

CHAPTER 16

Cost Audit

Question 1

For what purposes the Cost Auditor refers to financial records while conducting Cost Audit of an entity?

Answer

A cost auditor is ultimately required to express an opinion as to whether the company has maintained proper cost accounting records so as to give a true and fair view of cost of production, etc. In arriving at this opinion, the cost auditor is required to ascertain about multitude of information such as cost of raw materials consumed, cost of power, cost of stock, employer costs, provision for depreciation, royalty and technical payment, abnormal cost, scrap, fuel etc. Annexure to the cost audit reports require detailed information in respect of financial position including capital employed, net worth, profit, net rates, operating profit, unit cost of power and fuel, total wages and salaries, etc. It is obvious therefore that cost audit cannot be done without reference to financial books, more so in the context of the statutory requirement to have a statement of reconciliation with financial accounts as part of cost audit report. Further the cost statements also contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Cost Accounting Records Rules; Overhead expenditure also needs allocation between activities covered by rules and activities not so covered. Naturally this can be done only with reference to financial ledger. Under Part II of Revised Schedule VI to the Companies Act, 1956, quite a few matters which were to be mentioned in the Profit and Loss Account of the company are also to be covered in cost statements such as consumption of raw materials in quantity and value, sale of finished goods under classified headings in quantity and nature, actual production quantity of value, inventory in quantity of value for each class of goods, etc. A correlation between consumption of raw materials as per cost records and financial records may throw up the need for inquiry into errors, mistakes and manipulation. Material discrepancy between financial records and cost records will be highlighted in the reconciliation statement which would required that the cost auditor may examine deviation before reporting on the same. Thus it is imperative for the cost auditor to refer to financial records for conducting the cost audit.

Question 2

"Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme.

Answer

Matters to be included in Cost Audit Programme: It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit

programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately taken care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:

(a) Review of Cost accounting record: This will include:

- (i) Method of costing in use - batch, process or unit.
- (ii) Method of accounting for raw materials; stores and spares, wastages, spoilage defectives, etc.
- (iii) System of recording wages, salaries, overtime and spares, wastages, etc.
- (iv) Basis of allocation of overheads to cost centres and of absorption by products and apportionment of service department's expenses.
- (v) Treatment of interest, recording of royalties, research and development expenses, etc.
- (vi) Method of accounting of depreciation.
- (vii) Method of stock-taking and its valuation including inventory policies.
- (viii) System of budgetary control.
- (ix) System of internal auditing.

(b) Verification of cost statement and other data: This will mainly cover:

- (i) Licensed, installed and utilised capacities.
- (ii) Financial ratios.
- (iii) Production data.
- (iv) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads provision for depreciation etc.
- (v) Sales realisation.
- (vi) Abnormal non-recurring and special costs.
- (vii) Cost statements.
- (viii) Reconciliation with financial books.

Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.

Question 3

What are the advantages that accrue because of a Cost audit?

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Answer

Cost Audit will be advantageous to the stockholders in the following manner:

To Management -

- (i) Management will get reliable data for its day-to-day operations like price fixing, control, decision-making, etc.
- (ii) A close and continuous check on all wastages will be kept through a proper system of reporting to management.
- (iii) Inefficiencies in the working of the company will be brought to light to facilitate corrective action.
- (iv) Management by exception becomes possible through allocation of responsibilities to individual managers.
- (v) The system of budgetary control and standard costing will be greatly facilitated.
- (vi) A reliable check on the valuation of closing stock and work-in-progress can be established.
- (vii) It helps in the detection of errors and fraud.

To Society -

- (i) Cost audit is often introduced for the purpose of fixation of prices. The prices so fixed are based on the correct costing data and so the consumers are saved from exploitation.
- (ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.

To Shareholder - Cost audit ensures that proper records are kept as to purchases and utilisation of materials and expenses incurred on wages, etc. It also makes sure that the valuation of closing stocks and work- in-progress is on a fair basis. Thus the shareholders are assured of a fair return on their investment.

To Government -

- (i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.
- (ii) Cost audit helps in the fixation of ceiling prices of essential commodities and thus undue profiteering is checked.
- (iii) Cost audit enables the government to focus its attention on inefficient units.
- (iv) Cost audit enables the government to decide in favour of giving protection to certain industries.
- (v) Cost audit facilitates settlement of trade disputes brought to the government.
- (vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.

Question 4

Write a short note on - True and Fair Cost of Production.

Answer

True and Fair Cost of Production: A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking. The Cost Audit (Report) Rules, 1996 as amended in 2001, prescribe the rules regarding the cost audit report. The prescribed format of the report contains assertions regarding whether cost accounting records have been properly kept so as to give a true and fair view of the cost of production/ processing/ manufacturing/ mining activities and marketing of the product under reference. It may be noted that unlike in the case of audit of financial statements, the cost auditor does not have to state whether the cost statements reflect a true and fair view. In any case, the true and fair concept is known to us in the context of financial accounts. Based on that knowledge, it may be assumed that the following are the relevant considerations in determining whether the cost of production determined is true and fair:

- (i) Determination of cost following the generally accepted cost accounting principles.
- (ii) Application of the costing system appropriate to the product.
- (iii) Materiality.
- (iv) Consistency in the application of costing system and cost accounting principles.
- (v) Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents.
- (vi) Elimination of material prior-period adjustments.
- (vii) Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

Question 5

Write a short note on - Reconciliation of cost and financial accounts.

Answer

Reconciliation of Cost and Financial Accounts: A cost auditor is ultimately required to express an opinion as to whether the company has maintained proper cost accounting records so as to give a true and fair view of cost of production etc. In arriving at this opinion, the cost auditor is required to ascertain about multitude of information such as cost of raw materials consumed, cost of power and scrap fuel cost of stock, employer costs, provision for depreciation, royalty and technical payment, abnormal cost, etc. Annexure to the cost audit reports requires detailed information in respect of financial position including capital employed, net worth, profit, net rates, operating profit, unit cost of power and fuel, total wages and salaries etc. It is obvious therefore that cost audit cannot be done without reference to financial books, more so in the context of the statutory requirement to have a statement of reconciliation with financial accounts as part of cost audit

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report. Further the cost statements are to contain a summary of all expenditure incurred by the company and the share in such expenditure attributable to the activities covered by Cost Accounting Records Rules; Overhead expenditure also needs allocation between activities covered by rules and activities not so covered. Naturally this can be done only with reference to financial ledger. Under Part II of Revised Schedule VI to the Companies Act, 1956, quite a few matters which were to be mentioned in the Profit and Loss Account of the company are also to be covered in cost statements such as consumption of raw materials in quantity and value, sale of finished goods under classified headings in quantity and nature, actual production quantity of value, inventory in quantity of value for each class of goods, etc. A correlation between consumption of raw materials as per cost records and financial records may throw up the need for inquiry into errors, mistakes and manipulation. Material discrepancy between financial records and cost records will be highlighted in the reconciliation statement which would require that the cost auditor may examine deviation before reporting on the same. Thus it is imperative for the cost auditor to refer to financial records.

Question 6

What is the purpose served by Introduction of Cost audit?

Answer

According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:

- (i) verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing techniques and
- (ii) examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

The undenoted circumstances may warrant the introduction of cost audit:

- (a) **Price fixation** - The need for fixation of retention prices in the case of materials of national importance, like steel, cement etc. may be useful in knowing the true cost of production.
- (b) **Cost variation within the industry** - Where the cost of production varies significantly from unit to unit in the same industry, cost audit may be necessary to find the reasons for such differences.
- (c) **Inefficient management** - Where a factory is run inefficiently and uneconomically, institution of cost audit may be necessary. It may be particularly useful for the Government before it takes over any unit.
- (d) **Tax-assessment** - Where a duty or tax is levied on products based on cost of production, the levying authorities may ask for cost audit to determine the correct cost of production.
- (e) **Trade disputes** - Cost audit may be useful in settling trade disputes about claim for higher wages, bonus, etc.