CHAPTER - II
CHAPTER-II
A CONCEPTUAL FRAMEWORK OF COST AUDIT PRACTICE

2.1 Definition and Concept of Cost Audit
2.2 Difference between Financial Audit and Cost Audit
2.3 Objects or Functions of Cost Audit
2.4 Advantages of Cost Audit
2.5 Aspects or Scope of Cost Audit
2.6 Types & Classification of Cost Audit
2.7 Types & Classification of Cost Audit
2.8 Technique and Procedure of Cost Audit
2.9 Cost Audit Plan and Programme
A CONCEPTUAL FRAMEWORK OF COST AUDIT PRACTICE

With the growth and development of cost accounting system, it became necessary to maintain cost records and cost books to record costs and the related transactions correctly. It is necessary that either in financial accounting or in cost accounting or in management accounting system, wherever books and records are kept, they must be examined independently to ensure that they have been kept and recorded fairly and correctly and that there are no errors of omission and commission and there are no defalcation. So once the cost accounts are prepared, they should be audited in all fairness. It should be so done either by the internal staff of the company to the satisfaction of management, or under Statutory audit, by the Government approved auditors in case of companies in India to which Section 209 (1) (d) and Section 233 (B) of the Companies Act apply. The Companies (Amendment) Act, 1965 empowers the Government of India to enforce cost audit on any company it may deem fit. It is a matter of interest that India is probably the only country in the world where statutory cost audit has been enforced on certain industries. In other countries, audit is conducted by the management for its satisfaction, internally, to achieve the objectives of the cost accounting system and to improve operational efficiency.

2.1 Definition and Concept of Cost Audit

Definition: “Cost audit is the verification of cost accounts and check on the adherence to the cost accounting plan.” —I.C.M.A. London
“By the term ‘Cost audit’ is meant the detailed checking of the costing system, technique and accounts to verify their correctness and to ensure adherence to the objective of cost accounting.” —Smith & Day

Like financial audit, cost audit is also an attest function. It is a systematic and accurate recording of detailed transactions and operations of manufacturing, processing, contracting, extracting, transporting, supplying, etc., so as to show the actual cost of each individual piece of work, service or process or operation.

“Cost audit would apparently mean an examination of cost books, cost accounts, cost statements and subsidiary and prime documents with a view to satisfying the auditor that these represent a fair and true view of the cost of production. This will naturally mean an examination of the appropriateness of the cost accounting system adopted by the business and effectiveness of its implementation.”¹

The cost auditor is expected to examine the cost books, cost accounts, cost statements and all other relevant documents to see not only that they have been correctly written and recorded but that they also give a fair and correct picture of the business with regard to costing operations.

The Cost Accountant adopts the costing system suitable to the business. He lays down the routine and procedure and designs the various forms and documents for cost collection, cost analysing and cost ascertainment. He decides the allocation, apportionment and absorption of costs on appropriate base, and presents them informatively. The routine and procedures once rightly adopted must be followed strictly in order to make them fruitful. The management has, at times, to take heavy

¹ J. G. Tilthe 'Cost Audit and Management Audit' (Mumbai).
decisions involving huge sums on the basis of cost information presented to them by the cost accountant. Therefore, it has to be ensured that the cost information presented to the management is correct and the data is reliable. This reliability and correctness can be vouched safely by an adequate and independent system of cost audit, and not merely by test-checks.

The Cost Auditor, therefore, has to see that inventory control has been rightly exercised, costs properly allocated, closing stock correctly valued and there has been correct cost ascertainment, proper cost presentation and effective cost control. In a way, all the aspects affecting cost are to be examined by the cost auditor.

From the definitions of cost audit, it is evident that cost audit aims at:

(a) verifying that the cost books, cost accounts and cost-records have been correctly maintained as per costing system adopted;

(b) verifying that the cost plan i.e., the prescribed routine and procedure, has been adhered to; and

(c) detecting errors and preventing fraud, misappropriations and defalcations.

2.2 Difference between Financial Audit and Cost Audit

Financial accounting and cost accounting are the two main branches of accounting system. The same criteria and principles of audit hold good in both the systems of accounting and sometimes it becomes difficult to make clear-cut distinction between the two audits. However, an auditor of financial accounting is more concerned with financial aspects, recording of cash and bank transactions, capital, debtors,
creditors, assets & liabilities, etc, while the cost auditor is more concerned with correct recording, ascertainment, presentation and control of costs. This leads to the following points of distinction:

1. In financial audit, the audit report is addressed and placed before the shareholders of the company, but the cost audit report is addressed to the appointing authority. In financial audit, auditor is the representative of the shareholders while in cost audit; he is the nominee of the appointing authorities and reports to them on cost effectiveness.

In statutory cost audit, the report is to be submitted by the cost auditor to the Central Government, with a copy to the company.

2. Audit of Financial accounts has been made statutorily compulsory by the Companies Act while Cost audit is not compulsory except in certain cases i.e., in case of companies which carry on manufacturing or mining business and which are required to maintain Cost Accounts under Section 209(1)(d) of the Companies Act and are asked to get their accounts audited under Section 233(B) by the Central Government.

3. The audit examination of financial accounts is not as detailed as that of cost accounts. In case of statutory cost audit, the cost auditor has to furnish details in the annexure along with Cost Audit Report.

4. In financial audit, the auditor is required to report on the Profit & Loss Ale and the Balance Sheet whether they exhibit a true and fair view of the state of affairs of the company. In the cost audit, the auditor has to report whether company’s cost accounting records have been properly kept as to give a true and fair view of the cost of production, processing,
manufacturing or mining activities, and the marketing of the product under reference.

5. The financial auditor is required to examine that the business transactions have been recorded correctly but the cost auditor has also to see that inventory management and control, inventory limits, E.O.Q. etc., have been properly adhered to.

6. The financial audit is not so much related to decision-making aspects as the cost audit is related. The cost auditor points out errors and irregularities in managerial decision-making.

7. The financial auditor has to verify the correct valuation of the closing stocks but the cost auditor has also to see that there is sufficient closing stock to meet the needs of the manufacture.

8. The financial audit exhibits whether correct profits have been arrived at or not but in cost audit, the possibility of earning more profits are explored and advice is made available for the future for better results on the basis of previous records and experiences.

9. Financial audit is conducted at the instance of owners of the business but cost audit can also be done at the instances of Government, Banks and Investors, Industrial Tribunals and Customers, etc.

10. Financial audit is concerned with the financial aspects but the cost audit is more related to cost aspects. The cost auditor has to examine carrying and non-carrying costs, engineering and works studies, variances, budgetary control and ratio studies, etc.
2.3 Objects or Functions of Cost Audit

The objects or functions of cost audit are the following:

1. To check accuracy of cost accounting records and to verify that they have been maintained in accordance and in conformity with the cost accounting principles.

2. To verify that the management is adhering to the accepted procedures and processes of cost accounting.

3. To detect errors and defalcations, if any.

4. To see how far the present practices of maintaining cost records, submission of reports and returns are helpful and adequate. Changes may be suggested where necessary to make them more meaningful and decision oriented.

5. To pinpoint the deficiencies or the inefficiencies in the use of materials, labour, and machines and to assist the management thereby.

6. To verify that the cost has been ascertained correctly and rightly presented.

7. To see that the cost control and cost reduction programmes have been rightly enforced.

8. To examine whether the expenditure incurred upto date is within the budget-estimates and standards determined.

9. To find out the return on capital and see whether it matches with the estimated revenue and profits.

10. To guide the management by giving positive suggestions to improve the working of cost accounting department.
11. To see whether the principles of costing has been followed.

2.4 Advantages of Cost Audit

The advantages of cost audit are the following:

(A) To the Management

1. It brings to the knowledge of management the errors, defalcations, frauds and inconsistencies.

2. The management feels assured that its cost accounting is true and fair and any decision taken on the basis of audited accounts would be fair.

3. The audited accounts become reliable for cost reports and for dealing with Government and other external parties.

4. Audit suggestions make the management cost conscious, and future plans and policies can be drawn in a better perspective.

5. It helps the management to reduce costs and control costs in a more effective way.

6. It leads the management to initiate action to avoid abnormal wastage in the usage of materials and labour hours. The labour efficiency is increased, capacity is better utilized and profitability increased.

7. Audited cost accounts are useful for inter-firm comparison.

(B) To the Shareholders

1. Cost audit inculcates a sense of goodwill and faith towards the company’s production management and marketing management in the minds of the shareholders.
2. As the cost audit examines the valuation of closing stocks and work-in-progress, the shareholders feel satisfied with the profit shown by the company, on this account.

3. The external audit brings to the knowledge of the shareholders the efficiency of the management, proper utilization of man, material and resources, productivity and weak good points of organisation.

(C) To the Costing Department

1. Cost audit exercises good moral influence on the staff of costing department.

2. It keeps the books of accounts and records up-to-date.

3. Suggestions by the auditor improve the routine and procedures of the department.

4. A clean audit report enhances the prestige of the cost accountant and his department.

5. It improves cost accounting methods and internal checking system.

(D) To the Government

1. It helps the Government in price fixation and price control.

2. In matters of tariff protection to certain industries, audited cost accounts present reliable cost structure to the Governments.

3. In cost-plus contracts, entered into by the Government with the private firms, the correct costs can be ascertained and payment of bills is made readily.
4. Country's economic planning based on production, imports, exports, etc., can be better decided on the basis of audited cost data.

(E) To the Statutory Audit

1. The statutory auditor is generally relieved of his responsibility towards the checking of accounts to the extent the internal Cost Auditor has checked them.

2. The statutory auditor can safely pay his attention to the matters which are related to the objects of his audit.

2.5 Aspects or Scope of Cost Audit

There are two main aspects of cost audit—(1) Propriety Audit, and (2) Efficiency Audit.

1. **Propriety Audit**: It has been defined as “audit of executive action and plans bearing on the finance and expenditure of the company”.\(^2\)

This audit is related to the propriety, i.e., fitness or rightness of the expenditure made. An expenditure may have been sanctioned and it may have been supported by the vouchers, yet the propriety audit has to satisfy whether or not the expenditure made was appropriate to the circumstances of the case and that there could not have been a better alternative. So this audit is concerned with the audit of such actions of the executives as have a bearing on the finances and expenditures of the company or concern.

The cost auditor, under propriety audit, has to ensure that:

(a) the expenditure has been planned in a way as to give the optimum results;

\(^2\) *Management Accounting, Feb., 1965*
(b) the planned expenditure its size and channels have produced the optimum results; and

c) there is no other better alternative to the expenditure made and results obtained.

2. Efficiency Audit: This is also known as 'Performance audit' and is related to working efficiency of the cost-plan. It has to be seen whether the plan has been executed efficiently or not and for this the results obtained are to be judged. For example, the budget is a plan and the efficiency audit would determine whether the expenditure is incurred according to the budget and the results obtained are also in accordance with the budget, or not. The emphasis is on the point that:

(a) every unit of money invested must give the optimum or the best result,

(b) the investment made in different types and areas is balanced and optimum.

'The Management Accounting' defines Efficiency audit as the audit which ensures the application of the basic economic principle that resources will flow into the most remunerative channels.

The Efficiency audit is based on determining the working efficiency of the enterprise and so it is related to the examination of aspects like inventory control, productivity, utilization of installed capacity, cost control, profitability, etc.
2.6 Types & Classification of Cost Audit

Types of Cost Audit

Following are the types of cost audit:

1. **Cost Audit on behalf of Management**: Audit may be instituted by the management for its own satisfaction. The purpose of this audit is to provide correct and reliable cost information to management for taking managerial decisions and to ensure that the costing department is functioning according to the plan. In this audit, the cost auditor helps the management in several ways by pointing out the drawbacks of the system and suggesting ways and means to control and reduce costs. The errors are corrected and defalcations are prevented.

   The Cost Auditor is appointed by the management for this audit.

2. **Statutory Audit**: Under Section 233B of the Companies Act, 1956, sub-section 1, it has been laid down that where in the opinion of the Central Government it is necessary so to do in relation to any company required under clause (d) of sub-section (1) of section 209 to include in its books of account the particulars referred to therein, the Central Government may, by order, direct that an audit of cost accounts of the company shall be conducted in such manner as may be specified in the order, by an auditor who shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1956.

3. **Cost Audit by the Government**: Besides the Statutory audit, the audit can be instituted by any Government—Central or State—for the following purposes:

   (a) to ascertain cost of production and marketing in case of industries to
- whom financial assistance in the form of subsidy, grant-in-aid, lower or free rates of taxes, etc., is to be provided,

(b) to ascertain costs in order to fix maximum prices of products,

(c) to ascertain cost of contracts to be given to contractors under Cost-plus contracts, and

(d) to fix limits of loans to be advanced by financial corporations, small scale industries, and banks to different industries, on the basis of production costs.

4. Cost Audit by Contractees: Where it is decided by the contractee with the contractor that the contractor would be paid the cost of the contract plus fixed percentage of profit, as in case of ‘Cost-plus’ contracts, the audit is instituted by the contractee to ascertain correct cost of the contract. Similarly, where a contractor appoints sub-contractors on the basis of cost and profit basis, the contractor institutes cost audit of the accounts of sub-contractors to settle payments.

5. Cost Audit by Tribunals: To settle labour disputes on wages, bonus, profit sharing, etc., the Tribunals may ask for cost audit of the concerned businesses. Similarly, Income-tax Tribunals may direct cost audit for assessment of tax based on profits of a manufacturing concern.

6. Cost Audit by Trade Associations: In the case of concerns of similar nature costs are compared with each other under Uniform Costing or Inter-firm comparison by Trade Associations. Trade Associations want to know costs to seek concessions from the Governments in the gestation or take-off periods of certain concerns, and for that purpose, cost audit is required.
2.7 Classification of Cost Audit

Cost audit can be classified as (i) Internal audit & (ii) External audit.

(i) Internal Audit: Audit may be external, i.e., conducted by outside parties or it may be internal. Internal audit is done by the auditor who is in the employment of the business, with the help of his departmental staff. The objectives and scope of internal audit differ from concern to concern depending on the requirements of the managements. The objectives of internal audit are the following:

(a) to ensure that the business is being run according to plan;
(b) to verify the correctness of accounts by vouching;
(c) to check that the budgets have been prepared correctly;
(d) to detect errors of omission, commission, and errors of principle, and to prevent frauds and defalcations
(e) to check that forms and documents are executed regularly and submitted punctually;
(f) to ensure that accounting is done daily, as per schedule;
(g) to check whether the routine and procedures are being following as per cost plan;
(h) to detect weaknesses of the system and remove them;
(i) to see that there is no communication gap between top management and the executives; the business policy and instructions are communicated to the workers as scheduled and the managerial reports are submitted in time to the management;
(j) to verify the inventory control and check physically the stocks;

(k) to compare the costs of products from period to period, analyse the causes of variations and suggest ways and means to reduce and control costs; and

(l) to affect moral check and improve efficiency.

(ii) External or Statutory Audit: The external audit is conducted with a particular object in view, by the outside auditors, and thus has a limited scope. It may be conducted by the Tribunal, Government, Contractee, or Trade Association, but in each case the object is specific and limited. The external auditor is not an employee of the company but an outside party and he is responsible not to the company but to his appointing authority to whom be submits his report.

2.8 Technique and Procedure of Cost Audit

In order to reap the benefit of cost audit, it is necessary that it should be done in its entirety and should be continuously done. Before commencement of audit, the costing method and technique adopted should be examined. The list of various sheet, documents, schedules, statements etc. related to cost and cost records and books should be obtained. It should be examined whether the work of internal control is effectively being done. It should also be seen that what is the object for conducting the audit, and scope of audit, nature and size of business. In case if the size of the business is very large, then the function of bookkeeping and accounting and internal control system should be very effectively organized.
After examining the above aspect, the cost auditor makes his cost audit programme which is similar to financial audit. The work of vouching, checking and ticking is similar to financial audit.

Generally, the technique of cost audit should be as follows:

(1) All the receipts and payments should be vouched i.e., each transaction should have a voucher, so as to verify the reliability of transactions.

(2) All the calculations, postings should be verified. For this special tick mark should be adopted. If the work is more and time is less then test check should be applied.

(3) The items of suspense account should be examined very carefully. All the adjustment entry should be well examined.

(4) The comparison of actual data with budgeted data should be made and any variance should be carefully analyzed.

(5) As regards to technique the following points are to be considered:

   (i) Physical Examination,

   (ii) Physical Count,

   (iii) Confirmation,

   (iv) Examination of original document,

   (v) Scanning,

   (vi) Enquiry.

(6) He should note down all those points in his note book which he considers reasonable.
2.9 Cost Audit Plan and Programme

While planning the cost audit, the following points should be taken into consideration:

(i) The type of the organisation,

(ii) The object of the proposed audit,

(iii) The system of cost accounting, routine and procedures adopted in the organisation,

(iv) Financial years for which audit is to be undertaken and the time allowed for completion of audit,

(v) Internal checks applied,

(vi) Extent of audit required, whether complete or partial, areas to be covered, volume of transactions, etc.

The procedure and programme for cost audit should be recorded in Audit Manual and the following points should be examined by the cost auditor:

1. Materials

(i) Inventory Control—size, maximum and minimum stocks, material limits, Re-order points, Safety stocks, A B C Analysis, etc.

(ii) Purchase schedule—Selection of Suppliers, approval of quotations, Terms of supply, Order placing and follow-up. Economic Order Quantity, Carrying and non-carrying costs, Lead Time, etc.

(iii) Receipt of materials and storage—Receipt, inspection, approval or rejection of material received, use of forms and documents with proper authorization, Bin cards, Stores Ledger, their reconciliation, etc.
(iv) Perpetual inventory system, physical stock checking and accounting for differences.

(v) Dictation and prevention of pilferage or loss of stocks. (vi) Issue of materials from stores to workshops or departments, authorization of Stores Requisitions, Weighing system, checking of weighing balances and measurements.

(vii) Checking of materials transferred from one job to the other or materials returned to stores, with the relevant documents and entries made in the cards and accounts.

(viii) Method of pricing the issues—whether it is in accordance with the system approved.

(ix) Wastage, scrap, spoilage and defectives—whether they are in reasonable limits, their Reports should be examined.

(x) Correct valuation of closing stocks and work-in-progress.

(xi) Accounting of materials received, issued, transferred, returned, etc. and accounting of materials consumed by jobs, products, etc., should be examined.

(xii) Budgetary control for materials and variances from standards should be examined for material cost control.

2. Labour

(i) Application of labour cost control factors and devices and optimum utilisation of labour, by production planning, budgets, standards, performance-reports, and study of effective wage policy.
(ii) Method of selection, appointment, and discharge; Labour turnover, and functioning of Personnel department.

(iii) Labour efficiency and productivity and their comparison with the standards fixed.

(iv) Standards fixation—whether the standards are attainable or not.

(v) Time-keeping system and correct booking of labour cost with regard to job/time cards.

(vi) Preparation of wage sheets and examining that correct wage amounts are disbursed to right workers and no frauds are perpetuated by inclusion of names of dummy workers.

(vii) Idle time and over-time—their control and treatment in accounting.

(viii) Forms, cards, sheets and other documents used for time-keeping, time-booking, and wage-payments should be properly authenticated and checked.

(ix) Wage-policy and method of remuneration—whether the system is working satisfactorily to the benefit of management and labour.

3. Overheads

(i) Proper classification of overheads into factory, administration, selling and distribution should be examined.

(ii) Allocation, apportionment and absorption of overheads on sound bases should be ensured.

(iii) Preparation of overhead budgets, comparison of actual with the budgets and standards, and analysis of variances.
(iv) Comparison of overhead expenditure to the volume of production.

(v) Correct allocation of overheads to the work-in-progress.

(vi) The method of charging depreciation should be carefully examined.

(vii) Treatment of items of overhead, e.g., factory rent, interest on capital, discounts, etc., should be examined whether they are treated on sound and accepted principles.

(viii) The administration, selling and distribution overheads require different treatment from factory overheads, in respect of their allocation and apportionment. Their proper accounting should be ensured.

4. Work-in-Progress

(i) Work-in-progress is to be valued at cost. It should be physically checked and verified with the incomplete work cards and records and correctly valued.

(ii) Regarding valuation, it should be examined that the practice of valuing it at Prime cost or at Factory cost is uniformly adopted.

(iii) The equivalent production units of the work-in-progress are correctly worked out.

(iv) The work-in-progress is within reasonable limits as compared to finished products.

5. Capital Expenditure

(i) It has to been seen that this expenditure is incurred according to the Capital Budget.
(ii) Investments in new plant or machinery or building should be made after proper cost-decision, and the cost-decision need be verified by the auditor.

(iii) Correctness of expenditure made and its accounting should be verified with the help of vouchers and order placed.

(iv) Provision of depreciation, repairs and maintenance should be examined.

(v) The purchase cost, transport charges, installation expenses, etc. are to be capitalised which the auditor should see.

(vi) The Plant & Machinery Register should be checked to see that full record has been kept for each plant or machinery separately.

(vii) All fixed assets should be physically verified.

(viii) It should be examined that the old assets have been discarded or sold with proper authorization.

6. Capacity Utilization

(i) There should be optimum utilization of the plant, machinery and other assets.

The auditor should examine the idle capacities and enquire into the causes of non-utilization.

(ii) The volume of production and machine hours utilized on that production should be checked in relation to each other.

The Cost Auditor should examine the above points mentioned under sub- heads carefully for completed audit. He should take note of the discrepancies and remove his doubts.
It is essential that before audit is started, all the books of accounts and records should be posted up to-date and vouchers filed serially. All relevant documents and information's should be made available to the auditor and full cooperation extended to him by the staff.