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The Cost Audit

By CLINTON W. BENNETT

Many of the difficulties that sometimes arise in obtaining expected results from a well-devised and installed cost system can be traced directly to faulty treating and supervising of the detail records. After the plan has been completely installed and its operation left to the client's force, conditions which are new to the staff are very likely to arise in the handling of the work and consequently important details may be erroneously treated.

Every cost installation should be given close supervision by the cost accountant until he feels that the client's staff can reasonably be expected properly to handle the work. However, regardless of this close supervision during the installation and the conscientious efforts of the client's staff both during the installation and afterwards, errors of principle often develop. Unless promptly detected and rectified these errors of principle may be repeated many times, depending upon the frequency with which the same detail may arise. It is thus apparent that quite serious misstatements may be embodied in the cost results.

As a means of eliminating this condition and assuring maximum results from the cost installation, the cost audit has been developed. It is the province of the cost audit to investigate every operating phase of the cost system. This work should not in any way interfere or dispense with the regular financial auditor. It should supply him with cost details upon which he can place more confidence in preparing his statements of operating results and inventories.

GENERAL SCOPE

The cost audit generally may be said to cover an examination of the details under the following headings:

- Purchasing
- Stores
- Material cost
- Labor cost
- Burden cost
- Waste and defective work
- Cost summaries
- Cost of production
- Cost of sales
- Monthly executive statements

Some of the more important details found in each of these divisions together with the auditing procedure will be considered in the following discussion :

Purchasing:

Care should be taken to insure that the purchasing department shall receive a written requisition for every article purchased, in such form that the order can be placed directly therefrom. Quotation records should be maintained and constantly kept up to date so that requirements may be filled in the quickest and best way.

An examination test of the purchase orders should be made. It is important that all vendor's invoices and goods-received slips be checked against the purchase order. This will serve to verify both prices and quantities.

The method used in following up purchases is an important consideration and the feasibility of graphic purchase control boards should be kept in mind.

Stores:

Detailed attention should be devoted to an examination of the methods used in requisitioning materials and to the obtaining of records of deliveries made. The stock-cards or books should be thoroughly examined. A stock record examination is essential whether the material purchase costs are carried on the stock records or not. Enough of the material requisitions and receiving slips and production reports should be checked to the stock records to satisfy the accountant that this important phase of the work is receiving proper attention.

To verify the material costs used, representative invoices should be checked against the stock-cards. No attempt should generally be made to verify all items, for, if representative prices are checked, those remaining can easily be verified merely by comparison. As a means of further checking the clerical accuracy of the records, a certain quantity of the cards should be added and the unit costs verified. The number of cards to check in this way will depend on their quantity as well as the variety of the materials handled. A slide rule will be found of assistance in this work.

After completing the clerical verifications, exhaustive tests should be made of the accuracy of the final results by comparing the balances shown on the stock-cards with the physical inventories

and the bin-tags. A record and analysis should be made of any variations so discovered and the variations should be reduced to a percentage basis. This will serve as a means of working towards correct book controls.

The proper balancing of purchases with consumption and quantities on hand is of the utmost importance. Few organizations devote sufficient thought to this important feature. It is not at all unusual to find factories carrying raw materials or partly-finished stock in excess of normal production requirements. As a result capital is unnecessarily tied up and valuable space is occupied solely because of the lack of proper planning.

A good cost system will bring these facts to light. However, it sometimes happens that this is one of the important duties which is neglected after the cost accountant has completed the installation and delegated the operation of the plan to the client's staff. Therefore, the cost audit programme may well place this phase of the investigation among the important steps to be taken.

The physical arrangement of the various store-rooms, the handling of work in process and the stores personnel are matters that should be given thought by the accountant.

Material Cost:

It will be necessary to verify the material costs used on the cost summaries. In some industries, materials are purchased for specific orders and the costs are charged directly thereto. Sometimes, the price of one lot of material is applied until the lot is exhausted, when the next oldest lot price will be used. Again, the material cost may represent a unit obtained by averaging the cost of all like materials purchased. The plan will depend on applicability to the particular industry.

Regardless of the method of obtaining the unit material costs, the results shown by the stock records should be checked to the cost summaries to verify the accuracy of the prices used in cost calculating.

Another important matter is accurate material specifications. Whether the conversion basis is weight, count, pound or square feet, correct cost results demand correct units on which to apply the cost price. A careful check of these units should be made. Errors are frequently discovered which are due to faulty weighing of units or incorrect computations.

As the material specifications are not generally as constantly checked as the labor costs, errors in their calculations may have a vital bearing on cost results since the mistake will be multiplied many or few times, depending on the number of varying calculations using this erroneous base.

Labor Cost:

The clock in and out cards should be compared with the work reports to an extent sufficient to satisfy the accountant that they are in substantial agreement. The work report cards should be checked against the payroll in sufficient quantities to provide a substantial check on the payroll. The same work reports should be traced to the cost collection records. In this way a direct check is obtained between the operating results and the detail costs. A check should be made on the wage rates, including hourly, piece and bonus rates and efficiencies, etc., by checking the original wage recommendation slips against the labor records, the payroll and the cost collection records. Of course the procedure will vary according to the wage-payment methods in use. Under the straight piece-work plan, this phase of the work will be quite simple, as the piece prices authorized can be traced directly to the cost records. Where straight day-work is in use, records will have to be maintained converting the rate per hour to a definite cost per unit unless the labor is to be charged directly against a specific job order. In either case the details should be verified. If the plant or department operates under the bonus, premium or other kindred wage system, consideration should be given to the original rates, the standard efficiencies, the actual efficiencies, etc., in order definitely to determine the influence each has exercised on costs.

Consideration should be given to a study of the classes of labor treated as indirect. Enough of the indirect reports should be checked to the payroll as well as to the cost collection details to satisfy as to their accuracy. After the labor details have been completely verified, the results should be checked to the cost summary established for each article or representative group of articles produced.

The total cost value of direct labor in work in process as shown by the detail records will then be compared with the labor-in-process control account for the month. The month used may well be the one next preceding the date of the examination. In this way an excellent check on the total labor will be obtained.

Burden Cost:

An investigation should be made of the expenses charged to the manufacturing as compared with those charged to the administrative and selling divisions. Errors are frequently made in distinguishing between these two classes of expense.

Next for consideration is the basis of factory burden distribution and the actual division of the expenses between departments or production centers. Thought should then be given to dividing the commercial expenses between the administrative and selling sections of the business. Finally comes a study of the methods used in applying all burdens to costs.

Factory Expense:

A sufficient quantity of invoices should be checked to the expense records to satisfy as to the accuracy of the latter. All the elements entering into the distribution of the expenses by departments should receive careful scrutiny.

The various distribution bases should be studied. It is often found that much time is used in analyzing and distributing burden to departments upon a basis so incorrect as to make the results of no practical value for cost-accounting purposes. The accountant should devote careful attention to this problem. He will find whether the bases used are fundamentally sound and correctly represent existing facts or not. No phase of cost accounting can be more easily controlled than can the burden and yet no other phase of cost accounting is so frequently incorrectly treated.

With the principles satisfactorily examined, attention should be devoted to making a test of the clerical details of the distributions.

The factory expenses and their distribution to departments or production centers have now been verified. Next the basis of applying these expenses to costs should be considered. While there are several commonly-used methods of applying burden the percentage-on-labor plan will be considered here for purposes of illustration.

It is evident that unless the burden application is properly controlled, correct results will not be obtained regardless of the care used in the distributions. Consequently, the direct labor of each department having a separate burden-rate should be produced monthly. This direct labor should be traced to the payroll. The burden-rates obtained by dividing the burden by the direct

labor should be checked. These burden-rates will then be traced to the cost summaries or other point of burden application.

The value of assets on which depreciation is calculated and the rates used should be examined. These asset values should be in substantial agreement with the ledger accounts. Care should be taken to study the collection and distribution of the other fixed charges, such as taxes, insurance and power-plant expense. Serious thought should be given to the methods used in handling returns, repair-shop expense and expenses of a like nature that are sometimes accorded scant attention.

Commercial Expense:

A correct split between administrative and selling expense is of vital importance. Any one having experience in industrial concerns can doubtless recall many discussions between the sales and accounting departments regarding charges made to selling of supposedly questionable items from the sales manager's point of view. But of far more importance than the personal satisfaction of any of the individuals involved is the necessity of having these charges made correctly, because of the erroneous executive reports that will flow from mistakes of this character. It is, therefore, advisable to test this phase of the work by tracing a sufficient number of entries back to original invoices.

After analyzing the distributions, representative burden summaries should be tested. The basis used for obtaining the expense percentage—for instance, the cost of sales—should be checked to this burden summary. Next in order is the verification of the final burden-rates. These are then checked to the cost summaries or other burden application point of control.

Waste and Defective Work:

Too much emphasis cannot be placed upon the importance of obtaining accurate waste and defective-work records. In every factory this is a vital problem. To say that the annual loss from waste and defective work frequently places the operating results on the wrong side of the ledger would not be far wrong. Losses of this nature are somewhat intangible and more or less apt to be overlooked. An optimistic executive dismisses the thought with the statement that so small are these losses they are not worth considering.

Knowing the importance of the waste and defective-work records, the accountant will investigate each phase of the problem. He will carefully check the waste reports. He will consider the results shown in the light of his experience in like plants elsewhere. The trend of the waste curve will be noted as throwing light on the problem. Any marked tendencies either up or down should be explained by the management. Next the waste rates should be checked to the cost-collection records. The defective-work reports should be examined as a means of discovering the cause of defect and the ratio of defective work to good production. Tests of the costs used in pricing these reports should be made from the cost records. A sufficient test of the clerical computations should also be made. Finally the defective-work total values will be posted to the proper accounts in the works ledger.

Cost Summaries:

After completing the details all the cost elements contained on the cost summaries will have been verified. Representative quantities of these summaries should then be examined and added to detect clerical errors. A study of the supporting cost records is essential when they represent standard costs.

In many industries the use of standard costs is of a great deal of assistance in aiding production through intelligent cost accounting. Many times definite cost standards correctly applied unearth and reflect inefficiencies in operating that otherwise would remain hidden.

Unless the standard rates are constantly checked against the actual results, however, very misleading and erroneous conclusions may be formed. The great advantage of the standard cost plan is to have at all times definitely-known basic standards with which to gauge constantly fluctuating actual operating results. With this comparison of actual results against standard rates omitted or half-heartedly carried out the important feature of an excellent cost plan is lost. Gross inaccuracies in cost standards are not unknown and they reflect seriously on the value of the cost system as a whole.

The ultimate use made of the cost results is also a subject worthy of careful analysis. A good cost system should be a valuable aid to the management in efforts to increase production. Obtaining the cost is only one of its functions. Frequently, however, valuable manufacturing data are allowed to remain buried simply because the cost accounting details do not require the use

of such information. In their efforts to produce accurate cost results, many corporation accountants lose sight of the importance of statistical records. In many ways the average executive's conception of cost accounting has changed materially in the past few years and progressive industrial managers are increasingly realizing the value of correct, modern, cost-accounting methods.

Cost of Production:

The detail production records should be checked to the stock records to verify the proper inclusion in stores of all goods produced. They should also be checked to the production summaries. A sufficient quantity of the cost prices used will be checked from the cost summaries. A test should follow of the clerical computations, additions and extensions. The final total will then be posted to the books.

Cost of Sales:

There is need of accurate cost-of-sales figures. When it is remembered that the cost of sales directly affects the profit-and-loss statement and the finished goods inventory, the necessity of obtaining correct results is apparent. A considerable quantity of the units sold will be posted to the cost-of-sales collection sheets. The cost prices should be checked from the cost summaries. Certain of these units sold should also be checked to the finished stores records. The extensions and additions will then be tested and the results will be posted to the financial books.

Monthly Executive Statements:

One of the most important duties of the general auditor is a thorough examination of the monthly executive statements. The details and results obtained should be carefully analyzed. A trial balance of the works ledger and private ledger at the date of the examination should be obtained. All balances shown should be checked to the ledgers. This procedure will serve more thoroughly to verify the cost results. Each item shown on the executive statements will be checked to the ledgers. The extensions and footings should be verified.

While this detailed procedure is being carried out by assistants, the accountant will devote considerable study to the executive statements that have been presented previously. The obtaining of reports each month covering the business operations is frequently the factor that decides an executive's mind in favor of a

cost system. He wants and ought to expect to be able to have accurate reports presented to him promptly at the end of each month. Having confidence in them, he directs his business ship accordingly. If the reports are incorrect the wrong business course is taken with results serious or trivial, depending on the importance of the expedition. There is a tendency on the part of many bookkeepers entrusted with the preparation of reports to use the results shown by the books and records without a comprehensive analysis to determine whether these results appear relatively reasonable or not. The accountant should therefore be constantly watching for entries of this nature.

CONCLUSION

It is, of course, manifestly impossible to prescribe a cost-audit programme that will exactly fit all conditions. Each cost audit contains as many peculiarities as there are differing industries. But, in general, the foregoing procedure has been found of practical application as a working basis in varying industrial organizations.

The cost audit is intended as a direct step towards developing and maintaining sound methods of cost accounting. It serves as a means of protecting the executive against faulty periodical reports. It makes for more efficient results in the cost department, since each operative knows that his work will be audited.

When the investigation is complete, the accountant will present his report setting forth the results of the examination and embodying suggestions for improvement.