CHAPTER – VII
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REVIEW OF LITERATURES
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Review of Relevant Literatures: Cost Audit Practice in India-A Case Study of Coal India Limited

A number of studies related to cost audit practice in India have been conducted in various industries. Some of the main findings are discussed herewith.

"Cost audit mechanism under the Companies Act, which is a measure of efficiency and performance and Corporate Social Responsibility can serve as an important tool for effective enterprise governance. Clause 49 of SEBI guidelines on Listing Agreements speak about performance monitoring. It is required to be amended to focus and to conform to the cost audit structure so that companies report on the efficiency performance in greater detail enabling the stakeholders to make better evaluation. Cost audit provisions can also help an enterprise to achieve management maturity. An appropriate cost management system is required in all business units to remain competitive and the government should ensure through a legal framework that such a cost management system is in-built in the governance structure of every company. The ministry of corporate affairs constituted an Expert Group to review the existing mechanism of statutory cost accounting records and cost audit.

The Group has redefined the cost audit objectives focusing on the efficiency review aspect making the entire mechanism a value-adding exercise without losing the legal backup and the mandatory force it gives
for compliance and has aligned the same with cost management and better enterprise governance.”¹

The group, in its report submitted in December, 2008, has recommended a radical shift of cost accounting records and cost audit from being compliance- or rule-based governance to performance management framework with focus on three key objectives viz. enterprise governance, competitiveness and strengthening the regulatory mechanism. These recommendations acquire great significance in the current context of governance failure. Cost audit methodology as structured originally under Section 233B and the existing Cost Audit Report Rules, is proposed to be realigned with the cost management perspectives.

According to Isaac M. Marks “Routine audit of clinical outcome and its cost is rarely done because agreed measures are lacking and it takes training and effort. Computerization of clinical benefit-cost audit can speed the process of data collection, aggregation and analysis. Use of a pilot system of this kind is described over four years, with 550 patients and 63 clinicians. Although many problems had to be overcome in computerizing an audit approach already long-familiar to staff in its paper-and-pencil form, use of the pilot computerized audit system still saved time. Results highlighted intriguing issues in clinical benefit-cost audit of mental health care. A new and more robust computerized clinical audit system suitable for dissemination has now been developed.”²

¹ Institute of Cost and Works Accountants of India
² Journal of Mental Health, Volume 4, Issue 1 February 1995, pages 63 - 70
“This study examines the cost of the new internal control audit required by the Sarbanes-Oxley Act of 2002 (SOX) for a sample of Fortune 1000 companies. The average audit fee increase from 2003 to 2004 of $2.3 million is significant and is primarily attributable to the new SOX audit. SOX audit costs appear to be based on company size, asset growth, and the effectiveness of internal controls in addition to the 2003 financial statement audit rate. Specifically, the SOX audit costs increase with size, but the SOX audit unit costs vary inversely with size. This inverse relationship is consistent with larger companies benefiting from returns to scale and smaller companies spending fewer resources on internal controls and being more likely to have material weaknesses in internal controls. The positive relationship between SOX audit costs and asset growth supports the notion that rapidly growing firms may not be able to update their internal control systems in a timely manner and, therefore, may be more likely to experience internal control weaknesses. Firms that reported ineffective internal controls experienced higher SOX audit costs than those that reported effective internal controls. We also find evidence that financial services firms paid significantly lower SOX audit rates and electronic equipment and electronics firms paid significantly higher SOX audit rates than firms in other industries.³

“According to Monir Zaman Mir Journal “cost audits as governance mechanism affected the trust of the users of financial statements and whether they provide the benefits intended by regulators.

³ SOX Costs: Auditor Attestation under Section 404, Susan W. Eldridge, University of Nebraska at Omaha - Department of Accounting, Burch T. Kealey, University of Nebraska at Omaha, June 13, 2005, M41, M49, G34, G38
The research method involved unstructured open-ended face-to-face interviews with cost auditors in practice, mid-to high-level accounts and finance executives of companies and investors. Twenty-three interviews were conducted over a five-week period from December 2004 to January 2005 in Kolkata city of India.

The selection of respondents was purposive, to explore the attitudes of these three groups towards mandatory cost audit. Mandatory cost audit in India has not enhanced the level of trust of investors and preparers of financial statements also have the opinion. It has not brought those benefits expected by regulators. It is suggested following the findings of this paper that future research should carefully consider the usefulness and cost and benefit aspects of the mandatory cost audit in India. This is a pioneering study providing an in-depth analysis of mandatory cost auditing in India. Affected the trust of the users of financial statements and whether they provide the benefits intended by regulators.  

"In this research work, Robert Williams demonstrates how such a cost audit can identify the major factors affecting costs, and makes some practical suggestions towards their reduction. What appears on the following pages was delivered in an extended form to a recent conference in London of the Institute of Practitioners in Work Study, Organisation and Methods."  


"Researchers have brought to light varied issues concerning cost audit practice in India. James L. Boockholdt, and D. R. Finley University of Houston have worked on a minimum-cost audit sampling methodology under conditions of predetermined beta risk which explain that a minimum-cost methodology for determining a statistical sampling plan in substantive audit tests. In this model, the auditor specifies \( \beta \), the risk of accepting an account balance as correct when it is not, according to audit evidence requirements. Using \( \beta \) as a constraint, the auditor then selects a sampling plan to optimize the trade-off between sampling costs and the costs of follow-up audit procedures. Tables to aid in this process and an illustration are provided."\(^6\)

"The paper Mandatory Cost Auditing in Bangladesh: Some Policy Options examines the significance of cost auditing. It employs a qualitative study based on secondary sources of data. We find that cost audit is an important phenomenon to enhance shareholder value through minimization of wastages, misappropriation and inefficiency. Proper cost audit enhances overall welfare of the consumers by helping them provide products and services at the minimum cost. However, there is different opinion on its net benefit."\(^7\)

"The research explain that the use of undergraduate accounting students to assist the one-person internal audit department at Wright State University in Dayton, Ohio, in conducting a low-cost audit of the school.

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7. Mandatory Cost Auditing in Bangladesh: Some Policy Options, ATM Tariquzzaman, Mohammad Abu Yusuf and Sabina Yasmin
The audit, conducted as part of the accounting department’s Auditing II course, helped students develop interviewing and documentation skills and professional ethics.\(^8\)

"According to Ashish K Bhattacharyya "Regulations regarding maintenance of cost accounting records and cost audit are likely to change. If the recommendations of the expert committee appointed by the Ministry of Corporate Affairs are accepted, all manufacturing companies with a paid-up capital of Rs 50 crores (500 million) or more will be required to get their cost accounting records audited by a statutory cost auditor. They also question the justification for government intervention. It is the time to debate these issues."\(^9\)

It is well established that a robust management accounting system is the backbone of enterprise governance. But, unfortunately, India is not at the highest maturity level of management accounting practices. According to a survey, India is at the maturity Level II, which is above the lowest level (Level I) but below the highest level (Level III). This implies that, in India, all the players are not conscious about their responsibilities; and a well-developed self-discipline mechanism, which is necessary to achieve the objectives of the whole economy and as well as those of stakeholders, does not exist. At this stage government intervention is necessary to strengthen management accounting practices. It may be withdrawn later when India reaches Level III.

\(^8\) Lightle, Susan S.; Timm, Teresa, Business Officer, v30 n11 p58-63 May 1997

\(^9\) Cost Audit: expert body’s advice can be considered, Ashish K Bhattacharyya / May 31, 2010, 0:37 IST
There is a view that cost audit does not add value. It presents the information, which is already being used by managers, in a prescribed format. It does not provide any additional input that has the potential to improve decision making. This argument is flawed. Audit of any kind creates value by providing a reasonable assurance that important matters correspond to pre-set criteria. For example, internal audit provides an assurance that the risk management system is adequate and effective. It is inappropriate to expect something beyond that from statutory cost audit.

Those who do not support statutory cost audit build their argument as follows. Management accounting system fulfils information needs of managers, who pursue the goal of creating shareholder value. Managers are keen to strengthen the competitive position of the company thorough innovations, both continuous and revolutionary. Continuous improvement in the product quality and attributes, and elimination of wastes in business processes are norms rather than exceptions. Therefore, they have a vested interest in the management accounting system. The board and the management design and implement internal control system to ensure that the management accounting system is adequate and effective. Therefore, statutory cost audit is redundant.

If, the above is a valid argument, statutory audit of financial statements is unnecessary. This is so because the board, by designing and implementing an appropriate internal control system ensures that financial accounting records are accurate and complete and that financial statements provide a true and fair view. Therefore, statutory financial audit is redundant. All will agree that this is a foolish argument. This is
foolish because statutory financial audit adds credibility to the information provided through financial statements. Withdrawal of the system of statutory financial audit will reduce the confidence of shareholders in this information and the cost of capital will increase. Therefore, there is a business case for statutory financial audit.

Till recently, financial statements were at the centre of annual report. But things have changed. Shareholders and other stakeholders seek the information which is being used by the board of directors in directing and controlling the company. This is evidenced by the segment reporting requirement under GAAP. Companies are meeting those needs by disclosing additional information in the annual report (e.g. in board of director's reports, MD&A, and through voluntary disclosures) or in guidance to analysts. Audit of such information is beyond the scope of the statutory financial audit.

Therefore, it is considered that the creditability of the additional disclosures is lower than the credibility of financial statements. Cost audit will indirectly add credibility to such additional disclosures because most of these are captured by the management accounting system. Moreover, cost audit will provide an assurance to stakeholders that the company has a world class management accounting system to support enterprise governance. This will reduce the cost of capital. Therefore, there is a business case for statutory cost audit, which is as strong as the business case for statutory financial audit.

"While financial audit serves the interest of the shareholders, we need cost audit for catering to the needs of the Government, the regulatory

Describing ‘statutory cost audit’ as a unique legislative innovation of India, the foreword by K. K. Sarkar emphasizes that cost audit is not just for fulfilling the requirements of a ‘control and command economy of the past.’ It is essential for cost effectiveness and economic efficiency of organizations that is key for survival and prosperity in a globalised and liberalized competitive world, he reasons.

The publication traces the debut of statutory cost audit to 1965, when the Companies Act was amended to introduce Section 209(1)(d) for statutory maintenance of cost records in selected industries and their audit under Section 233B. “In the mid 1960s and 70s, in line with the prevailing industrial policies, statutory cost audit served the cause of the public sector, for administered pricing as well as optimum utilization of resources initially financed by the state exchequer.”10

The authors aver that the debate on the utility of cost audit reflects the conflict between the owners and other stakeholders, between the short-term and long-term interests. Cost audit can play a useful role by converging the society’s goals with those of the management, in the interest of better resource utilization, the publication notes.

The 13-member expert group comprising representatives from three accounting institutes -- ICWAI, ICAI and ICSI -- industry body CII and market regulator SEBI, have recommended that all companies whose

turnover is more than Rs 50 crore should be mandated to maintain cost audit books. At present, companies engaged in only 44 products, including paper and sugar, need to get their accounts cost audited.

"We have recommended not going for 44 products. Make it compulsory for all industry, with exception to small companies with a threshold limit of Rs 50 crore turnover, make all, including goods, services and infrastructure compulsory to maintain cost accounts," ICWAI President and member of the expert group G Venkataraman told PTI. In it’s over 890-page suggestion, the group also mentioned that companies should be allowed to maintain their own cost accounting standards rather than designing it on a rule-oriented format. "We have given 39 recommendations on cost accounting standards, like the financials for every cost account written by the firms, a definition should go with it," the Institute of Cost and Works Accountant of India (ICWAI) president said.

For example, if a the cost accounting is about a material manufactured, then the company will have to mention as to what the material consists of and what is the percentage of the composition, Venkataraman elaborated. This, he added, would bring in clarity in the cost accounting books. Further, Venkataraman said ICWAI is working on converging cost accounting standards with the International Financial Reporting Standards (IFRS) by 2011.

"Not just accounting, but costing norms too would be merged with international standards by 2011. The ICWAI is preparing the roadmap for the amalgam of cost accounting standards with IFRS," The newly-
appointed head of the cost accounting regulator feels that with the marriage of Indian accounting norms with the international standards, the practice would become more efficient.\(^\text{11}\)

"The government may examine the cost of production and profit margins of public and private sector companies building highways, airports, container terminals, ports and other infrastructure projects by bringing them under compulsory cost auditing, a move aimed at hiking efficiency levels in the crucial sector. As per the plan, infrastructure developers will have to keep detailed records of production cost and submit audit reports of the details as and when the government asks for them, said a government official, who asked not to be named."\(^\text{12}\)

The move to keep a close watch on how efficiently money is spent by infrastructure companies is significant considering the relatively easy credit availability and relaxations granted to the sector in recent months to fire up economic activity in the country. Spending Rs 20,000 crore more than originally budgeted to build roads, houses, urban facilities and irrigation network. The government is raising funds from the market through tax-free bonds to facilitate long-term loans to infrastructure projects. Through tax-free bonds, the government is supporting projects of a total cost of Rs 1,00,000 crore jointly executed by government and private developers. RBI also allowed developers of integrated townships to borrow from abroad as part of the second -

\(^{11}\) Cost audit of all manufacturers should be compulsory: ICWAI  
\(^{12}\) CMA-ICMAI DGM-Global Voice Business [Scorecard: 579]
economic stimulus package announced on January 2. For government-private projects, the government gives up to 20% of the total project cost to make them viable. The intention to extend compulsory cost auditing to infrastructure companies has been incorporated in the Companies Bill, 2008, which is being examined by a parliamentary panel before it is sent back to Parliament for clearance, said an official of the ministry of corporate affairs, who asked not to be named. The Bill also proposed to give freedom to the board of directors of companies to appoint auditors with shareholder approval. Now, government approval is required for the appointment of cost auditors.

Cost audit records comprise detailed records of materials, labour, utilities, overheads, depreciation, royalty, research and development expenses, incentives on exports, borrowing costs and inter-company transaction. The data is useful for companies to improve efficiency while government uses it for policy-making. Besides bringing infrastructure under the ambit of cost auditing, the ministry is also planning to recast the format of cost records to be maintained, for which it is expected to invite public suggestions soon. The Institute of Costs and Works Accountants, the regulator of cost auditors, recently submitted a concept paper to the government in this regard. The records of production have to be maintained by any class of companies engaged in production, processing, manufacturing or mining activities except the small-scale industries with turnover less than Rs 10 crore. The government has the power to ask the registrar of companies to inspect the books of a company if any discrepancy is noticed in the report.