16
Cost Audit

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:

(a) verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing techniques, and

(b) 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.

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 Advanced Auditing and Professional Ethics

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 233B of the Companies Act.
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. 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?

(i) 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.

(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.

Presently we shall discuss in detail the aspects to be dealt with in the cost auditor’s report pursuant to the Cost Audit (Report) Rules, 1968 as amended in 1996 and again in 2001. These rules came into force from October 1, 2002. The aforesaid Rules have been issued
pursuant to Section 233-B (4) of the Companies Act which requires the cost auditor to make a report on the cost accounts and cost records maintained by the company.

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.

For determining the scope and extent of cost audit, the cost auditor will necessarily have regard to the relevant costing records required to be maintained pursuant to Section 209(l)(d) of the Companies Act, in respect of products manufactured by certain types of industries and the cost sheets prescribed. The records are broadly based on the elements of cost and, therefore, there is a great deal of similarity between the various records prescribed for various products. The cost sheets, however, vary from product to product, having regard to the nature of the product and the production process involved. The cost auditor will also have to pay special attention to the reporting requirements laid down under the Cost Audit (Report) Rules.

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 defects, 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 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 General Features of Cost Records

The following are the general features of cost records-

16.6.1 **Materials**: Under this broad head, records for raw materials, processed materials, consumable stores, etc, are to be maintained. Generally, these records are to show the materials purchased or procured, issue of the materials for production and the balance in quantities and amounts. The cost shall include all direct charges incurred upto the works. The issues should be identified with departments, cost centres and products. The material records should also include separate records for recording wastage, spoilage, rejections and losses in terms of quantity and cost, whether arising in transit, storage during manufacture or for other reasons. Sale proceeds of the waste materials, rejected materials and scrap should also be recorded and taken into account in determining the cost of production. The method followed
for adjusting the various losses should also be kept in record. Materials issued for capital projects should be properly indented and recorded.

If the value of materials consumed is determined on any basis other than the actuals, say on standard costing, the method adopted for such valuation as well as the method of reconciling such consumption with actuals and the treatment of variances, if any, should be kept on record.

16.6.2 Manufactured components and intermediates: With regard to components and intermediates manufactured by the company, separate records are required to be maintained showing the cost of manufacture of major components and intermediates. Records of quantities and values of manufactured components and intermediates along with the wastages, if any, are required to be maintained.

16.6.3 Stores and spare parts: Adequate records to show receipts, issues and balances, both in quantity and value, of various stores and spare parts required for repairs, maintenance and production are to be maintained. The value should include all direct charges, such as freight and insurance up to the works. The value of stores and spare parts used should be charged to the relevant heads, i.e., production or repair to plant and machinery, repairs to building or capital construction, if any; the value of stores charged to manufacture, should further be allocated to different departments or production units or cost centres, as may be appropriate. Any wastage, either in storage, transit or due to other reasons, should be shown separately. The method of dealing with such losses in the calculation of cost should be mentioned in the cost records.

16.6.4 Wages and salaries: Proper records should be maintained to show the attendance and earning of all employees and the departments and cost centres and the work on which they are employed. The records should show separately:
(a) overtime wages earned;
(b) piece-rate wages earned;
(c) incentive wages earned, either individually or collectively as production bonus or under any other scheme based on output; and
(d) earnings of casual labour.

Idle time is required to be separately recorded under classified headings, indicating the reasons. The cost records should also contain the method followed for accounting idle time payments in determining the cost of products.

The extent of wages and salaries capitalised, as additions to plant and machinery, buildings or other assets, should be accounted for under the appropriate capital heads. Care should be taken to exclude all wages and salaries that do not pertain to the manufacture of products covered under the relevant Cost Accounting Records Rules.

16.6.5 Overheads: In respect of overheads, the requirement is for a proper maintenance of records showing the various items of expenses comprising overheads. These expenses should be analysed and classified under the following heads:
(a) Works, 
(b) Administration, and 
(c) Selling and distribution.

Overheads often are general in nature in the sense that the benefit of the expenditure is enjoyed by various departments, products, cost centres and capital construction projects. Even within the company to which the Cost Accounting Records Rules apply, there may be products which are outside the ambit of the aforesaid Rules. Therefore, there should be proper and consistent allocation of overheads; firstly, on activities of capital nature, products or departments not coming within the purview of the Cost Accounting Records Rules and products covered by the Rules; thereafter the part of the overheads attributable to the product or products covered by the Rule should be apportioned to various departments, manufacturing units or cost centres otherwise than on the basis of actuals the method of reconciling such expenses with actuals, the variations, if any, and its treatment in determining the cost of manufactured product should be disclosed in the cost records.

16.6.6 Service department expenses including expenses on utilities: These include expenses incurred on power, fuel, water and steam produced or utilised for manufacturing operations, expenses on subsidized canteen, maintenance operations by a separate maintenance department, if any. Power, fuel, steam, water etc. may be purchased also by the company. Where these are purchased there should be proper records of units purchased, their rates and duties, if any. However, if power, water and steam is generated by the company itself, separate records should be maintained to show, in sufficient detail, the different items making up the cost of such power, water or steam produced and consumed. The records should be so maintained as would enable the assessment of consumption of the services by the different departments or manufacturing units. In cases, where allocation to various departments of manufacturing units is not made on the basis of the actuals, the basis adopted for such allocation should be indicated. Similarly, the expenses incurred on staff canteen or maintenance should also be apportioned on some reasonable basis and the same should be indicated in cost records.

16.6.7 Depreciation: Adequate records in respect of the depreciable fixed assets are required to be maintained showing the cost and other particulars of such assets. These records should inter alia indicate:

(a) the cost of each item of asset inclusive of installation charges;
(b) the date of installation;
(c) the rate of depreciation;
(d) the amount of depreciation provided.

In respect of those old assets, the original cost of acquisition of which cannot be ascertained without an unreasonable expenditure or delay, the valuation shown in the books on the first day of the financial year beginning on or after the commencement of the relevant Rules should be taken as the opening balance. It may be useful to note in this context that a manufacturing, mining or processing company is obliged to maintain records for fixed assets under the
requirement of the order issued by the Government under Section 227(4A) of the Companies Act. 1956. The company may usefully integrate these two requirements to avoid duplication. The basis on which depreciation is calculated and allocated to the various departments and cost centres and to the products should be clearly indicated in the cost records. The amount of depreciation charged should not be less than the amount chargeable under Section 205(2) of the Companies Act, 1956 (Students should refer to AS-6 as revised) and the depreciation allocated to the various departments should relate to the plant and machinery and other depreciable fixed assets used in the concerned department, etc. In case the amount of depreciation charged in the cost records in any financial year is higher than the amount chargeable under the aforesaid Section 205(2), the amount in excess should be disclosed separately in the records. The cumulative quantum of depreciation charged in respect of any asset in the costing records should be limited to the original cost of the concerned assets.

16.6.8 Packing: Proper records should be maintained showing the quantity and cost of various backing materials such as tin, cartons, gunny bags, etc. and for wages and other expenses incurred on packing size wise. Where packing expenses cover both products not included in the relevant Cost Accounting Records Rules and those included, the basis of apportionment of the total expenses incurred on packing between such products as are not included and the products covered by the aforesaid Rules should be clearly mentioned in the cost records and the basis should be applied consistently. Wastage, spoilage, rejections and losses of packaging materials, if any, should be indicated separately and the method adopted for adjusting these losses should be disclosed. Also, if any income is received by sale or disposal of these spoiled, rejected waste materials, the method of treating these recoveries in the determination of the cost of the product should be mentioned.

16.6.9 By-products: Proper records should be maintained for each item of by-product, if any, showing the receipts, issues and balances both in quantity and value. The basis adopted for valuation of the by-products should be equitable and consistent. Records indicating the actual sales realisation of by-products should be maintained. If any expenses have been incurred in further process of by-products, such expenses should also be separately stated. The treatment of realization of By-products in the determination of cost of main product should also be mentioned.

16.6.10 Production and Sales: Adequate records of production are required to be maintained in terms of value and quantity. If the goods are sold in packed condition then separate records of production of unpacked finished goods and packed finished goods should be maintained. These records should show all the receipts, issues and balances of goods produced by the company. The value should be based on the cost of production of the items concerned. The value of the issues and balances may, if the company so desires, be recorded monthly or at such shorter intervals as the company may decide. These records ipso facto will also constitute quantitative records of sales of the finished goods and inventory of the finished goods.

16.6.11 Inventories: Inventories may be classified as (a) raw materials; (b) stores & spare parts; (c) work-in-progress, and (d) finished goods. It may be observed that separate records to account for raw materials, spare parts and production in their balance column will have to
be maintained. However, separate records should be maintained for the work-in-progress showing the quantity and value at the end of the financial year (i.e. the period for which the costs are made up). Stock of all kinds should be physically verified and the stock verification records should be maintained in respect of all items held in stock, such as, raw materials, components, processed materials, packing materials, consumable stores, machinery spares, chemicals, fuels, finished goods and fixed assets. Reasons for shortages and excesses, if any, arising out of such verification and the method followed for adjusting the same in the cost of the products shall be indicated in the records. The method followed for determining the cost of work-in-progress and finished goods stock shall be indicated in the cost records so as to reveal the cost elements that have been taken into account in such computation. The method adopted should be followed consistently.

16.6.12 Variances: Where the company maintains cost records on any basis other than actuals, such as standard costing, the records should indicate the procedure followed by the company in working out the cost of the products under such a system. The method followed for adjusting the variances on determining the actual cost of the product should be indicated clearly in the cost records. The reasons for variances should be detailed in the cost records.

16.6.13 Cost Statements: Cost Statements or cost sheets are required to be prepared as part of the cost records in respect of each product. The forms of cost sheets have been prescribed in the Annexure to the respective Rules. The forms have been so devised arranged that they progressively build up the cost of production of the concerned products. The nature, purpose and contents of the cost sheet depend upon the nature of the products, production method, process involved, cost centres and the elements that make up the cost.

16.6.14 Reconciliation of Cost and Financial Accounts: The cost records should be reconciled (preferably periodically with the financial books of account so as to ensure accuracy.) Variations if any, should be clearly indicated and explained. The period for which such reconciliation be effected should not exceed the period of the financial year of the company. The reconciliation should be done in such a manner that profitability of the product under reference can be correctly adjudged and reconciled with the overall profits of the company. A statement showing the total expenses incurred by the company, including expenses excluded from the costing records and expenses on products not covered by the relevant Cost Accounting Records Rules, should be prepared and the share of the product covered by the Rules in such expenses should be indicated. Also the sale realisation of the products should be shown separately for products covered by the Rules and products not so covered and the margin representing the difference between respective sales realisation and the corresponding total cost should be determined. This statement in turn should be reconciled with the financial profit and loss account for the period. It may be mentioned that where a system of integrated cost and financial accounting is in operation, this reconciliation will be facilitated to a large extent. In this connection it may be noted that Schedule VI to the Companies Act requires the companies to give considerable amount of information regarding licensed capacity, installed capacity, actual production, consumption of raw material, etc. It should be ensured that the specific information required to be contained in both the costing and financial statements is not different. If at all any difference arises, the same should be properly reconciled and kept on record for reference.
16.6.15 **Royalty**: Adequate records shall be maintained showing the royalty paid (in cases where royalty payment exists) or any other payment made to foreign collaborators in terms of agreements entered into with them. Such records should be kept separately for each foreign collaborator. Also, the basis of computation of royalty for the financial year shall be mentioned in cost records. If the total royalty paid is allocable to different cost centres or semi-finished goods or products, the case of motor vehicles, the amount of royalty may be apportioned to various components produced by the company, sub-assemblies or completed motor vehicles according to the terms of agreement. Royalty should be treated as a direct charge wherever it is practicable. Where it is not so, this can be treated as overhead.

16.6.16 **Statistical records**: Statistical data as are relevant in the different cases are required to be maintained. These data generally include data on plant utilisation, idle machine time with reasons, capital employed in the activity covered by the relevant Cost Accounting Records Rules and capital work-in-progress including fresh investment in fixed assets that have not contributed to the production during the period under consideration. Besides, data that are of specific relevance in the particular case also should be maintained. For example, in the case of infant milk food, data such as percentage of fat and solid non-fat content in wet milk purchased and consumed need to be kept; also, quantitative reconciliation should be done of the fat and solid non-fat content of the wet milk and other milk based inputs with the fat and solid non-fat content of the various outputs that the inputs have produced including the by-product. Similarly, for cement and caustic soda proper statistical records about actual hours worked by each manufacturing unit or plant should be maintained. In the case of cement, records should also be maintained to show the production by each manufacturing unit or department producing raw materials process materials or finished products. Some similar requirements can be found in respect of other products as well. Since almost all the Cost Accounting Records Rules require statistical data to be maintained in respect of the actual run, i.e., hours worked, of the various plants and machines, either singly or as a combination, it may be convenient for the company to maintain this record in the fixed asset register itself which the company is otherwise required to maintain (Refer to para 7 above).

The specific records including the statistical records required to be maintained as aforesaid are intended *inter alia* to enable the company to exercise as far as possible, control over the various operations and costs with a view to achieving optimum economies in costs and to provide the necessary data required by the cost auditor for furnishing his report in accordance with the Cost Audit (Report) Rules.

16.6.17 **Incorporation of Provision Relating to Inter-Company Transfer in the Cost Accounting Records Rules**: The Central Government has been prescribing Cost Accounting Records Rules from time to time for various industries in exercise of the powers conferred under section 642(1) read with section 209(1)(d) of the Companies Act, 1956. Cost Accounting Records Rules have so far been prescribed in respect of 43 industries. The companies, which are covered by the Cost Accounting Records Rules, are required to maintain the cost data in the manner prescribed under these Rules.

The Cost Audit Reports are extensively used by the various Government agencies, revenue authorities, regulatory bodies and other institutions. Director General of Investigation and
16.14 Advanced Auditing and Professional Ethics

Registration (DGIR) has relied on these Reports as evidence in pursuit of cases with MRTP Commission. There is a great role of Cost Audit Reports particularly in the management and administration of Anti-Dumping Laws and Competition Laws. Cost Audit Reports can also help the industry in cases related to dumping of goods and services by the dominant manufactures to eliminate domestic competition. In fact Competition Law to be effective against any unfair competition activity, pre-supposes the availability of reliable and authenticated cost data.

Pricing is central to international trade under the liberalised economy. Normally, no inter-company transfer should take place below cost. Therefore, it is imperative that the respective Cost Accounting Records Rules should uniformly contain appropriate provisions requiring maintenance of cost records in all such cases. Therefore, amendments to all the existing Cost Accounting Records Rules have been made under section 209(1)(d) of the Companies Act requiring the prescribed industries to maintain proper cost records in respect of defined inter-company transactions. The Rules have significant importance to the Department of Company Affairs as the same are also linked to investor's protection by ensuring against shifting of profits between corporate units to the detriment of ordinary investor at large. Substantial amount of additional revenue by way of duties and taxes may also be generated by proper valuation of inter-company transactions between the related parties, if proper records as prescribed under these Rules are maintained.

With a view to keep pace with changing global economic trend and to identify and focus on the areas relevant to the current requirements of various interests involved, some of the existing Cost Accounting Records Rules viz., ‘Bulk Drugs’, ‘Formulations’, ‘Aluminium’, ‘Vanaspati’ and ‘Milk Food’ have also been simplified/rationalised. During the revision, the rules in respect of ‘Infant Milk Food’ have been merged with the rules relating to ‘Milk Food’. In some of the Cost Accounting Records Rules, the scope of applicability clause has also been widened. These new Rules are more purposeful, comprehensive and user friendly.

The Ministry of Company Affairs is also currently engaged in the process of formulating Cost Accounting Records Rules in respect of such core sectors, which are covered or likely to be covered under some regulatory mechanism. These Rules shall cover strategic sectors like Power, Telecommunication, Petroleum products, etc. and will be notified in the near future.

16.7 Cost Audit under the Companies Act

We have by now known in general the requirements of the various Cost Audit Record Rules issued under Section 209 (1)(d) of the Companies Act, 1956 and the general contents. Under Section 233B(2), the auditor is appointed by the Board of Directors of the company in accordance with the provisions of sub-section (1B) of Section 224 and with the previous approval of the Central Government. Provided that before the appointment of any auditor is made by the Board, a written certificate shall be obtained by the Board from the auditor proposed to be so appointed to the effect that the appointment, if made, will be in accordance with Section 224 (1B). An audit conducted by an auditor under this Section shall be in addition to an audit conducted by an auditor appointed under Section 224. It may be emphasised here that since the requirement is for audit, the approach and attitude of the auditor is essential in this field also. All the qualities that make a good auditor are essential. The cost auditor, like the auditor
of the financial accounts, should be independent, detached and impersonal. He should be able
to determine and correlate facts, exercise judgement and form opinion about the matters in
which he is concerned in his professional capacity. He is expected to carry out his work by
applying reasonable care, skill and competence.

16.7.1 Revised Procedure for Appointment of Cost Auditor by Companies: Section 233B
of the Companies Act, 1956 - Audit of cost accounts in certain cases - Revised
procedure for appointment of cost auditor by companies as per general circular no.
15/2011, dated 11-4-2011: Ministry has reviewed the existing procedure followed by the
companies for seeking prior approval of the Central Government for appointment of cost
auditor under section 233B(2) of the Companies Act, 1956. In supersession of any earlier
order/circular issued in this regard, the revised procedure to be followed by the companies
and cost auditor shall be as under:

(a) The company required to get its cost records audited under section 233B(1) of the
Companies Act, 1956 shall appoint a cost auditor who is a cost accountant as defined in
clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959
(23 of 1959) and who holds a valid certificate of practice under sub-section (1) of section
6 of that Act and includes a firm of cost accountants.

(b) The Audit Committee of the Board shall be the first point of reference regarding the
appointment of cost auditors.

(c) The Audit Committee shall ensure that the cost auditor is free from any disqualifications
as specified under section 233B(5) read with section 224 and sub-section (3) or sub-
section (4) of section 226 of the Companies Act, 1956.

(d) While a cost auditor shall have prime responsibility to ensure that he does not violate the
limits specified under section 224(1-B) of the Companies Act, 1956, the Audit Committee
shall also be responsible for such compliance by the cost auditor.

(e) The Audit Committee shall obtain a certificate from the cost auditor certifying his/its
independence and arm’s length relationship with the company.

(f) The company shall e-file its application with the Central Government on www.mca.gov.in
portal, in the prescribed Form 23C within ninety days from the date of commencement of
each financial year, along with the prescribed fee as per the Companies (Fees on
Applications) Rules, 1999 as amended from time-to-time and other documents as per
existing practice i.e., (i) certified copy of the Board Resolution proposing appointment of
the cost auditor; and (ii) copy of the certificate obtained from the cost auditor regarding
compliance of section 224(1B) of the Companies Act, 1956.

(g) On filing the application, the same shall be deemed to be approved by the Central
Government, unless contrary is heard within thirty days from the date of filing such
application.

(h) If within thirty days from the date of filing such application, the Central Government
directs the company to re-submit the said application with such additional information or
explanation, as may be specified in that direction, the period of thirty days for deemed
approval of the Central Government shall be counted from the date of re-submission by the company.

(i) After expiry of thirty days, as the case may be, the company shall issue formal letter of appointment to the cost auditor, as approved by the Board.

(j) Within thirty days of receipt of formal letter of appointment from the company, the cost auditor shall inform the Central Government in the prescribed form, along with a copy of such appointment. An e-form for the same is being developed and will be notified shortly.

(k) The company shall disclose full particulars of the cost auditor, along with the due date and actual date of filing of the cost audit report by the cost auditor, in its Annual Report for each relevant financial year.

(l) In those companies where constitution of an Audit Committee of the Board is not required by law, the words "Audit Committee" shall stand substituted by the words "Board of Directors".

2. If a company contravenes any provisions of this circular, the company and every officer thereof who is in default, including the persons referred to in sub-section (6) of section 209 of the Act, shall be punishable as provided under sub-section (2) of section 642 read with sub-sections (5) and (7) of section 209 and sub-section (11) of section 233B of Companies Act, 1956.

3. If default is made by the cost auditor in complying with the aforesaid provisions, he shall be punishable with fine, which may extend to five thousand rupees.

4. The modified procedure contained in this circular shall be effective from the financial year commencing on or after the 1st day of April, 2011.

Upon receipt of an order under sub-section (1), it shall be duty of the company to give all facilities and assistance to the person appointed for conducting the audit of the cost accounts of the company.

16.7.2 Books of Accounts to be maintained by Company u/s 209(1) – 209(1) Every company shall keep at its registered office proper books of account with respect to

(a) 
(b) 
(c) 
(d) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account:

Provided that all or any of the books of account aforesaid may be kept at such other place in India as the Board of directors may decide and when the Board of directors so decides, the company shall, within seven days of the decision, file with the Registrar a notice in writing giving the full address of that other place.
16.7.3 Exemption from Cost Audit: The exemption from Cost Audit on year-to-year basis in the following situation:
(i) Temporary Closure of the company/products
(ii) Negligible production activity

Fees:

<table>
<thead>
<tr>
<th>Company having an authorized capital of</th>
<th>Amount of fees to be paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Less than ₹ 25 lakh</td>
<td>₹ 500</td>
</tr>
<tr>
<td>B ₹ 25 lakh or more but less than ₹ 5 crore</td>
<td>₹ 1000</td>
</tr>
<tr>
<td>C ₹ 5 crore or more</td>
<td>₹ 2000</td>
</tr>
</tbody>
</table>

Appropriate fee for each year for which approval for exemption is sought may be remitted through demand draft drawn in favour of Pay and Accounts Officer, Department of Company Affairs, payable at New Delhi.

Documents required - Following documents are required to be furnished along with application for exemption:
(i) Printed or attested true copy of complete Annual Report containing balance sheet and profit and loss account for the year for which exemption is being sought along with copies of the same pertaining to preceding two years.
(ii) An affidavit containing full facts of capacity utilization, turnover and financial status of the company such as sick or not, duly signed by two Directors of the company and authenticated by a Notary Public.
(iii) A brief note/status report on steps taken by the management for revival of the said unit.

16.8 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. Licenced 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 may be noted that as per the Cost Audit (Report) Rules, 1996, the cost auditor has to send the audit report within 180 days from the end of the company’s financial year. Thus, a cost auditor now gets about 90 days to perform the work in an effective manner instead of 30 days as per the Cost Audit (Report) Rules, 1986. Therefore, it is expected that the cost auditor
would have sufficient time to do justice to his work. In any case, he has necessarily to resort to test checking for obtaining the necessary audit satisfaction. 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. It is also interesting to note that no specific period of office has been specified for the cost auditor and, therefore, it seems logical to interpret that the cost auditor holds his office from the time he is appointed till the date of submission of his report and the powers under Section 227 (1) of the Companies Act can be exercised only during the aforesaid period. He is not entitled to receive any notice etc., of the annual general meeting or to attend it. It seems also possible that removal of a cost auditor before he has finished his term by completion of his work would be simple for any management because the law has not prescribed any procedure therefore.

**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 Cost Accounting Records.
Rules; overhead expenditure also needs allocation between activities covered by the rules and activities not so covered. Naturally, this can be done only by 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 VI to the Companies Act, quite a few matters are there which could be of direct relevance to the cost auditor - for example, consumption of raw materials in quantity and value, sales of finished goods under classified headings in quantity and value, licensed and installed capacities, actual production in quantities, inventory in quality and value in respect of each class of goods produced and/or dealt with by the company.

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 Cost Accounting Records 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.

**Reporting** - After completion of audit of costing and other relevant records the cost auditor is to submit his report in terms of Section 233B(4) of the Companies Act to the Central...
Government. A copy of the report has to be sent to the company at the same time. Further, as per the Cost Audit (Report) Amendment Rules, 1996, the cost auditor shall also reply to any clarification sought by the Company Law Board on the Cost Audit Report submitted by him, within 30 days. The form and contents of the cost auditor’s report has been specified in the Cost Audit (Report) Rules, 1968 and as amended by the Cost Audit (Report) Amendment Rules, 1996 and 2001. It has been stated earlier that the scope, extent and manner of audit of a cost auditor under the Companies Act can only be determined by reference to the reporting requirements and, of course, the costing records required to be maintained. We have seen generally what the costing records are and what they should contain. We shall now examine what the reporting requirements are. After that only it will be possible to formulate details of the audit programme about which a reference has been made earlier.

16.8.1 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) proper cost accounting records, as prescribed under clause (d) of sub-section (1) of section 209 of the Companies Act, 1956, have/have not been kept by the company;
   (iii) proper returns adequate for the purpose of my/our Cost Audit have/have not been received from the branches not visited by me/us;
   (iv) the said books and records give/do not give the information required by the Companies Act, 1956 in the manner so required;
   (v) the cost statements in respect of product or activity under reference as specified in the Annexures/Proformae of Schedules I, Schedule II or Schedule III of the concerned Cost Accounting Records (**..........................) Rules duly audited by me/us are kept in the company.

2. In my/our opinion, the company's cost accounting records have/have not been properly kept so as to give a true and fair view of the cost of production, cost of sales and margin of the product under reference as prescribed under the rules.

3. Based on my/our examination of the records of the company subject to aforesaid qualifications, if any, I/We give my/our observations and suggestions on the following -
   (a) the adequacy or otherwise of the cost accounting system including inventory valuation in vogue in the company and suggestions for the improvement thereof. The Cost auditor shall also indicate the persistent deficiencies in the system, pointed out in earlier reports but not rectified;
   (b) the adequacy or otherwise of the budgetary control system, if any, in vogue in the company;
   (c) matters which appear to him to be clearly wrong in principle or apparently unjustifiable;
   (d) cases, where price charged for related party transactions as defined in the respective Cost Accounting Records Rules is different from normal price, impact of such lower/higher price on margin of the product under reference shall be specified;
Advanced Auditing and Professional Ethics

(e) areas where the company is incurring losses or where there is considerable decline in profitability, the cost auditor should comment on the reasons thereof including indicative break-even point. The cost auditor shall also comment on the default, if any on the payments due to the Government, financial institutions and banks, penal interest levied thereon and its impact on the cost of sales and profitability;

(f) steps required to strengthen the company under the competitive environment especially with regard to need for protection from cheaper imports, if any;

(g) export commitments of the company vis-à-vis actual exports for the year under review. Also comment on comparative profitability and pricing policy of the company for domestic and export sales. Give impact of exports benefits/ incentives offered by the Government on export profitability;

(h) the scope and performance of internal audit of cost records, if any, and comment on its adequacy or otherwise.

4. The Cost Auditor shall suggest measures for making further improvements in the performance in respect of cost control and cost reduction.

5. The Cost Auditor may also give his other observations and suggestions, if any, relevant to the cost audit.

16.9 Rights and Duties of Cost Auditor

The cost auditor enjoys the powers and has the duties as contained in Section 227(l) of the Companies Act, 1956 [vide Section 233B (4) of the Companies Act, 1956]. It may be observed that Section 227(1) does not contain anything which may be considered a duty. It really contains the rights and powers that are allowed to an auditor. Consequently reference to the word “duty” in Section 233B(4) is superfluous and redundant. Like the auditor of financial accounts, the cost auditor also has the right of access at all times to the books and vouchers, of the company (not necessarily related to cost records or cost accounts and he is entitled to require from the officers of the company such information and explanations as he may consider necessary in his duties as the cost auditor. Sub-section (6) of Section 233B makes it a duty of the company to give all facilities and assistance to the cost auditor. It has also been provided in Rule 5 of the Cost Audit (Report) Rules that the company and every officer thereof, including persons referred to in Section 209(6) of the Companies Act, 1956, shall make available to the cost auditor within 135 days from the end of the financial year of the company such cost accounting records, cost statements and other books and papers that would be required for conducting the cost audit. Under the aforesaid Rule, the company and its officers mentioned about are required to render necessary assistance to the cost auditor so as to enable him to complete the cost audit and sent his report within 180 days from the end of the company’s financial year to which the cost audit report relates. The cost auditor’s duty as contained in Section 233B(4) is to make a report to the Central Government in the form prescribed under the Cost Audit (Report) Rules. Further, as per the Cost Audit (Report) Amendment Rules, 2001, the cost auditor shall also reply to any clarification sought by the Company Law Board on the Cost Audit Report submitted by him within 30 days.
The reports that the cost auditor is required to make under the aforesaid Rules indicates the nature of duty he is to perform. It may be noticed that similar to the audit or of financial accounts, how the cost auditor is to perform his duty, what procedures and techniques are to be applied and how he is to plan his work, have been left to his judgement. However, it is clear that he is to carry out an examination of the costing books of account and other relevant records. In the process, he is to obtain information and explanations which he considers necessary for a proper examination. He will have to assess at various stages of the examination what information and explanations are necessary. This is a matter where skill and experience of the cost auditor will be an indispensable aid. The power to obtain information and explanations is a tool to accomplish the duty cast on him. He should know how to use this tool. He should also make systematic record of the information and explanations sought in the audit note book and keep observations about whether they have been obtained, and, if obtained, whether they sufficiently resolve the queries in his mind. If a cost audit is performed without seeking information and explanations or evaluation of the information and explanation obtained, it may be construed that an essential part of the duty has not been performed, specially when it is established that circumstances were such that should have evoked queries. It may be observed that the requirements to report about obtaining of information and explanations is similar to the one meant for the financial auditor. The cost auditor has also to state in his report whether proper cost accounting records as required under Section 229(l) (b) have been kept by the company and whether the said books and records give the information required by the Companies Act, 1956 in the manner required. To deal with this matter, the auditor has to satisfy himself that when cost accounting records are required to be maintained, pursuant to the Cost Accounting (Record) Rules applicable to the client company, these have been properly maintained. Merely having the record will not meet with the intention of the law. The auditor has to further satisfy himself that the information and data collected and compiled therein are correct and the cost of production determined therefrom is fair. If the cost auditor finds departures from the prescribed form and manner, he should look into the reasons for the departure and satisfy himself that it is not material and is in accordance with the circumstances of the company. For example, if a company producing infant milk food does not have the system of payment to workers on the piece rate basis, the cost records for salaries and wages will not show any such payment although the relevant rules require a separate disclosure of payments based on piece rate. However, if the departure is one that can not be justified, the conclusion should be that the records have not been kept in the manner required by the relevant Rules and therefore not in conformity with the requirement of the Companies Act, 1956. It may be noted that the cost auditor is concerned with the maintenance of cost records as prescribed under Section 209(1)(d) of the Companies Act, 1956, though he has access to other books and records also. A financial auditor on the other hand is concerned with the maintenance of “proper books of account as required by law” which is a far wider canvas and includes cost records also.

The cost auditor has also to state whether proper returns adequate for the purpose of cost audit have been received from branches not visited by him. It may be observed that unlike the financial audit there is no provision for separate cost audit of cost records maintained at the branch. It may also be appreciated that a branch not physically carrying out any manufacturing
16.24 Advanced Auditing and Professional Ethics

operation, nevertheless may incur expenses that figure in the various cost statements and cost records prescribed. The cost auditor as such is responsible not only for the records maintained at the head office or the place where manufacturing operations take place, but also for the records that concern a cost audit, maintained at the branch. For enabling the cost auditor to have a total view of the costing records the branch is impliedly required to send proper returns to the head office for incorporation in the main costing records. It is necessary that the branch returns, to the extent they concern cost accounts of the product covered by the applicable Rules, should contain all the information that is required under the rules, as far as it is applicable to the operations of the branch. The form of the returns should also be such as to facilitate proper incorporation of the data and information in the main cost records. Otherwise the returns may not be considered as proper returns. Similarly, adequate evidence should be available alongwith the returns to support figures contained in the returns. A visit by the cost auditor to the branch to ascertain the true state of cost records is not precluded.

Ultimately, the cost auditor is to state whether in his opinion the company’s cost accounting records have been properly kept so as to give a true and fair view of the cost of production, processing etc., as the case may be, and marketing of the product. Basically whether the cost of production ascertained is true and fair or not is dependent upon whether cost accounting records have been properly kept. It has been observed earlier that even a mechanical maintenance of cost accounting records, if they are in accordance with the cost records prescribed, may, in terms of the letter of law, lead to an expression of affirmative opinion. The question that should be resolved is: what is the objective of the whole exercise involved in cost audit? If the objective is determination of the true cost of production, then mere adherence with the Cost Records Rules is not enough. By scrupulously following the Rules one may arrive at a certain cost of production figure which may not necessarily represent a true and fair figure. But it seems, this is not the intention of law. That is why in another part of the Cost Audit (Report) Rules, there is a requirement to comment on the costing system followed.

16.9.1 True and fair cost of production etc.: 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.

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The report of the cost auditor discussed above will be subject to the cost auditor's observations and conclusions, if any, made pursuant to clause 16 of the Annexure to the Cost Audit Report Rules. Also the report is subject to observations of the cost auditor on the various matters contained in the Annexure.

**Annexure to Cost Audit Report [As per Cost Audit (Report) Rules]** - Under the Cost Audit (Report) Rules 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. The annexure to the Cost Audit (Report) Rules as further amended by the Cost Audit (Report) Amendment Rules, 2001 is briefly described below:

1. **General** -
   
   (1) (a) Name and address of the registered office of the company whose accounts are audited.

   (b) Name and address of the place where the cost accounting records are maintained viz. registered office, head office or factory.

   (2) Name of the product and location of the unit to which the Annexure pertains.

   (3) The Company's financial year to which the Cost Audit Report relates.

   (4) Date of first commencement of commercial production of the product under reference.

   (5) Location of other sites manufacturing or producing or processing or mining the product or carrying out the activity under reference.

   (6) Name and address of the Cost Auditor.

   (7) Membership number of the Cost Accountant. In case of firm of Cost Accountants, name and membership number of all the partners.

   (8) Reference number and date of Government Order under which the Audit is conducted.

   (9) Reference number and date of the Government letter approving the appointment of the Cost Auditor.

   (10) Date of Board of Directors' meeting wherein the Annexure and Proforma to the cost audit report were approved.

   (11) The number of Audit Committee meetings held by the company, and attended by the Cost Auditor during the year under reference.

   (12) Name, qualification and designation of the officer heading the cost accounting section or department of the company.

   (13) In case of loan license/ job work arrangement by the company, mention the name of the third party and location of the factory, where the product has been produced/ manufactured.

   (14) If there is any foreign technical collaboration for the product under reference, the following details shall be given:

   (a) name and address of the foreign collaborators;
(b) main terms of agreement;
(c) amount of royalty, lump sum payment, technical aid fee payable and the basis of calculating the same;
(d) whether the technical collaborator has contributed to the share capital. If so, the paid up share capital so held.

(15) If the company is engaged in other activities besides the manufacture of the product under reference, the following details in respect of each such product or activity shall be given:
(a) list of the products or activities;
(b) list of the products or activities for which Cost Accounting Records Rules have been prescribed under section 209(1)(d) of the Act.;
(c) whether Cost Audit Order has been issued by the government in respect of any of the products or activities. If so, number and date of the order.

(16) A printed copy of the Annual Report, containing audited Profit and Loss Account, Balance Sheet and Auditor’s Report in respect of the company’s financial year for which the report is rendered, shall be enclosed with the Cost Audit Report.

2. Cost Accounting System -

(1) Briefly describe the cost accounting system existing in the company, keeping in view the requirements of the Cost Accounting Records Rules applicable to the class of companies manufacturing the product under reference and also its adequacy or otherwise to determine correctly the cost of production, cost of sales, sales realisation and margin of the product under reference.

(2) Briefly specify the changes, if any, made in the costing system; basis of inventory valuation; method of overhead allocation; apportionment to cost centers/departments and final absorption to the product under reference etc., during the current financial year as compared to the previous financial year.

3. Process Of Manufacture - A brief note regarding the process of manufacture along with flow chart covering production, utility and service department of the product.

4. Quantitative Details - As per this report the cost auditor is required to give quantitative information for the current year and two immediately preceding previous years. This quantitative information includes, total available capacity (i.e. installed capacity + capacity enhanced during the year), capacity used during the year and percentage of utilization. The auditor is also required to give information about opening stock of finished good, quantity produce during the year, quantity sold and closing stock of finished goods.

5. Major Input Materials / Component Consumed - Under this heading, the cost auditor is required to give details of quantity, rate and amount for current year and two previous years, in respect of major input materials each of which constitute at least 2% of total raw material cost. These details are to be given separately for indigenous, self-manufactured and imported
input materials. The cost auditor also required to give detail of standard and actual consumption of input material per unit.

6. **Break-up of cost of input materials imported during the year** - Under this heading the cost auditor is required to give following details in respect of all major imported input materials each of which constitute at least 2% of the total material cost. (a) FOB price in foreign currency, (b) Insurance and freight, (c) customs duty, (d) clearing charges, (e) inland freight, and (f) other expenses. These details are to be given for current year as well as two previous years.

7. **Power, Fuel and Utilities** - Under this heading the cost auditor is required to give information about quantity, rate and amount for current years and two previous year, separately for indigenous, self-manufactured and imported, power, fuel and utilities. The details should be furnished in respect of major items each constituting at least 2% of the total material cost. The cost auditor also required to give information about standard and actual consumption of powers, fuel and utilities in terms of quantity per unit of production.

8. **Salaries and Wages** - The cost auditor is required to give quantitative as well as cost details about salaries and wages.

Under quantitative information, the auditor is required to give details of, average number of direct and indirect workers, man-day available, man-day actually worked and reason wise analysis of idle maydays. Under cost information the auditor is required to give details of, direct and indirect labour cost on production and employees cost for administration, selling and distribution.

9. **Repairs and Maintenance** - The auditor is required to give information about repairs and maintenance on land and building, plant and machinery, staff quarters and colony and other.

10. **Fixed Assets Register and Depreciation** - The cost auditor is required to give information about, whether fixed asset register is maintained cost centre-wise, amount of depreciation u/s 205(2) of companies act, amount of depreciation absorbed in cost record and amount of over/under absorbed depreciation.

11. **Gross Block, Depreciation and Lease Rent** - Auditor is required to give details of gross block, depreciation and lease rent of major cost centres/products. It is not necessary to give gross block of assets given on lease, if any.

12. **Overheads** - Under this the auditor is required to give information about factory overhead, administrative overhead, selling overhead and distribution overhead. This information is to be given for the current year and two previous years.

13. **Research and Development Expenses** - The auditor is required to give information about research and development expenses for, process development, existing product development and new product development. The auditor also required to state amount capitalized/deferred and amount provided in the cost record. This information is to be given for current year as well or for two previous years.

14. **Royalty and Technical Know how Charges** -The auditor is required to give information about, royalty on production/sales, lumpsum payment of royalty and technical knowhow
charges. The auditor also required to state amount capitalized/deferred and amount provided in the cost record. This information is to be given for current year as well as for two previous years.

15. **Quality Control Expenses** - Under this heading the auditor is required to give information about, ISO number of company if any, name of certifying agency, salaries and wages and other direct expenses relating to quality control.

16. **Pollution Control Expenses** - Under this heading the auditor gives information about expenses of company for pollution control on account of effluent treatment, control of air pollution, control of ash pound and penalty for pollution under any Act. These information, are to be given for current year as well as two previous year.

17. **Abnormal Non recurring cost** - The auditor is required to give details of abnormal non-recurring cost for the current year and two previous years for the product under reference and for factory as a whole.

18A. **Non-moving stock** - Under this heading the auditor is required to give information about value of non-moving direct material, indirect material, work in progress and finished goods. The value of this non-moving item is also to be expressed in percentage form as compared to closing stock of that item.

18B. **Written off stock** - The auditor is required to give data of written off stock for the current year and two previous year, for the product under reference and for factory as a whole.

19A. **Inventory Valuation** - The cost auditor is required to report on the basis of valuation as adopted for the valuation of, input materials, chemicals, additives and consumables, stores and spares, packing materials, work-in progress, finished goods and scrap/wastage. The auditor also required to state, total value of inventory as per cost accounts and financial accounts and reason for major difference, if any between these two values.

19B. **Physical Verification of Inventory** - The cost auditor is required to indicate is there any shortage or excess value of inventory which is discovered during physical verification of inventory. This information are to be given separately for raw materials, chemicals, additives, consumable, stores and spares, packing materials, tools and implements, W.I.P and finished goods respectively.

20. **Sales of the product under reference** - The cost auditor is required to report on the quantity, rate and amount of sales of major product. These details are to be given separately for purchase goods, loan license basis and own manufactured goods. These information are to be given for current year as well as previous year.

21. **Margin per unit of output** - The cost auditor is required to report on the cost of sales, sales realization and margin, per unit of output. These details are to be given separately for purchase goods, loan licence basis and own manufactured goods. These details are to be furnished for major product group and for current year and two previous year. Separate details shall be furnished for margin on indigenous sales and export sales. Where the product (such as sugar, bulk drugs, etc.) is sold at different price in accordance with government policy,
sales realization and margin on such product at different price shall be shown separately along with quantity and value.

22. **Competitive margin against imports** - Under this heading auditor required to give information about, total production of the product in the country, total production by the company and percentage share of the company in total inland production. The auditor is also required to give information about, cost of production per unit separately for inland sale and export sale. These information are to be given for current year as well as for two previous years.

23. **Value addition and Distribution of earning** - The auditor is required to give a value add statement, in which, information about gross value added and distribution of such value added to different segment of company.

24. **Financial position and ratio analysis** - Auditor is required to give financial position information as well as ratio analysis. These information are to be given for product, factory as a whole, company as a whole for current year and two previous years. Under financial position details auditor is required to give information about, capital employed, networth, profit and net sales. For ratio analysis auditor is required to give following ratio. (1) Operating expenses as percentage of net sales, (2) profit as percentage of capital employed, networth, net sales and value addition, (3) current ratio, (4) net working capital in terms of months of cost of sales excluding depreciation and (5) debt equity ratio.

25. **Capitalisation of revenue expenditure** - Under this the auditor is required to give information about capitalization of revenue expenditure, these information are to be given for the product under reference and for factory as a whole. These information should contain detail of expenditure for raw materials, direct wages and salaries, consumable stores, repairs and maintenance, depreciation, factory overhead, administrative overhead and other expenses.

26. **Related party transactions** - The auditor required to briefly describe the transfer pricing, followed by the company in respect of "related party relationship" as defined in the relevant cost accounting records rules made under clause (d) of sub-section (1) of section 209 of the Act. The following particulars for sale and purchase transaction with related party may be furnished by the auditor (a) particulars of related party, (b) product/activity, (c) quantity, (d) rate, and (e) amount.

27. **Central excise reconciliation for the product under reference** - Auditor is required to give following details for excise reconciliation.

   (i) Quantitative detail: Auditor is required to give details of opening stock, production, total sales and closing stock of finished goods.

   (ii) Details of clearance: Under this auditor is required to give details of assessable value, rate and amount of duty on total excisable clearance and total duty payable.

   (iii) Summary of Cenvat credit: Under this auditor is required to give details of opening balance of cenvat credit, credit availed during the year, closing balance of cenvat credit and credit utilized during the year.
(iv) Reconciliation of duty paid: Under this auditor is required to give details of total excise duty payable, excise duty paid through Cenvat account and P.L.A and any difference.

(v) Reconciliation of duty paid and recovered: Under this the auditor is required to give detail of excise duty paid as per Profit and Loss Account, excise duty recovered as per Profit and Loss Account and any difference between duty paid and recovered, if so state amount and reason for difference.

(vi) Reconciliation of turnover: For this auditor is required to give details of turnover as per RT-12, turnover as per annual accounts (net off duties and taxes) and any difference between these two, if so, state amount and reason for difference.

28. **Profit Reconciliation** - The auditor is required to give reconciliation between profit or loss, as per cost accounting records and financial accounts records.

**Proforma**

Name of the company :

Name and address of the factory :

Name of the product :

Statement showing the cost of production, cost of sales, sales realisation and margin in respect of the product(s) under reference produced during the year/period:

**A. Quantitative Information:**

Particulars (Unit of measurement to be specified)

1. (i) Installed capacity
   (ii) Capacity enhanced during the year by leasing arrangement etc.

2. Actual production / output :
   (i) Self;
   (ii) third parties, if any;

3. Production as percentage of installed capacity

4. Captive consumption, if any

5. Quantity sold
   (a) Domestic
   (b) Export

6. Closing Stock (finished goods)

7. Opening Stock (finished goods)

**B. Cost Information:**

Particulars (Quantity and Rate for unit to be stated)

1. Material consumed : (item-wise covering at least 80% of items by value)
1. Purchased:
   (a) Indigenous (specify)
   (b) Imported (specify)
2. Self manufactured (specify)
3. Process chemicals (specify)
4. Utilities
   1. Purchased:
      (a) Indigenous (specify)
      (b) Imported (specify)
   2. Self manufactured (specify)
4. Direct wages and salaries
5. Consumable stores and spares
6. Depreciation
7. Lease rent, if any
8. Repairs and maintenance:
   (a) Building
   (b) Plant and Machinery
   (c) Others, if any
9. Other works overhead
10. Total Works Overheads (2 to 9)
11. Royalty, if any
12. Technical assistance/know-how fee
13. Research and development
14. Quality control
15. Administrative overhead (relating to production activities)
   (a) Salaries and wages
   (b) Others (specify)
   (c) Total(a+b)
16. Total (1+ 10 to 15)
16.32 Advanced Auditing and Professional Ethics

17. Adjustment for variances (where standard costing system is followed)

18. Add: Opening stock
   Less: Closing Stock
   (Work-in-progress)

19. Less: Credits (from wastage and by-products) / Recoveries, if any

20. Packing cost Primary
    (a) Materials
    (b) Others
    (c) Total

21. Cost of production (16 to 20)

22. Finished Goods purchased, if any

23. Opening Stock
    Closing Stock
    (finished products)

24. Total (21+22 +23)

25. Quantity and cost transferred for :
    (i) captive consumption, if any
    (ii) sales
    (iii) others, if any

26. Packing cost Secondary
    (a) Materials
    (b) Others
    (c) Total

27. Other expenses :
    (a) Administrative overheads (others)
    (b) Others (specify)

28. Selling and distribution expenses
    (a) Salaries and wages
    (b) Freight and transport charges
(c) Commission to selling agents
(d) Advertisement expenses
(e) Royalty on sales, if any
(f) Warranty expenses after adjusting income from chargeable services
(g) Others
(h) Total(a to g)

29. Interest and finance charges:
   (a) for manufacturing activity
   (b) others
   (c) total

30. Total cost of sales (excluding excise duty) of packed quantity sold (24 to 29)

31. Sales realisation
   Less: Excise duty and other statutory levies

32. Net sales realisation

33. Margin (32 – 30)

34. Add: export benefits and incentives, if any

35. Total margin (including export benefits)

36. Ex-factory price (excluding sales tax etc.)

37. Maximum retail price (excluding sales tax etc.)

38. Maximum retail price, if any, prescribed by the Government/statutory/regulatory body etc.

Notes:

1. Separate proforma shall be prepared for each type/variety/description of product(s) under reference.

2. Separate proforma shall be prepared for the quantity used for captive consumption, quantity sold within the country and the quantity exported. Expenses incurred on export and the incentive earned thereon shall be indicated in the proforma applicable for the quantity produced and exported.

3. Separate proforma shall be prepared for any related party/inter-unit transfer of intermediate/finished product(s) under reference.
4. The administrative overheads shall be included in the cost of production only to the extent they contribute in putting the goods produced to their present location and condition. The balance of administrative overheads, if any, shall be included in the cost of goods sold. The proforma may be amended accordingly, if required.

5. The proforma may be suitably modified to cover the special features, if any, of the product under reference on the basis of proforma prescribed for working out cost of sales, margin, etc. of the said product in the relevant Cost Accounting Records Rules.

6. Indicate whether the prices of the product under reference are ex-factory prices, F.O.R prices, door delivery prices or any other terms. In case of ex-factory prices, whether cost of dispatch packing materials, freight, insurance and delivery charges are recoverable from the customers separately.

F.No.52/10/CAB-2001

(A. Ramaswamy)
Joint Secretary to the Government of India,

Note: The principal rules were published vide G.S.R. number 511(E), dated the 4th November, 1996.