug Regulatory Authority (DRA) directives, Ministry of Health's directives and Stock Exchange listing requirements for listed pharmaceutical companies.

- **Extra Cost and Resources to maintain Records -** The pharma industry is of the view that compliance of applicable formats (cost statements) of CAR Order, 2013 would be extra requirement to comply with and this would entail extra time, efforts, resources and costs for them to maintain records and at the same time have the information available for audit incurring extra costs;

- **Existing Costing Systems are Sufficient and comply with Int'l Standards -** The pharma sector asserts that the existing costing systems in place allow adequate recording of associated manufacturing costs from raw material status, related conversion and to final finished goods status. Specifically, in case of large national/multinational pharmaceutical companies, these costing records are not only in compliance with the International Financial Reporting Standards but also Drug Act of Pakistan.

- **Add to complexity of Work and Cost of Product -** Another justification provided by pharma industry for not having cost audit is that it would result in additional resources including expensive ERP system. This would entail additional running cost and investment that would not be viable and economically feasible for companies. This would also increase complexity of work and cost of product. Further, for large companies, thousands of work sheets would be required to comply with Annexures of CAR Order.

- **Material cost accounts for 80% of Production Cost -** The pharma sector is of the viewpoint that CAR Order, 2013 focuses mainly on allocation of overheads into subcategories and various cost centers based on nature of work, whereas in case of pharma industry, material costs accounts for nearly 70% to 80% of the cost of production. Other major components of conversion cost are labor costs and utilities.

- **Extra Costs on Customization in ERP -** The pharma industry feels that it would be quite difficult to comply

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with the requirements of CAR Order, 2013 by those companies which are not using ERP as it would cost them additional money required for customization in ERP.

- **Cost Audit not a global practice -** One reservation of pharma industry is that the applicability of cost accounting records and audit of cost audit regime existed only in Pakistan, India and Bangladesh and it is not applicable in other jurisdictions of the world. Hence, it should be declared unnecessary.

Justifications for having Cost Audit in Pharmaceutical Industry

One of the reservations of the pharmaceutical companies against the applicability of cost audit is that it would add to the cost of doing business and result in extra costs and resources. This argument does not carry weight as it is an undeniable fact that maintenance of cost accounting records leads to competitiveness and efficiency. This fact has also been acknowledged by the 'Competition Commission of Pakistan' in its Policy Note issued to SECP on 5th September 2011 issued under Section 29 of the Competition Act, 2010. The relevant text of CCP Policy Note is reproduced below:

Quote: ***CCP observes that the maintenance of cost accounting records and cost audits may contribute towards enhancing competitiveness of the sectors.*** *However, in Pakistan, where the concept and practice of enterprise governance is developing, enterprises may not be inclined to self-regulate and conduct cost audits. This is despite the fact that they may benefit, for instance, by using results to improve their competitiveness through various measures. In any case, it is understandable that the SECP would want to foster self-disciplinary mechanisms by instituting a cost accounting system that collects and collates cost data.* ***CCP views cost audits as instruments that promote efficiency*** *as they may identify processes and activities where improvements can be made to enhance productivity and reduce/eliminate wastage of resources.* **Unquote**

From the above observations by CCP, it is quite evident that cost audit is not a hindrance towards increasing cost of doing business, rather it help industries in overcoming their undue costs to remain competitive in market. Hence, statutory application of cost accounting records for the pharmaceutical industry would help this sector to achieve cost competitiveness and making strategic decisions to face the challenges of open market competition.

As far as the argument of PBC with regard to disclosure of confidential data is concerned which they say would adversely affect the competitive advantage of pharma companies, it may be pointed out here that recently **in USA, the legislators have proposed bills that would force the drug companies to open their books so that the public can see how much is spent by them to develop, manufacture and market new medicines.** In this context, the Governor of New York, Mr. Andrew Cuomo also included a 'disclosure demand' in his own state budget proposal. Further, the White House budget proposal, proposals have been included to make the drug makers obligatory to publicly disclose various data, including research and development costs. This information would be used as part of a plan to negotiate lower prices for the 'Medicare drug program' known as Part D.

> "Audited Cost Statements can be quite helpful in protecting the interests of drug consumers as the government can fix proper prices of drugs and medicines on cost basis which would eventually lead to curbing any kind of profiteering thereby protecting rights of consumers"

Though the pharma lobby in USA is making efforts to defeat these bills initiated by law makers and in many States the legislation has stalled, nevertheless irrespective of the outcome of these efforts, it is quite evident that there is a growing realization in the world that there is need to identify and disclose the costs related to manufacture of medicines for arriving at the reasonable prices of drugs to protect the consumers' rights. This necessitates cost audit in this industry.

The argument put forward by pharma companies in Pakistan that cost information is proprietary is also challengeable. A precedence of disclosing cost information is seen in USA where the **'Sunshine Act'** which is a section of the 'Patient Protection and Affordable Care Act of 2010', requires the pharmaceutical and medical service companies to 'report to the Federal Government' certain payments and other transfers that they make to US physicians and teaching hospitals. The Sunshine Act also requires the companies to report any physician ownership or investment interests.

Now, let's have a look at some other advantages and benefits of introduction of mandatory cost audit in the pharmaceutical industry in Pakistan:

- **Cost Accounting Records can be quite helpful to pharmaceutical industry in achieving economic efficiency** through better utilization of resources, reducing wastages, business process re-engineering, re-organization of operations and systems, supply chain adjustments etc. The use of cost accounting techniques can help them to increase efficiency within the manufacturing and operational processes, and to control inventory and reduce waste and errors in manufacturing process. Some cost management techniques used in pharmaceutical industries are standard costing, ABC method, six sigma and lean manufacturing. This would also help in improving quality products.

- **Cost audit can provide cost information required for transfer pricing and related party transactions.** Due to high level of regulation and control in pharma sector and to maintain quality of drugs, most of the manufacturing and research in pharma industry is performed by group companies. The most typical related party transactions are import of API for secondary manufacturing and import of finished formulations for distribution in local market. The information required for domestic as well as international transfer pricing can be derived from the cost accounting records and cost audit reports.

- **Audited Cost Statements can be quite helpful in protecting the interests of drug consumers** as the government can fix proper prices of drugs and medicines on cost basis which would eventually lead to curbing any kind of profiteering thereby protecting rights of consumers. In India, cost audits were made obligatory in the wake of reports that exorbitant trade margins exist in the sector. A comparison of medicines' production cost with their retail price would help in right pricing decision and checking real extent of trade margins on different products.

- **Cost Audit can help Pharma companies in taking Outsourcing decisions.** There is a growing concern in the global pharma industry to reduce their manufacturing costs as well as optimization of facilities based on existing and project demand. For instance, Pfizer is now considering reduction in its number of manufacturing bases worldwide with overlapping functions from 100 to 41. Pfizer and few other global pharma firms are now seriously thinking about outsourcing and co-manufacturing in order to control costs which are the key to competiveness. They are also adopting lean manufacturing and process intensifications procedures to bring down the manufacturing costs.

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- **Cost Audit can help Pharma companies in making intra-industry comparisons.** If a standard and uniform cost accounting records are applicable on the pharma industry in Pakistan, it would facilitate the companies in intra-industry comparisons. The cost of one Pharma Company can help the other company to compare its own cost data for taking important decision for reducing cost or making some other improvements. However, inter-industry comparison is possible only when the application of cost accounting records becomes common to all companies and their cost data is made accessible through published cost accounts. This would also lead to increasing the added value of medicines though increase profitability per unit of input or resources.