

Query from CMA Ajay Joshi through email dated 23rd February 2016

Expert Advice on Treatment of Royalty paid for Technical Know How in Cost Records

I would request you to please provide guidance on the issue of treatment of Royalty paid for Technical Knowhow.

The consideration is as under:

- A. The Cost Accounting Standards state that Fee paid for Technical knowhow should be treated as a part of cost of production. This would be the case where a yearly or lump sum fee (duly recovered over a number of Years) is paid for acquiring Technical Know How.
- B. The problem arises when instead of a Fee, Royalty based on Sales (as per D I P P rules) is paid for technical knowhow obtained by the company from the Licensor. The Rules governing payment of Royalty allow Royalty to be paid only on the basis of sales of qualifying products, subject to some deductions, and accordingly the quantification of Royalty is possible only after the sales have been effected and not before. This is leading to a situation where while the Royalty is paid for Technical Knowhow obtained, quantification of the same is not possible until the sales are made which is a post manufacturing activity.

In view of the above, opinion is sought as to

- A. *Whether the Royalty paid based on sales for obtaining Technical Knowhow should be treated as a Cost of Production Item or a Cost of Sales Item.*
- B. *If this is to be treated as a Cost of Sales Item then should the Royalty Line in the Abridged Cost Statement be kept blank or should this be shown as a line item but not considered for Work In Process and Finished Goods Valuation.*
- C. *If it is to be treated as a production cost item then should Royalty paid also be considered for valuing Work In Process and Finished Goods and should this also be considered as a cost item for issuance of a CAS 4 certificate.*

There is a significant difference in views on this subject and an expert official opinion would be of immense help in the profession taking a consistent view on this.

Clarification:

Your kind attention is drawn to CAS-20 Cost Accounting Standard on Royalty and Technical Know-how Fee. Para 6 on Assignment of cost of Royalty and Technical Know Fee deals with assignment and is reproduced below:

“6. Assignment of costs

6.1 Royalty and Technical Know-how fee that is directly traceable to a cost object shall be assigned to that cost object. In case such fee is not directly traceable to a cost object then it shall be assigned on any of the following basis:

- a. *Units produced*
- b. *Units sold*

c. Sales value

6.2 The amount of Royalty fee paid for mining rights shall form part of the cost of material.

6.3 The amount of Royalty and Technical Know-how fee shall be assigned on the nature/ purpose of such fee.

The amount of royalty and technical know-how fee related to product or process know how shall be treated as cost of production; if it is related to trademarks or brands shall be treated as cost of sales. “

In view of para 6.3 above, Royalty and Technical fee shall be assigned on the nature /purpose of such fee and explanation given thereunder. Clarification to our query is appended below:

- A. The Royalty paid for obtaining Technical Knowhow should be treated as part of cost of production or cost of sales on the basis of the nature /purpose of such fee.
- B. If it is treated as a Cost of Sales, and there is no other royalty payment relating to cost of production, the line item “*Technical know-how fee/ Royalty*” in Abridged Cost Statement may be kept blank. Royalty paid in such cases will form part of selling and distribution overheads in the Abridged Cost Statement.
- C. If it is treated as a cost of production then the Royalty paid also be considered for valuing Work In Process and Finished Goods and should be considered as a cost item for issuance of a CAS 4 certificate.