16.1 Concept of Cost Audit

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:

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

It, therefore, means that the cost auditors attention and approach should be to see that the cost accounting plan is in consonance with the objectives set by the organisation and the system of accounting is geared towards the attainment of the objectives. A cost accounting system designed to exercise control over cost may be different from the one if the objective is to fix price. The cost auditor should examine whether the methods laid down for ascertaining expenses as direct or indirect are cases in point. The cost auditor should also establish the correctness or otherwise of the figures by the processes of vouching verification, reconciliation etc.

The origin of the concept of cost audit could be traced to the Second World War period when the practice of assigning cost plus contracts started. However, probably India is the only country in the “free” world where cost audit is statutorily prescribed. Cost audit can offer valuable assistance to the management in its decision making process since it ensures reliable cost accounting data and information. The management will be in a position to know what price is to be fixed for a product, whether the wastages are avoidable, whether to re-organise purchase or sales or inventory systems to make the work more efficient and so on. Existence of such a system of audit will also be of great use for maintaining internal control and internal check and can be an advantageous even to the statutory financial auditor. Cost audit, apart from having all the normal ingredients of audit namely vouching, verification etc. has within its compass elements of efficiency audit.

* Source of image: www.costaudit.org
16.2 Types of Cost Audit

Cost audit is basically carried out at the instance of the management for obvious advantages. Apart from this, different other circumstances also sometimes occasion audit of cost accounts. The different types of cost audit that we come across may be the following:

16.2.1 Cost audit on behalf of the management

The principal object of this audit is to see that the cost data placed before the management are verified and reliable and they are prepared in such detail as will serve the purpose of the management in taking appropriate decisions. The detailed objectives include-

(a) Establishing the accuracy of the costing data, as for example, cost of material used, allocation of wages into direct and indirect and on different products, functions and cost centres.

(b) Ensuring that the objectives of cost accounting are being achieved through appropriate collection, segregation, analysis and compilation of data.

(c) Ascertaining abnormal losses and gains along with the relevant causes, expressed in financial terms in a manner that the person responsible for such loss or gain is identified.

(d) Determination of the unit cost of production in a precise but practicable manner.

(e) Establishing proper overhead rates for absorption of overheads by various units of costs so that the cost is properly ascertained and there is no significant over or under recovery of expenses.

(f) Fixation of contract price and the determination of the additional or supplementary charge that can be raised against customers for alterations, etc.

(g) Improving the quality of cost accounting system by obtaining the audit observations and suggestions of cost auditor.

16.2.2 Cost audit on behalf of a customer

In case of cost plus contracts, often the buyer or the contractee insists on a cost audit to satisfy himself about the correct ascertainment of cost. More often than not, the provision, for a cost audit in such a circumstance is put in the relevant contract with the stipulation that the supplier or the contractor will extend all co-operation to the cost auditor. The cost of production arrived at for this purpose may differ from the cost of production ascertained for internal purposes.

16.2.3 Cost audit on behalf of Government

Sometimes, government is approached with requests for subsidies, protection, etc. Before taking a decision the government may prefer to have the cost of production of the product determined on the basis of cost audit to satisfy itself whether the need is genuine or the industry seeking assistance is generally efficiently run. The government, of its own also may initiate cost audit, in public interest to establish the fair price of any product.
16.2.4 Cost audit by trade association
Where activities of a trade association include maintenance of a price of the products manufactured by the member units or where there is pooling or contribution arrangements, the trade association may require the accuracy of costing information submitted by the member-units checked. The trade association may seek full information on the costing system, level of efficiency, utilisation of capacity, etc.

16.2.5 Statutory cost audit
This is covered by the provisions of section 148 of the Companies Act, 2013. Apart from the aforesaid types of cost audit, the undernoted 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.

16.3 Advantages of Cost Audit
Cost audit will prove to be useful to the management, society, shareholders and the government.

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<th>Advantages of Cost Audit</th>
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The advantages are as under:

16.3.1 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.

16.3.2 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.

16.3.3 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.

16.3.4 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.
16.4 Functions of Cost Auditor

The Institute of Cost and Works Accountants of India has detailed the principal functions of a cost auditor by way of comparison with the functions of the auditor of financial accounts. The principal functions of cost auditor, according to the aforesaid Institute are the following:

(i) **Inventory**
   
   (a) Is the size of the inventory adequate or excess compared with the production programme?
   
   (b) Is the provision most economical?
   
   (c) Does it ensure optimum order size?
   
   (d) Does it take into account the storage cost on the one hand, and carrying cost on the other?
   
   (e) Does it take note of lead time of the various items or groups of items?
   
   (f) Does the receipt and issue system cause any bottle-neck in production?
   
   (g) Does it involve too many forms and too much paper work?
   
   (h) Is there any room for reduction of inventory cost consistent with production needs?
   
   (i) Is the inventory as per the priced store ledger and as certified by the management physically correct?
   
   (j) Is the same amount of attention and care given to monies translated into material things like raw materials, stores and supplies of all kinds as given to liquid cash?
   
   (k) Does the issue of raw materials make the production in accordance with the standard or schedule or otherwise or covered by authorised schedule?
   
   (l) Is the expenditure of consumable stores within the standard? If not, why not?

(ii) **Opening and Closing Stocks** - The cost auditor will see the following:

   (a) that the opening stock is not unduly large compared with the volume of production during the year;

   (b) that the opening stock against various jobs really represents the actual physical stock in the production shop and is not merely an accounting figure;

   (c) that the responsibility of the shop foreman in-charge of the stock held in the production shop is clear and properly documented; that he maintains proper record of actual consumption vis-a-vis the actual withdrawal from the stock.

Valuation and correct indication of closing stock in the Trading and Profit and Loss Account and in Balance Sheet is equally important. The Cost Auditor will examine and certify:

   (a) that the physical verification is correctly carried out;

   (b) that the valuation is correct with reference to the actual cost of production and recognised policy for valuation;
(c) that volume of closing stock is commensurate with the volume of production and that it does not reflect any failure or bottleneck in sales budget or production budget;

(d) that the volume of unmoved stores is not abnormal in comparison with the normal rate of yearly consumption. The Cost Auditor will recommend disposal of such unmoved stores with consequent release of capital unnecessarily locked up to the advantage of the financial resources of the concern.

(iii) **Store Issue Procedure in Stocks** - The Cost Auditor will see:

(a) that withdrawal of materials or stores to production shop is scientific or covered by authorised schedule and permits receipt to be located;

(b) that there is no possibility of loss or pilferage of stock lying in the production section;

(c) that surplus materials and scraps arising in production shops are returned to stores correctly and without delay for which necessary credit is given to unit cost of production. If transferred to other jobs, proper transfer voucher has been prepared and copies sent to the accounts, stores, etc.

(iv) **Work-in Progress** - The Cost Auditor will see the following:

(a) that work-in-progress has been physically verified and that it agrees with the balance in the incomplete cost card;

(b) that valuation of the work-in-progress is correct with reference to stage of completion of each job or process and the value job cost cards or process cost sheet;

(c) that there is no over-valuation or under-valuation of opening work-in-progress or closing work-in-progress, thereby artificially pushing up and down net profits or net assets as the case may be;

(d) that the volume and value of work-in-progress is not disproportionate compared with the finished out-turn.

(v) **Labour** -

(a) Proper utilisation of labour and increase in productivity are now receiving attention, several productivity teams have emphasised importance of higher productivity. It is, therefore, essential to assess the performance efficiency of labour and compare it with standard performance, so that labour utilisation could be progressively improved. The labour force in Indian industries is generally very high compared to similar types of industries in other developed countries. Our aim should be to reach that level, though not immediately but over some time. A study of this nature would give an idea where the inefficiency lies so that timely and adequate steps could be taken to ensure maximum utilisation of labour to reduce labour cost.

(b) Cost of labour is allocated to different jobs with reference to time or job cards.
16.7 Advanced Auditing and Professional Ethics

(vi) **Capacity Utilisation** - The cost auditor will see:

(a) that the idle capacity in any production shop or of transport facilities for distribution is not excessive;

(b) that production volume and overall machine time utilised are commensurate. In other words, the machine hours utilised have given the optimum output.

(vii) **Overheads and indirect expenditure** - The cost auditor will see and certify:

(a) that allocation of indirect expenditure over production, sales, and distribution is logical and correct;

(b) that compared with the value of production in a production shop, overhead charges are not excessive;

(c) that actual indirect expenditure does not exceed budgets or standard expenditure significantly and that any variations are satisfactorily explained and accounted for;

(d) that the relation of indirect expenditure in keeping with the load on individual production shop is appropriate;

(e) correctness of appropriate allocation of overhead expenditure (both production and sales) will be certified by the cost auditor;

(f) that allocation of overheads between finished products and unfinished products is in accordance with correct principles.

Shortly we shall discuss in detail the aspects to be dealt with in the cost auditor’s report pursuant to the Companies (Cost Records and Audit) Rules, 2014. The aforesaid Rules have been issued pursuant to section 148 of the Companies Act, 2013 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

It may be noted that the requirement of the statutory cost audit in our Companies Act is something special, because statutes in most of the other countries do not contain a similar requirement. In most of the countries the concept of cost audit as such is also non-existent and the objectives, whatever they may be, are achieved by properly designing the scope and depth of internal audit.

The object with which the statutory requirement of cost audit has been included in the Companies Act can only be ascertained by a study of the cost audit report requirements. They include control over cost, wastage and losses, efficiency in the utilisation of human, material, and other resources, determination of appropriate selling price, proper maintenance of cost records appropriate use of the costing system, etc.

16.5 Programme of Cost Audit

The audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. However, the significant things that should not be missed are: proper vouching of expenses, capital and revenue character determination, allocation of expenses,
apportionment of overheads, arithmetical accuracy, the statutory requirements, examination of contracts and agreements, review of the Board’s and shareholders’ minute books to trace important decisions having bearing on costs, verification of title deeds and documents relating to properties and assets, etc. Cost audit, in order to be effective, should be completed at one time as far as practicable. The exact content of cost audit largely depends on the size of the organisation, range of products, production process, the existence of a well organised costing department and of a well designed costing system, and the existence of a capable internal auditing system. Other relevant considerations may be:

(a) System of cost accounting in vogue and the organisation of the cost department, forms, schedules, etc.

(b) System of internal check used in the organisation.

(c) Frequency of audits, areas to be covered, volume of transactions, efficiency of the internal check, needs of management, purpose of cost audit, its benefits, etc.

After considering the aforesaid factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Like every other audit, a systematic planning of cost audit routine is necessary.

Broadly speaking cost audit programme may be divided into the following stages:

(a) Review of Cost Accounting Records - 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.
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(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 statements and other data** - This will include the verification of:

(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.

16.6 Cost Audit under the Companies Act

It is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

Cost Audit is covered by section 148 of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143.

As per the section 148, the Central Government may by order specify audit of items of cost in respect of certain companies.

Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

However, the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

The Central Government has notified the Companies (Cost Records and Audit) Rules, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

**Maintenance of Cost Records**: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account.
These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006. The said rule has divided the list of companies into regulated sectors (Part A) and non-regulated sectors (Part B).

As per Rule 5 of the Companies (Cost Records and Audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year commencing, is required to maintain cost records in Form CRA-1. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

**Additionally, the auditor is also required to report as per clause (vi) to Paragraph 3 of the CARO, 2016, which is discussed below:**

“Whether maintenance of cost records has been specified by the Central Government under sub-section (1) of Section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.”

**Audit Procedures and Reporting:**

The Order requires the auditor to report whether cost accounts and records have been made and maintained. The word “made” applies in respect of cost accounts (or cost statements) and the word “maintained” applies in respect of cost records relating to materials, labour, overheads, etc. The auditor has to report under the clause irrespective of whether a cost audit has been ordered by the central government.

The auditor should obtain a written representation from the management stating:

(a) whether cost records are required to be maintained for any product(s) or services of the company under section 148 of the Act, and the Companies (Cost Records and Audit) Rules, 2014; and

(b) whether cost accounts and records are being made and maintained regularly.

The auditor should also obtain a list of books/records made and maintained in this regard. The Order does not require a detailed examination of such records. The auditor should, therefore, conduct a general review of the cost records to ensure that the records as prescribed are made and maintained. He should, of course, make such reference to the records as is necessary for the purposes of his audit.

It is necessary that the extent of the examination made by the auditor is clearly brought out in his report. The following wording is, therefore, suggested:

“We have broadly reviewed the books of account maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under section 148 of the Act, and are of the opinion that prima facie, the prescribed accounts and records have been made and maintained.”
Where the auditor finds that the records have not been written or are not prima facie complete, it will be necessary for the auditor to make a suitable comment in his report.

Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an auditor within one hundred and eighty days of the commencement of every financial year. **However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.**

The certificate to be obtained from the cost auditor shall certify that the-

(a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;

(b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;

(c) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and

(d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

Every referred company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in Form CRA-2, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

The cost auditor appointed as such shall continue in such capacity till the expiry of one hundred and eighty days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

**However, the cost auditor may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the cost auditor and recording the reasons for such removal in writing.**

It may be noted that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect.

**It may further be noted that the above provisions shall not prejudice the right of the cost auditor to resign from such office of the company.**

**Casual Vacancy in the Office of a Cost Auditor:** Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors
within 30 days of occurrence of such vacancy and the company shall inform the central
government in Form CRA-2 within 30 days of such appointment of cost auditor.

The cost auditor shall submit the cost audit report along with his or its reservations or
qualifications or observations or suggestions, if any, in Form CRA-3. He shall forward his "duly
signed" report to the Board of Directors of the company within a period of one hundred and
eighty days from the closure of the financial year to which the report relates and the Board of
Directors shall consider and examine such report particularly any reservation or qualification
contained therein.

*It may be noted that the Board of Directors shall approve the cost statements, including
other statements to be annexed to the cost audit report, for submission to the cost auditor
to report thereon, before they are signed on behalf of the Board by any of the director
authorised by the Board.*

**Duty to report on fraud:** The provisions of sub-section (12) of section 143 of the Companies
Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a
cost auditor during performance of his functions under section 148 of the Act and these rules.

**Cost Audit Rules not to apply in certain cases:** The requirement for cost audit under these
rules shall not be applicable to a company which is covered under rule 3, and,

(i) whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or

(ii) which is operating from a special economic zone.

(iii) *which is engaged in generation of electricity for captive consumption through
Captive Generating Plant.*

If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct
that the audit of cost records of class of companies, which are covered under sub-section (1)
and which have a net worth of such amount as may be prescribed or a turnover of such amount
as may be prescribed, shall be conducted in the manner specified in the order.

**Who can be cost auditor:** The audit shall be conducted by a Cost Accountant in Practice who
shall be appointed by the Board of such remuneration as may be determined by the members
in such manner as may be prescribed.

Provided that no person appointed under section 139 as an auditor of the company shall be
appointed for conducting the audit of cost records.

Provided further that the auditor conducting the cost audit shall comply with the cost auditing
standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost
and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959,
with the approval of the Central Government).

**Appointment and Remuneration of Cost Auditor:** As per rule 14 of the Companies (Audit and
Auditors) Rules, 2014

(a) in the case of companies which are required to constitute an audit committee-

   (i) the Board shall appoint an individual, who is a cost accountant in practice, or a firm
of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;

(ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;

(b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

Qualification, disqualification, rights, duties and obligations of Cost Auditor: The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

It may be noted that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

Submission of Cost Audit Report: A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in Form CRA-4 in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

If, after considering the cost audit report referred to under this section and the, information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

Penal Provisions in case of default: If any default is made in complying with the provisions of this section,

(a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147 (Section 147 is discussed separately in Chapter 6);

(b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147. (Section 147 is discussed separately in Chapter 6).
16.7 Steps in Cost Audit

Broadly, cost audit is comprised of three steps i.e., review, verification and reporting.

**Review** - Collection and assimilation of all the relevant information and technicalities about the industry is an essential prerequisite of cost audit. The review should cover the following aspects:

1. Nature of the industry - priority industry, export-oriented industry etc.
2. Production method/process.
3. Important raw materials and their sources.
4. Licensed capacity and installed capacity.
5. Method of costing in use.
7. Method of accounting of wastages, spoilages and rejections.
8. Records relating to jigs and dies.
9. System of wages, salaries & overtime payment including incentive schemes, if any.
10. Basis of allocation of overheads to cost centres and of absorption to products.
11. Method of allocation of service department expenses.
12. Treatment of interest on borrowings.
14. Agreement with collaborators or others for payment of royalty, its computation and payment.
15. Treatment of research and development expenses.
16. Accounting for sales and purchase - treatment with regard to sales tax, excise duty, etc.
19. Inventory valuation policy and method.
20. System of budgetary control.
22. State of internal control over cost accounts and cost accounting records.
24. Special cost accounting practice and methods peculiar to the industry under audit.

The cost auditor should familiarize himself with the memorandum and articles of association, past audit reports on the financial accounts, annual reports issued by the Board, the Chairman’s speech, etc. He should also thoroughly review the costing system in vogue in relation to the production process and method, and should have a detailed knowledge of the flow of the production process and the documents that arise or are received in that course. A list of the costing books of account maintained by client should also be obtained by the cost auditor so that he knows the purpose and contents of such books.

A detailed audit programme should thereafter be prepared so that the work to be done and the manner in which it is to be done are planned. Students already know the purpose, contents and utility of an audit programme in the context of audit of financial accounts. All these are equally applicable in case of cost audit. Also, the cost auditor should do recording of all relevant information about the client, his business, production process, unresolved queries and matters requiring follow-up or discussion in a properly organised audit note book and working papers. Here again the functions and utilities are the same as in the case of financial audit and note books and working papers can be maintained in the very same manner as in the case of financial audit.

It is definitely desirable that the cost auditor should plan his test checking on the basis of strict rules of statistical sampling so that he knows how much risk he takes in adopting test checks and how reliable would be the opinion that he will express. He should also carefully study and evaluate internal controls and their operation on the costing books and records before deciding in favour of test of cost audit and may defer the appointment of the cost auditor as much as it can and thereby reduce further the time available to him.

**Verification of cost statements and other data** - The examination of the cost statements and other records by the cost auditor will generally cover the following:

(i) Licensed capacity, installed and utilised capacities;
(ii) Financial ratios;
(iii) Production data;
(iv) Cost of raw materials consumed;
(v) Cost of power and fuel;
(vi) Employee costs;
(vii) Cost of stores etc. consumed;
(viii) Provision for depreciation;
(ix) Overheads and their allocation;
(x) Royalty and technical aid payments;
(xi) Sales relationships, local & export;
(xii) Abnormal, non-recurring and special cost;
(xiii) Cost statements;
(xiv) Reconciliation with financial books.

**Necessity to refer to financial records** - It is needless to mention that the cost audit programme should cover all the above and any other matter that the cost auditor considers necessary. It is also obvious that cost audit under the Companies Act cannot be performed without reference to financial books and records. This is simply for the reason that a apart from the requirement to have reconciliation between cost and financial accounts done. 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 Companies (Cost Records and Audit) Rules; overhead expenditure also needs allocation between activities covered by the rules and activities not so covered. Naturally, this can be done only be reference to the financial ledger. Expenses like salaries and wages may not be fully reflected in the cost statements and to ascertain whether appropriate charge has been made in the cost records, there would invariably be a necessity to refer to the full charge for salaries and wages in the financial ledger. Under the requirement of Part II of Schedule III to the Companies Act, 2013, quite a few matters are there which could be of direct relevance to the cost auditor - for example, consumption of raw materials, purchases of stock-in-trade, sales of products/services, changes in inventories in respect of finished goods, work-in-progress, stock-in-trade etc.

We can see from the above discussion that there exists quite a sizeable overlapping between the financial accounting records and cost accounting records. Effectiveness of both the audits, and specially cost audit, can be enhanced substantially if appropriate available data, and documents pertaining to the other field are kept in view while making audit verification. It may especially help the audit (cost and financial both) to locate errors, mistakes and omissions present in either set of accounts. If the cost auditor takes the pain of correlating the consumption of raw materials as appearing in the cost records with consumption disclosed in the financial records, he may be able to locate substantial errors either in cost records or in financial records. At least a material discrepancy between the two sets of consumption data will put him on special enquiry about the correctness of costing data and in these process errors in either may be established. Then comes the question: suppose he is convinced of the presence of a mistake in financial accounts after satisfying himself about the correctness of costing records, what he should do? He has no apparent duty to inform the auditor of financial accounts about the detection of the mistake. But nothing forbids him from asking the company to rectify the relevant cost statement where the complete financial data is compiled and allocated between activities covered by the Companies (Cost Records and Audit) Rules and other activities. Also, the reconciliation statement between costing and financial data will invariably contain indication of the discrepancy. Also he may bring the discrepancy to the notice of the management in writing and a copy of such communication may be endorsed to the financial auditor. In fact, no definite course of conduct has emerged as yet but it can be emphasised that the possibility of existence of mistakes in either record being located by the other auditor probably will lead to the
development of necessary rapport between the two auditors. It may be pertinent to note that both the auditors have access to the records in the other field under the authority of law and it is the duty of the each auditor to refer to them to obtain necessary audit evidence that may help him in the discharge of duties cast on him. The auditor of financial accounts examines various allocations of overheads etc. to ascertain whether financial data is at variance with costing data. This he should provide in his audit programme itself. However, it is doubtful whether the cost auditor's report will be made available to the financial auditor even though in great many cases cost audit would be over before financial audit. Further, the provisions related to duty to report on fraud under sub-section (12) of section 143 of the Companies Act, 2013 and the relevant rules shall also apply mutatis mutandis to a cost auditor during performance of his functions.

**Reporting** - After completion of audit of costing and other relevant records the cost auditor is to submit his report. A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein. If, after considering the cost audit report furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

**GENERAL FEATURES OF COST AUDIT REPORT -**

1. (i) I/We have/have not obtained all the information and explanations, which to the best of my/our knowledge and belief were necessary for the purpose of this audit.

   (ii) In my/our opinion, proper cost records, as per rule 5 of the Companies (Cost Records and Audit) Rules, 2014, have/have not been maintained by the company in respect of good(s)/service(s) under reference;

   (iii) In my/our opinion, proper returns adequate for the purpose of Cost Audit have/have not been received from the branches not visited by me/us.

   (iv) In my/our opinion and to the best of my/our information, the said books and records give/do not give the information required by the Companies Act, 2013, in the manner so required.

   (v) In my/our opinion, company has/does not have adequate system of internal audit of cost records which to my/our opinion is commensurate to its nature and size of its business.

   (vi) In my/our opinion, information, statements in the annexure to this cost audit report gives/does not give a true and fair view of the cost of production of good(s)/rendering of service(s), cost of sales, margin and other information relating to good(s)/service(s) under reference.

   (vii) Detailed unit-wise and product/service-wise cost statements and schedules thereto in respect of the product/service under reference of the company duly audited and certified by me/us are/are not kept in the company.
2. If as a result of the examination of the books of account, the cost auditor desires to point out any material deficiency or give a qualified report, he/she shall indicate the same against the relevant para (i) to (vii) in the prescribed form of the Cost Audit Report giving details of discrepancies he/she has come across.

3. The report, suggestions, observations and conclusions given by the cost auditor shall be based on verified data, reference to which shall be made here and shall, wherever practicable, be included after the company has been afforded an opportunity to comment on them.

16.8 Rights and Duties of Cost Auditor

The cost auditor enjoys the powers and has the duties as contained in the Companies Act, 2013 which is discussed under Para 6.8 ‘Powers/Rights of Auditors’ and 6.9 ‘Duties of Auditors’ of Chapter 6 ‘The Company Audit’.

16.9 True and Fair Cost of Production

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:

1. Determination of cost following the generally accepted cost accounting principles.
2. Application of the costing system appropriate to the product.
3. Materiality.
4. Consistency in the application of costing system and cost accounting principles.
5. Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents.
6. Elimination of material prior-period adjustments.
7. Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

The report of the cost auditor discussed above will be subject to the cost auditor’s observations and conclusions, if any. Also the report is subject to observations of the cost auditor on the various matters contained in the Annexure.

Under the Companies (Cost Records and Audit) Rules, 2014, an Annexure has been provided to be filled by the cost auditor and annexed to the report that he makes. The matters contained in the Annexure form part of the cost auditor’s report.

[Note: For detailed knowledge of Annexure to the Cost Audit Report, students may refer Form CRA-3 (Pursuant to rule 6(4) of the Companies (Cost Records and Audit) Rules, 2014)]